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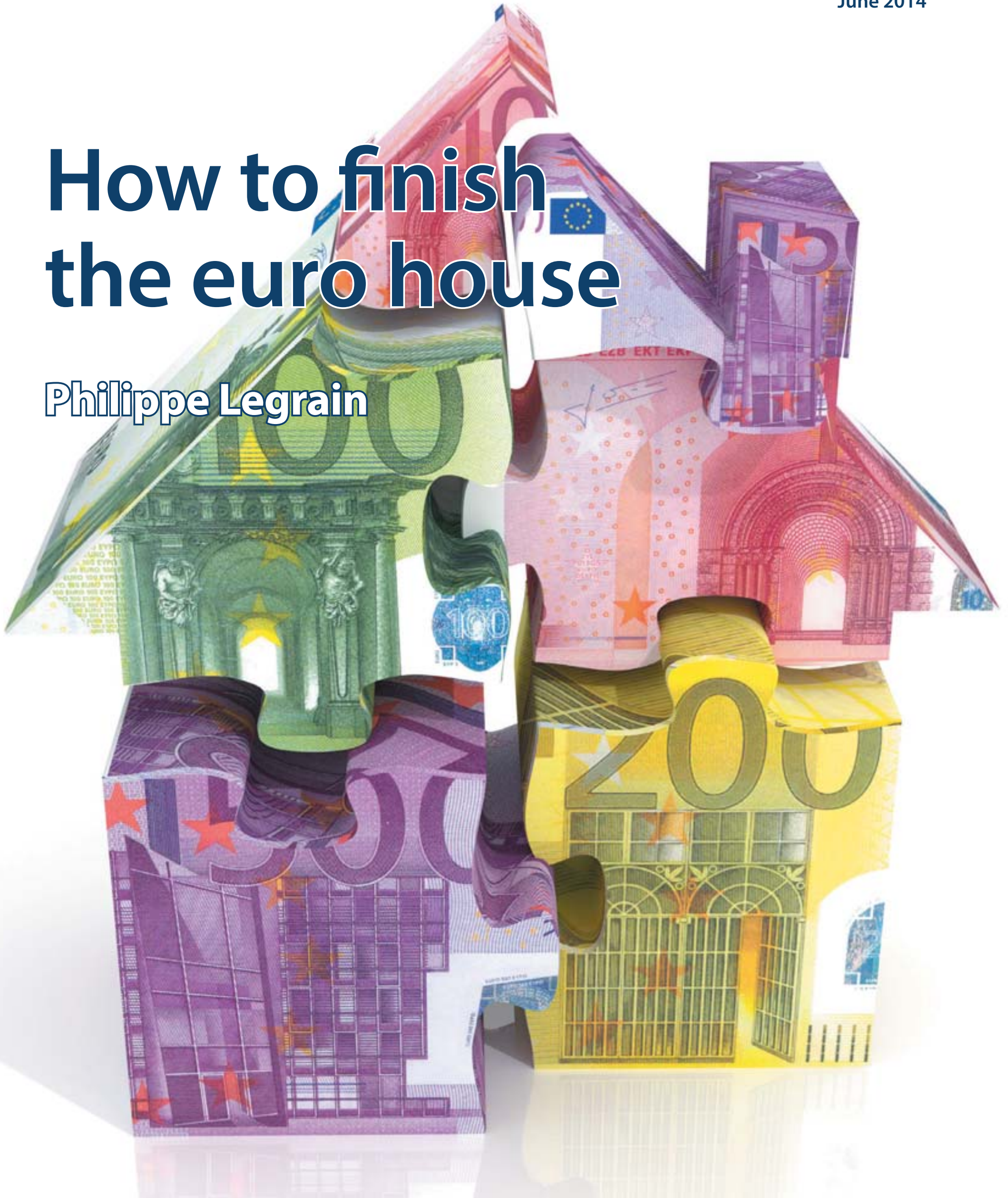
How to finish the euro house

Philippe Legrain



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Published by the Centre for European Reform (CER), 14 Great College Street, London, SW1P 3RX
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About the CER

The Centre for European Reform is a think-tank devoted to making the European Union work better and strengthening its role in the world. The CER is pro-European but not uncritical.

We regard European integration as largely beneficial but recognise that in many respects the Union does not work well. We also think that the EU should take on more responsibilities globally, on issues ranging from climate change to security. The CER aims to promote an open, outward-looking and effective European Union.

About the author

Philippe Legrain was economic adviser to the President of the European Commission from 2011 to February 2014. Previously a visiting fellow at the London School of Economics' European Institute, his latest book is 'European spring: Why our economies and politics are in a mess – and how to put them right (published by Amazon.co.uk, 2014).

How to finish the euro house

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Contents

Introduction Page 7

Chapter 1: 4x4 governance Page 9

Chapter 2: What has changed and where we are now Page 11

Chapter 3: Blueprints for reform Page 29

Chapter 4: Four futures Page 33

Conclusion Page 41

Introduction

The euro is a half-built house whose foundations have been weakened by successive policy mistakes. Battered by a financial hurricane, it has been patched up, altered and extended repeatedly in recent years. Even so, it became so dangerously unstable that it came to the brink of collapse. Finally, in the summer of 2012 the European Central Bank (ECB) stepped in to shore it up. But while the storm has abated for now, the euro remains a ramshackle edifice. Worse, what began as an enlightened experiment in economic cohabitation is becoming a glorified debtors' prison. How, then, might its architecture be improved and completed?

The immediate crisis in the eurozone does not require major institutional changes. What is needed are bank restructuring and debt write-downs (both public and private), together with policies to support demand while promoting balanced economic adjustment – notably, measures to increase investment and reforms to boost competition (and hence productivity) rather than 'competitiveness' through wage restraint. These policies could have been implemented back in 2010 with the prevailing institutional set-up and likewise could be today.

This report focuses instead on how to improve the long-term governance of the eurozone. It addresses four questions. To what extent does the eurozone need common rules, institutions and policies in financial, fiscal, monetary and economic affairs? What should those be? How would eurozone-only institutions interact with EU-wide ones – in particular, what do they mean for Britain? And how should democratic accountability and choice be ensured?

Eurozone governance took a wrong turn during the crisis. The interests of banks in the core of the eurozone were prioritised over those of eurozone citizens. The banks' risky lending to the eurozone periphery was a principal cause of the crisis but the periphery's taxpayers – rather than those in the core – are being made to carry the lion's

share of the bill. As a result, the eurozone is now divided between creditor countries – principally Germany – and debtor ones, with EU institutions becoming instruments for creditors to impose their will on debtors. Bailing out Greece's foreign creditors, thereby breaching the 'no bail-out' rule, made German taxpayers feel liable for other member-states' debts, leading the German government to demand economically inflexible and politically divisive centralisation of fiscal controls in Brussels. The dangers of a highly independent central bank with a deflationary bias that often acts outside its mandate in an openly political manner have also been revealed. Tragically, the crisis has eroded political support for some of the institutional changes needed to make the eurozone work better.

The report argues that while there are a kaleidoscope of potential institutional set-ups for the eurozone and an even greater range of policy settings, only a handful are economically sensible or politically plausible. In effect, there are four possible futures for the eurozone: a Germanic one, a technocratic one, a fiscally federal one and a flexible (or decentralised) one. A fiscally federal eurozone would be best, failing that a flexible one, but for now we are heading towards a Germanic eurozone with a technocratic edge. It is debatable, however, whether this is politically sustainable in the longer term. If not, it might provide the impetus for a fiscally federal eurozone – or provoke its break-up.

The report is structured as follows. It starts by setting out what the aims of eurozone governance ought to be and how they might be achieved. It then sketches out the initial architecture of the eurozone, the flaws that the crisis has revealed, what has changed since then and the current state of play. Third, it outlines five prominent proposals for future reform: the Four Presidents' Roadmap 'towards a genuine economic and monetary union', the European Commission's Blueprint 'for a deep and genuine economic and monetary union', the report by Notre Europe – Jacques Delors Institute's Padoa Schioppa Group, the Glienicker Group proposal 'towards a Euro Union' by leading German scholars and the Eiffel Group proposal 'for a Euro Community' by leading French ones. Fourth, it sets out and assesses the four possible models for the future eurozone architecture mentioned in the previous paragraph.

Chapter 1

4x4 governance

The euro is an unprecedented experiment: independent EU member-states voluntarily agreed to share a currency and a central bank on an ostensibly equal basis, with common fiscal rules but without a common financial framework or treasury, let alone a shared government. It is much more ambitious than previous monetary unions between separate states. These have either been much looser (both the Latin Monetary Union and the Scandinavian one in the nineteenth century) or highly unequal, hitching a small country to a much bigger one (Ireland to Britain between 1922 and 1979, or Luxembourg to Belgium from 1922 until the euro's launch in 1999).[1] But it is threadbare compared with most monetary unions, which typically come about within a single state and also involve both a fiscal and a banking union. Thus Scotland shared a currency with England only after the Act of Union in 1707, while in the United States competing currencies gave way to a common one only in 1913, with the creation of the Federal Reserve. Since the Great Depression of the 1930s, US banks have been regulated, supervised and resolved at a federal level, with federal authorities also providing deposit insurance and acting as an effective lender of last resort to illiquid banks. Even before the creation of the Federal Reserve, Treasury bills and bonds served as a common liquid and 'safe' asset for US banks, while since the 1930s the federal government has also played a much bigger role in stabilising the economic cycle and disparities across regions.

1: For more details, see Kevin H. O'Rourke and Alan M. Taylor, 'Cross of Euros', *Journal of Economic Perspectives*, Volume 27, Number 3, summer 2013.

Some argue that a monetary union can only function properly with a fully-fledged fiscal union, which in turn entails political union – in effect, a federal United States of the Eurozone. But that is a big logical leap: there is not enough evidence from economic history to make firm conclusions. Various kinds of half-way house may also be viable. Since there is little support among voters for political union for now – on the contrary, the crisis has pitted countries against each other and exacerbated the popular backlash against European integration – it seems more fruitful to explore various other options that are politically plausible and seem economically sensible.

To work well, eurozone governance ought to do four things. First, it should try to prevent problems – financial crises, fiscal difficulties, economic slumps or booms – from emerging. Second, it ought to limit their consequences when they do arise: avoid banks dragging down governments, prevent panic in government bond markets, avert a self-fulfilling inflation spiral or deflation trap, keep job losses or overheating to a minimum. Third, it should resolve problems – tackle distressed banks, deal with excessive debts (both public and private), stabilise low inflation, promote economic recovery – promptly, fairly and safely. Last but not least, eurozone governance should be democratically accountable and provide for choice. Achieving those goals requires work on four interlocking planks of the eurozone's architecture – its financial, fiscal, monetary and economic framework – along with its democratic underpinnings.

Clearly, there is much to do: the eurozone has suffered most of the above-mentioned problems, exacerbated their consequences rather than limiting them, failed to resolve them quickly, fairly and safely, and shown disregard for democracy in the process. This is partly due to institutional failings, notably the absence of mechanisms for resolving banks and restructuring sovereign debts, as well as the lack of an explicit treaty mandate for the ECB to be a lender of last resort to eurozone governments. But it is also due to policy mistakes, which in turn reflect a lack of information, poor judgement, ideological bias, flawed incentives and political capture. So unless ways are found to reduce the likelihood of systematic future policy mistakes, institutional changes can take us only so far. For example, while there is a clear case for eurozone-wide (and indeed EU-wide) banking oversight, this will not prevent future financial crises if bank regulation leaves little margin for error and supervisors are too cosy with bankers and politicians.

Chapter 2

What has changed and where we are now

Initially, eurozone governance was largely decentralised. While minimal standards for bank regulation were set at EU level, supervision and deposit insurance were national – and provisions for bank resolution non-existent. National governments retained ample fiscal discretion, provided their deficits were not excessive, with the safeguards that governments that got into trouble could be bailed out neither by their peers (the 'no-bailout rule') nor by the ECB (the ban on monetary financing). Governments retained almost full discretion over other aspects of economic policy, albeit with weak peer pressure to reform their economies to make them more dynamic and 'competitive' (the Lisbon Strategy) and a loose attempt at policy co-ordination (the European Commission's Broad Economic Policy Guidelines). The only federal institution was the ECB, to which national central banks were subservient, and which was meant to operate independently of national governments and without privileging one part of the eurozone over another.

The crisis and subsequent policy mistakes revealed serious flaws in the eurozone's governance, both institutional and political. Eurozone authorities – the ECB, the European Commission, domestic financial supervisors and national governments – all failed to limit financial excesses in the pre-crisis years (as indeed did those in Britain and the United States). Flawed regulations encouraged banks to amass large holdings of government bonds, which were necessarily national in the absence of a common eurozone bond. When banks went bust, banks were bailed out by national governments individually, exposing the absence of a common mechanism for dealing with bank failures and a fear of imposing losses on banks' creditors. Together, this created a 'doom loop', with weak banks dragging down weak governments, which in turn dragged banks down further. Greece's insolvency in

2010 highlighted the absence of a formal mechanism for restructuring sovereign debt within the eurozone (and globally for that matter) and great resistance to doing so. When further policy mistakes, discussed below, sparked panic in government bond markets, this highlighted that the ECB was not formally mandated to halt such a panic and that it was loath to intervene. The crisis has also revealed the risks of having a central bank as independent as the ECB and its inherent deflationary bias.

Eurozone governance has changed a great deal during the crisis. Eurozone governments and the ECB finally recognised some of the above-mentioned flaws, while expending huge efforts to tackle perceived ones in the eurozone's fiscal governance. A limited banking union has been agreed, along with common EU requirements for national bank resolution, and a bevy of new EU financial regulations introduced. The no-bailout rule was breached with the bailout of an insolvent Greece's creditors by other eurozone governments (and the IMF) in 2010. This breach has subsequently been formalised: a permanent rescue fund for cash-strapped governments has been created, the European Stability Mechanism (ESM). An ad-hoc governance structure for governments that have received conditional EU-IMF loan programmes has also been cobbled together: the Troika, which brings together the European Commission, the ECB and the International Monetary Fund. Other eurozone governments' fiscal discretion has also been greatly constrained through tighter EU rules and an intergovernmental treaty that enshrines German-style curbs on public borrowing in national constitutions. As part of the successor to the Lisbon Strategy, Europe 2020, EU governments must now submit national reform programmes to the European Commission, which then issues country-specific recommendations for reform.[2] The Commission can also now demand changes to other economic policies in countries deemed to be suffering from excessive macroeconomic imbalances. The ECB has intervened at will in areas that go well beyond monetary policy in a nakedly political manner. It eventually signalled its willingness to act, in effect, as an ad hoc, conditional lender of last resort to illiquid governments through its unused Outright Monetary Transactions (OMT) programme. The rest of this section elaborates a bit further on those changes, starting with finance before discussing the changes in fiscal, monetary and economic policy.

2: http://ec.europa.eu/europe2020/europe-2020-in-a-nutshell/priorities/economic-governance/index_en.htm.

Finance

The financial crisis exposed flaws in the eurozone's financial system. The euro's first decade coincided with a credit boom across the Western financial system that involved a massive expansion of cross-border lending, notably by German and French banks (as well as British ones). Their reckless lending, together with that of local banks, inflated property bubbles in Spain, Ireland and the Netherlands. It also financed a surge of consumer borrowing in a stagnant Portuguese economy and a borrowing binge by the Greek government. Banks' recklessness was fuelled by low interest rates and abetted by the complacency (and sometimes the complicity) of regulators and politicians. EU capital requirements were too lax and too easily gamed by bankers: some banks ended up financing €100 of loans with as much as €98 of debt and only €2 of equity. Those rules also treated government debt as if it was 'risk-free', encouraging eurozone banks to buy higher-yielding Southern European government bonds, causing Greek bond yields to converge with Germany's. This unfortunate development was celebrated by the ECB (whose collateral lending rules also treated Greek debt as 'risk-free') as a sign of the euro's success. The ECB also turned a blind eye to rapid credit growth and the build-up of debt both within the financial sector and in the economy at large, principally among households. National supervisors tended to champion, rather than curb, domestic banks. Politicians were complicit too: their outlook was generally corporatist and their behaviour sometimes even corrupt.

When the bubbles burst and banks went bust, eurozone leaders decided in 2008 that banks and their creditors would be bailed out by national governments individually, tying their fates together. The burden proved unbearable for Ireland and Spain, which were forced to seek loans from the EU and the IMF to prop up local banks. Worse, eurozone policy-makers' mistakes sparked panic in government bond markets between the bailout of Greece's creditors in May 2010 and ECB President Mario Draghi's pledge to do "whatever it takes" to save the euro on 26th July 2012. The ensuing doom loop dragged down weak banks with large holdings of domestic government bonds, exacerbating the strain on the government backstopping them. Governments responded with ever greater austerity, depressing economic activity, thereby causing bank loans to go sour, and banks to curb credit even to viable businesses. This, in turn, hit tax revenues and increased spending on unemployment benefits, which in turn weakened public finances (and confidence in the banks),

thereby completing the vicious circle (see chart 1). While the ECB's intervention has acted as a circuit breaker, financial scars remain (not to mention economic and social ones). Eurozone financial markets have fragmented; most lending is national again. Local banks have even greater holdings of domestic government bonds. Creditworthy businesses in Southern Europe face a higher cost of credit than in Northern Europe – if they can obtain it at all (see chart 2). While legally intact, the EU's single market in finance has effectively broken down.

Chart 1: Government borrowing costs

Source: European Central Bank.

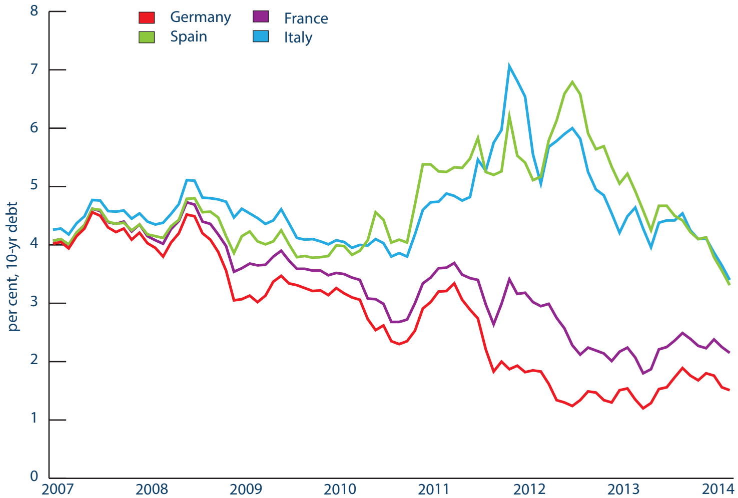
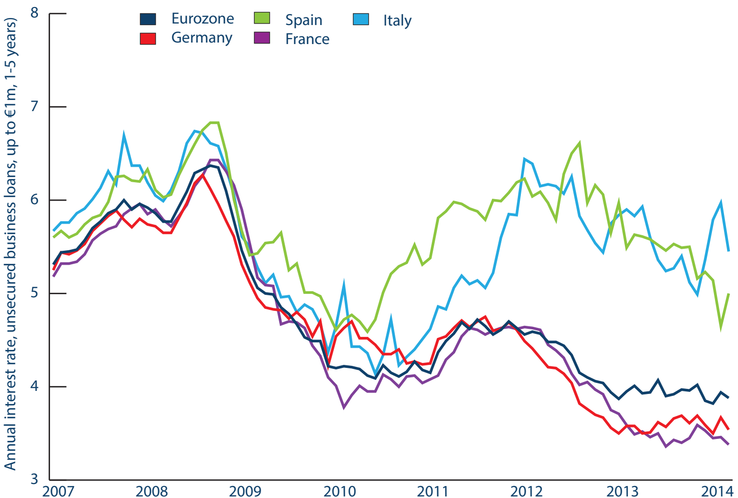


Chart 2: Corporate borrowing costs

Source: European Central Bank.



Since cross-border bank lending arguably did more harm than good in the pre-crisis years, one option would be to try to keep banking mostly national. After all, even within the United States, most banking is local. But that would go against the spirit (and the treaty) of European integration and would be tough to enforce in practice. Admittedly, there are now capital controls within the eurozone, both explicit (in Cyprus) and opaque (German financial supervisors limit German banks' lending to Southern Europe), both of dubious legality. But they are viewed as temporary crisis measures rather than a permanent regime shift. In any case, since capital markets are global and sophisticated, they could be circumvented, for example through financial derivatives or foreign affiliates, if banks were keen to get around them.

The alternative is to try to make pan-European finance work better. The aim should be to restore healthy financial flows between the participating economies while reducing the risk of future crises, preventing bank failures from dragging down governments and reviving the doom loop, and restructuring banks promptly, fairly and safely. To that end, action has been taken both at an EU level and within the eurozone.

The EU now has common financial regulations that establish minimum standards – a 'single rulebook' – for everything from insurance to hedge funds. Banks are required to have slightly bigger capital buffers to absorb potential losses and larger reserves of cash and other liquid assets to deal with cash-flow problems.[3] Those buffers against losses are meant to be greater for riskier assets, but government bonds are still deemed 'risk-free'. So the likelihood of future crises remains high. An official expert group chaired by Erkki Liikanen, the governor of the Bank of Finland, has also opined on whether the structure of banks needs reform. Like the Vickers report in Britain, the Liikanen report stops short of recommending breaking up banks, suggesting instead that risky trading activities be ring-fenced from retail banking. In 2014 the Commission published proposals that dilute Liikanen's recommendations; in any case nothing will happen until after November when the new Commission is in place. Eleven countries (but not Britain) are planning to tax financial transactions. European watchdogs have also been created – the London-based European Banking Authority (EBA), the Paris-based European Securities and Markets Authority (ESMA) and the Frankfurt-based European Insurance and Occupational Pensions Authority (EIOPA) – along with a European Systemic Risk Board that is meant to take an overarching view. However,

3: See the Capital Requirements Directive IV package http://ec.europa.eu/internal_market/bank/regcapital/legislation_in_force_en.htm.

these European agencies are weak and oversight remains primarily national. The EBA's various 'stress tests' of the strength of European banks' balance-sheets have so far lacked credibility.

Common EU rules for restructuring and winding down failed banks have finally been agreed and are due to come into force in 2016. They stipulate that banks draw up annual plans for addressing balance-sheet problems, and that national supervisors set out how banks might be restructured and wound down in an orderly fashion, including by bailing in the creditors of failing banks.[4] But they still leave national supervisors ample discretion. So national practices will vary and supervisors will have plenty of scope to turn a blind eye to banks' problems, exclude creditors from bail-ins and agree to taxpayer bailouts. All countries must also guarantee bank deposits up to €100,000 (£85,000), but national authorities' ability to make good on that promise varies.

"In practice, rescuing banks will remain in the hands of the national governments."

Within the eurozone, a limited banking union is also being introduced. In November 2014, the ECB is due to become the primary supervisor of 130 or so bigger eurozone banks, representing roughly 85 per cent of eurozone bank assets. Whether it will prove less captured by the banks than national supervisors remains to be seen. A single resolution mechanism for restructuring and closing down failed banks will also be introduced in 2015. The aim was to have a single means of dealing with failing eurozone banks that operates independently of national authorities and minimises the burden on taxpayers, breaking the link between weak banks and weak sovereigns that caused the doom loop. But Germany's refusal to cede control over its banks gutted the plans of their substance. National governments retain a veto over closing down any bank. The mechanism is complex to the point of being potentially unworkable; it is inconceivable that a bank could be wound down over a weekend, as is necessary to avert market panic. And the collective funds that eventually will be at its disposal are limited: just €55 billion. In practice, then, rescuing banks will remain in the hands of national governments, whose capacity to bail them out varies: French and German banks will benefit from having implicit governments guarantees; Cypriot banks will not. Proposals for shared deposit insurance have also been shelved. Countries outside the eurozone

4: According to the Bank Recovery and Resolution Directive (BRRD), shareholders would take a hit first, followed by junior bondholders, then senior ones and finally uninsured depositors; deposits of less than €100,000 would be protected. Once losses of 8 per cent of total liabilities had been imposed, a resolution fund, ideally funded over time by banks, would step in to cover losses of a further 5 per cent of liabilities. If that was still not enough, taxpayer funds could be called on once all unsecured creditors had been bailed in. http://ec.europa.eu/internal_market/bank/crisis_management/index_en.htm

can opt into this 'banking union', but so far none have. Worried that once the ECB became the single eurozone bank supervisor it would dominate decisions at the EBA, Britain has secured a double-majority voting system that requires a majority of both eurozone and non-eurozone countries to make decisions.

As things stand, the eurozone as a whole is likely to struggle with a weak banking system, with only patchy efforts to restructure banks in a fair way. Worse, the eurozone is set to remain fragmented between north and south, or 'core' and 'periphery'. Banks in Northern Europe will benefit from credible implicit state guarantees, while Southern European ones will have to fend for themselves. That is a bonus for struggling Southern European taxpayers, but implies that even sound banks could have funding costs that are much higher than those in Northern Europe for the foreseeable future. As a result, the real cost of credit for businesses and households is likely to remain higher, crimping growth. A lasting division between a northern core and a southern periphery would entrench a hierarchical system subordinating debtor countries to creditor ones, a far cry from the community of equals that the eurozone was meant to be.

Fiscal issues

The objectives of eurozone fiscal governance ought to be as follows: to enable governments to borrow to fund investments in future growth as well as to cushion the blow of downturns, while preventing them from becoming insolvent (unable to pay their debts) or illiquid (temporarily unable to borrow); and to deal with any solvency or liquidity problems that do emerge promptly, fairly and safely.

In the euro's original incarnation, call it Euro 1.0, governments had plenty of autonomy within a loose framework of EU rules: deficits no greater than 3 per cent of GDP and public debt no more than 60 per cent of GDP (or declining towards that level). These fiscal rules were enshrined in the Stability and Growth Pact, which the European Commission was tasked with monitoring and enforcing, ultimately by fining EU governments that failed to cut their excessive deficits – if a big enough majority of governments agreed. In the event that a government ran into difficulties, other EU governments were forbidden from taking on their debts while the ECB was banned from financing them directly. In 2005, the rules were tightened and complicated. In

Euro 1.1, governments were required to set a 'medium term objective' for their underlying deficit (that is, stripping out one-off items and the impact of the economic cycle) – no more than 1 per cent of GDP – consistent with staying within the deficit and debt limits or achieving them promptly. In effect, in the pre-crisis years it was assumed that EU prodding and market pressure would together keep public borrowing in check, with the no-bailout rule and the ban on monetary financing as fail-safes to prevent one government's excessive borrowing becoming others' responsibility.

"The budget deficits that opened up after 2008 are the result of the financial crisis."

The dominant crisis narrative in Berlin and Brussels asserts that the EU's failure to prevent Greece lying about its excessive borrowing highlighted a broader failure to keep public borrowing in check – and hence a need for tighter rules to limit future profligacy. The evidence suggests otherwise. In the pre-crisis years, Ireland averaged a big budget surplus between 1999 and 2007 and Spain a slender one.[5] Italy's public borrowing averaged less than the EU limit of 3 per cent of GDP.[6] Portugal was twice brought to book for running an excessive deficit and then deemed to have got its fiscal house in order – but still suffered a government debt crisis (see chart 3).[7] In contrast, the two governments that were let off the hook for their excessive borrowing in 2003 and 2004 – France and Germany – have been largely unscathed. As for public debt, Ireland's and Spain's was very low in 2007, the year the financial crisis struck.[8] Portugal's was only fractionally higher than Germany's.[9] Italy's admission to the euro was green-lighted in 1997 even though it had a public debt of 122 per cent of GDP, but over the following decade its debt fell by 19 percentage points (see chart 4). So one can argue that Italy should not have been admitted in the first place, but not that it ran up huge debts once it joined. For the most part, the budget deficits that opened up after 2008 (and the resulting increases in public debt ratios) are consequences of the crisis – the counterpart of the collapse in private spending and the result of bank bailouts – not the causes of it. What they highlighted was a failure not of fiscal governance, but of financial governance, as the previous section explained.

5: Personal calculations from European Commission, AMECO database, general government net lending/borrowing, per cent of GDP at market prices. Ireland averaged a surplus of 1.6 per cent of GDP between 1999 and 2007, Spain a surplus of 0.2 per cent of GDP.

6: Italy averaged a deficit of 2.9 per cent of GDP.

7: Portugal was disciplined for an excessive deficit in 2002, deemed to be in compliance with EU rules by 2004, and then again subject to the excessive deficit procedure from 2005 to 2008.

8: European Commission, AMECO database, general government consolidated gross debt as a percentage of GDP at market prices. Ireland's was 25 per cent of GDP, Spain's 36 per cent.

9: Portugal's was 68 per cent in 2007, Germany's 65 per cent.

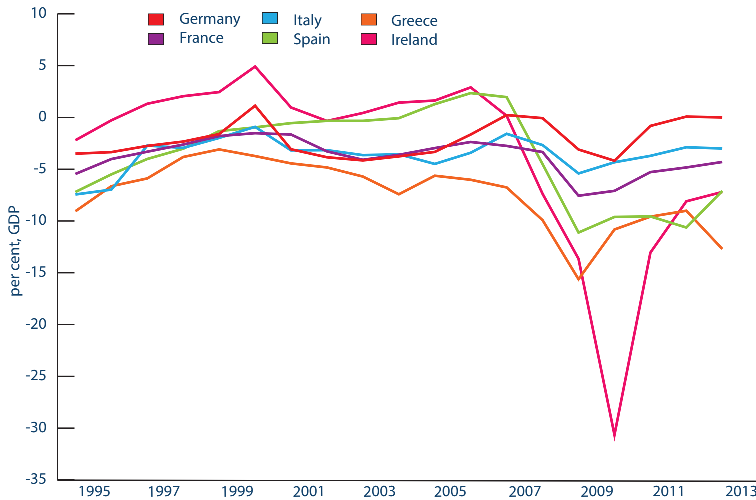


Chart 3: Budget deficits

Source: European Central Bank.

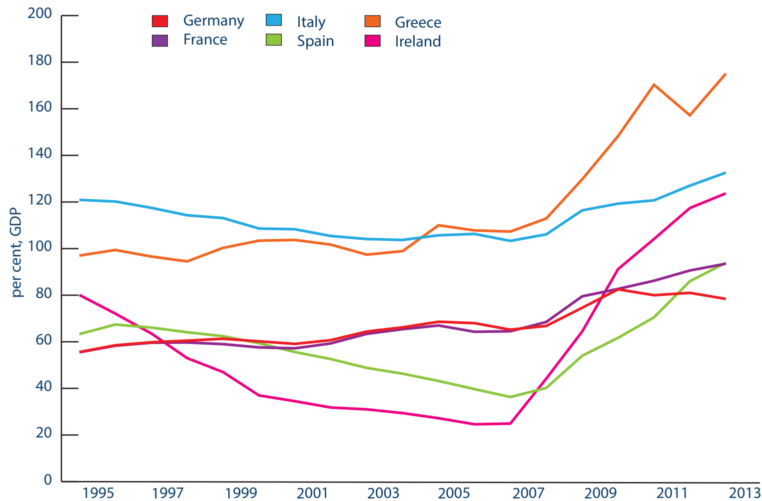


Chart 4: Public debt

Source: European Central Bank.

The more serious fiscal mistakes were made later – by German and eurozone policy-makers. They decided to breach the no-bailout rule by lending to an insolvent Greece in May 2010, rather than restructuring its debts. They sparked panic in government bond markets by justifying their bailout of Greece's creditors as necessary to safeguard the financial stability of the eurozone as a whole, exacerbating the crisis. Over the next two years, the threat of disorderly Greek default and, subsequently,

the explicit threat by Germany and the ECB to force Greece out of the euro brought the eurozone to the brink of collapse. Moreover, because Angela Merkel regretted putting Germany on the hook for Greece's debts, she convinced Nicolas Sarkozy in Deauville in September 2010 that in future the debts of governments that encountered temporary difficulties to borrow should be written down. Threatening to impose losses on the creditors of illiquid borrowers triggered panic; the mistake was reversed in late 2011. From July 2011 on, the panic became systemic as Italy's bond yields rose rapidly, followed by Spain's, Belgium's and even for a while France's. Yet the ECB refused to do enough to halt the panic, insisting that it was legally unable to act, until finally Draghi did so on July 26th 2012.

So the real fiscal flaws exposed by the crisis are: the absence of a mechanism for restructuring sovereign debt in the eurozone and a deep reluctance to do so; and the lack of an explicit mandate in the EU treaties for the ECB to act as a lender of last resort for eurozone governments; and the decision to use fiscal policy counter-cyclically by simultaneously embarking on front-loaded austerity, causing deep recessions. This highlighted a further flaw in the eurozone's fiscal governance: the fact that EU rules and eurozone policy-makers' decisions ignore the collective impact of individual countries' fiscal decisions. Since eurozone economies trade a lot with each other, one country's depressed domestic market is another's weak export market, amplifying the collective impact of austerity. Worse, Berlin and Brussels seized on the crisis as an opportunity to assert greater control over governments' borrowing on a permanent basis in order to avoid what they saw as a risk of future mismanagement of public finances.

The screws were first tightened with a 'six-pack' of measures in December 2011.[10] Euro 2.0 required governments with underlying ('structural') deficits that exceed their medium-term objective to reduce them by at least 0.5 per cent of GDP a year – and faster if their debts exceed EU limits (those with debts greater than 60 per cent of GDP must reduce the excess by one twentieth each year.)[11] Public spending not matched by revenues must not rise faster than the trend rate of economic growth. Fines of up to 0.5 per cent of GDP can be imposed faster on recalcitrant governments – unless a big enough majority of EU leaders object. The ink was barely dry on Euro 2.0 when a separate set of compliance measures was unveiled: the treaty containing a German-inspired fiscal compact that came into force in January 2013 (the one 'vetoed' by the British

10: These changes, which also include the introduction of the macroeconomic imbalances procedure, are known as the 'six-pack' in EU jargon. http://europa.eu/rapid/press-release_MEMO-11-898_en.htm

11: On average over three years.

Prime Minister, David Cameron).[12] Euro 2.1 involves even tighter rules (an underlying deficit target of no more than 0.5 per cent of GDP). These are to be enshrined in national – preferably constitutional – law (rather than interpreted by Brussels). Governments with excessive deficits must also commit to reforms to boost 'competitiveness' and growth. And any government can ask the European Court of Justice to impose fines on their non-compliant peers. Finally, the screws were tightened for a third time in May 2013.[13] Euro 2.2 requires governments to submit their draft annual budget to the Commission and eurozone finance ministers the previous October. The Commission can demand changes to budgets that it deems non-compliant. It can also impose tighter controls on governments experiencing, or that it thinks are threatened by, financial difficulties, forcing them to tackle the perceived problems and submit to regular reviews by EU officials.[14]

These devilishly complicated rules give plenty of work (and power) to EU officials and impose a bureaucratic headache on eurozone governments.[15] They are confusing for experts and baffling for ordinary citizens. They try to punish governments that have borrowed too much by imposing fines on them. Politically, decisions about taxation and spending are at the heart of national democracies, yet the new EU rules force incoming governments to pursue broadly the same policies as the ones voters have just rejected. They greatly limit national governments' flexibility to employ fiscal policy to counter periods of weak economic activity, which is vital for countries that share an interest rate and lack a common budget for responding to downturns. The EU budget, which amounts to some 1 per cent of GDP and a bit over 2 per cent of government spending in the EU, does not act as a macroeconomic stabiliser. The only EU institution that can serve that purpose is the European Investment Bank, which has expanded its lending since the crisis to some €70 billion a year, co-financing projects worth a multiple of that.[16]

12: Under the Treaty on Stability, Co-ordination and Governance came into force on 1 January 2013, signatories have committed themselves to a medium-term objective (MTO) of a government budget with a structural (ie, cyclically adjusted) deficit no greater than 0.5 per cent of GDP. Governments with a structural deficit greater than their MTO must close the gap by at least 0.5 per cent of GDP a year, with a faster pace of adjustment for governments with debts exceeding 60 per cent of GDP. Failure to comply will lead to further interventions under the Excessive Deficit Procedure.

13: http://europa.eu/rapid/press-release_MEMO-13-457_en.htm

14: http://europa.eu/rapid/press-release_MEMO-13-318_en.htm

15: See, for example, the notes to governments explaining what they must do to comply: http://ec.europa.eu/economy_finance/economic_governance/sgp/pdf/coc/code_of_conduct_en.pdf

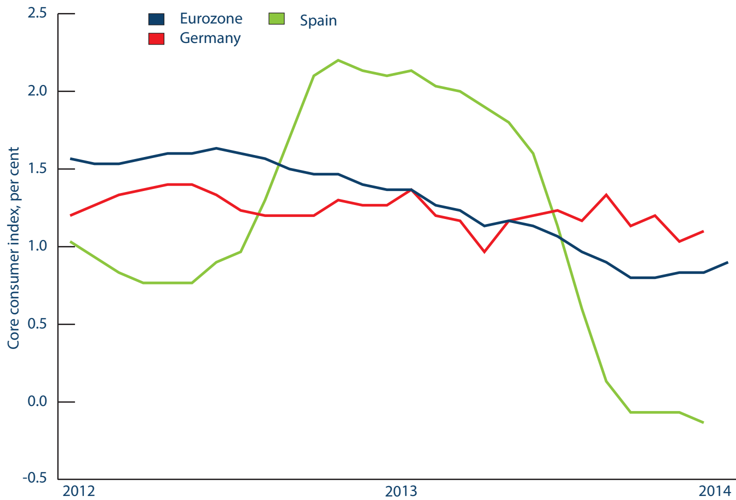
16: The EIB lends primarily, but not exclusively, in EU countries.

Monetary policy

The crisis has also exposed flaws in the mandate, governance, policies and conduct of the ECB. Most central banks now operate independently of governments day to day, but the ECB's autonomy is exceptional. It decides both what its target should be – it has settled on consumer-price inflation of "below, but close to 2 per cent" – and how to achieve it. It can even choose to do nothing when it fails to meet its target: eurozone inflation has sunk to under 1 per cent since October 2013, but the ECB has continued to eschew the unconventional measures employed by other major central banks (see chart 5). The ECB has allowed growth in the money supply (M3) to slide to little more than 1 per cent, and hence well below the 4.5 per cent the ECB used to argue was consistent with the eurozone's trend rate of economic growth (see chart 6). The ECB's deliberations are also the most secretive of all major central banks and it is scarcely accountable to elected authorities: it agrees only to a 'dialogue' with the European Parliament rather than hearings or testimony, and the Parliament cannot fire any board member who fails to perform. Its extreme independence is enshrined in an EU treaty that can only be revised if all EU governments, national parliaments and in some cases a popular vote agree.

Chart 5: Consumer price inflation

Source: European Central Bank.



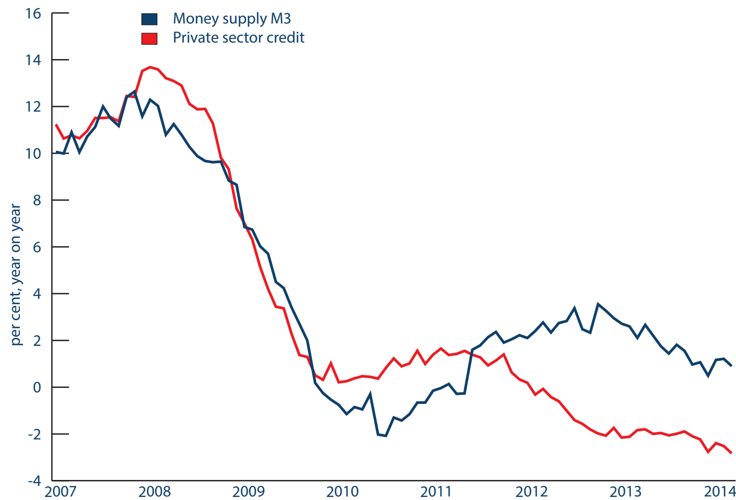


Chart 6: Money supply

Source: European Central Bank.

In the pre-crisis years, the ECB did meet its chosen target for consumer-price inflation. But its stance since then has suggested a deflationary bias: it has been quick to raise interest rates to tackle alleged inflation risks while doing too little to head off the risk of deflation. In the summer of 2008, when the crisis was already raging, it misinterpreted rising oil and commodities prices – a change in relative prices – as presaging generalised inflation and raised interest rates, only to reverse course drastically in September when Lehman Brothers collapsed.[17] It then repeated the mistake twice in 2011, when the panic in sovereign bond markets was already widespread, raising interest rates on April 13th and July 13th – the latter just after Italian bond yields had spiked.[18] In each case, the ECB focused on possible future inflation risks when the eurozone was in recession and its financial sector in crisis. As Oscar Wilde might have said, to strangle the economy with a rate rise once is unfortunate. Twice is carelessness. Subsequently, the ECB has been slow to cut interest rates, trimming its benchmark rate to 0.25 per cent only in November 2013; the Federal Reserve cut interest rates to 0.25 per cent as early as December 2008 and the Bank of England to 0.5 per cent in 2009. Worse, official interest rates in Frankfurt have not fed through to the rates that a creditworthy company in Italy or household in Spain has to pay. To use the technical jargon, the monetary transmission mechanism is broken – and the ECB has done little about it. With deflation looming, it is again too passive.

17: On July 9th 2008, the ECB raised its deposit rate from 3 per cent to 3.25 per cent and the interest rate on variable-rate tenders from 4 per cent to 4.25 per cent. http://www.ecb.int/stats/monetary/rates/html/index.en.html

18: On April 13th 2011, the ECB raised the interest rate on its fixed-rate tenders from 1 per cent to 1.25 per cent, and by a further 0.25 per cent on July 13th 2011. http://www.ecb.int/stats/monetary/rates/html/index.en.html

The central bank has also neglected its broader responsibilities for financial stability and growth and employment. In the pre-crisis years, it turned a blind eye to asset-price bubbles and financial excesses. It then helped spark the panic in government bond markets. In May 2010, ECB President Jean-Claude Trichet opposed a Greek debt restructuring and was prepared to risk a full-blown crisis to ensure his view prevailed. (The ECB exacerbated this situation by buying Greek government bonds through the Securities Market Programme, giving it a vested interest in opposing a restructuring that would expose the foolishness of buying the bonds of an insolvent government.) In November 2010 Trichet threatened to force Ireland out of the euro in order to put pressure on its government to stick to its pledge to stand behind the debts of all Irish banks – locking in the 'doom loop'. He was also a leading advocate of front-loaded collective austerity, which has caused so much unnecessary suffering and destabilised public finances, even arguing that it would be 'expansionary'. Both Trichet and Draghi threatened to force Greece out of the euro in the event it defaulted, provoking panic across the eurozone. Worst of all, while it has provided open-ended support to eurozone banks, the ECB refused for a long time to quell the panic in government bond markets that it helped create. Fears that intervening could prompt future recklessness on the part of governments were hardly grounds to stand by and watch the house burn down, especially since enforcing the EU's fiscal rules does not fall within the ECB's mandate.[19] Nor should a central bank which protests that its independence is sacrosanct be constrained by political pressure from particular governments. This game of chicken, designed to force governments to embark on austerity, caused huge suffering and pushed the eurozone to the brink of collapse.

The ECB refuses to co-operate with any of the eurozone's 18 fiscal authorities, on the grounds that this would comprise an unacceptable invasion of its independence. Yet in a slump, authorities need to work together to avert deflation. While refusing to co-operate with fiscal authorities and being scarcely accountable to democratic ones, the ECB gets involved in political issues that have significant distributional consequences, notably in its treatment of Greece and Ireland, but also more generally. It is also inappropriate that, together with the European Commission and the IMF, it is part of the Troika that imposes austerity and reform programmes on countries that have borrowed from the EU and IMF. The ECB cannot have it both ways: refusing any political accountability for its monetary and financial decisions while intervening in political and fiscal matters. Clearly, when its power is put to good

19: Others worried about inflation, even though the eurozone economy was stagnant and the money supply falling. In any case, any bond purchases could be sterilised by withdrawing money from the economy elsewhere.

use – as a lender of last resort to illiquid governments, for instance – it can be a force for good, but even so it needs reform. Unfortunately, this is not even on policy-makers' agenda. What little debate there is – for example, whether to publish minutes of its meetings – takes place within the confines of its Frankfurt headquarters.

The ECB is buttressed by a secular religion which holds that central bank independence is sacred and ought to be inviolate. It is cherished by federalists because it is a truly supranational European institution. Yet the general principle in a democracy is that power is exercised by elected authorities. When democratic authorities delegate power to unelected ones, that power ought to be exercised openly and accountably. The ECB should be judged by its results.

The ECB has used its far-reaching independence to define its mandate very narrowly: the pursuit of price stability. The justification for this is ensuring low and stable inflation is the best way of meeting other desirable goals such as low unemployment, growth or financial stability. But in a slump when demand is weak and debt burdens onerous, there is a trade-off between inflation and growth/unemployment: higher inflation would boost spending and employment by lowering real interest rates, eroding the real burden of debt and encouraging both consumers and companies to bring forward spending. Focusing exclusively on keeping inflation (too) low has come at the expense of financial stability and living standards, while privileging creditors over debtors. At the very least, the ECB needs a broader mandate that takes account of both asset-price and consumer-price inflation, financial and price stability, as well as growth and employment. There also needs to be more co-operation between elected fiscal authorities and unelected monetary ones. Closer co-ordination would ensure better economic outcomes, while the ECB ought to take account of the views of elected governments. For example, in normal times when interest rates are positive and inflation risks exist, the ECB might agree to lower interest rates if governments cut their borrowing. Such co-operation would be easier if a common eurozone Treasury were created, but in the meantime this could involve the Eurogroup (eurozone finance ministers). The ECB also ought to act as a lender of last resort for solvent governments, as it is the only institution that can stem a sovereign bond panic. As it acquires new responsibilities for banking supervision, it is even more important that the ECB becomes properly accountable. Power corrupts; and a concentration of unaccountable power corrupts absolutely.

Economic policy

Sharing a currency imposes at least two constraints on its members: they must share a single official interest rate and they can no longer vary their nominal exchange rates with each other. Economic theory suggests that in order to thrive with one money, a monetary union needs to form an 'optimum currency area'. To cope with a one-size-fits-all interest rate, its component parts need to be similar in structure and cyclical behaviour; to cushion the blow of shocks that affect some parts differently to others, they need a common budget or risk-sharing mechanism; and to adjust to such shocks, economies need to be flexible and integrated. In other words, the eurozone needs to operate more as one. Otherwise, a one-size-fits-none interest rate (or an external shock) risks pushing component economies apart and their rigidities will then make it hard to bounce back.

Unfortunately, eurozone economies are different, often ossified and not as integrated as they ought to be: the EU single market remains incomplete, notably in services and energy, and labour mobility low. Reforms in crisis-hit countries have sometimes helped; but for the most part, they have focused on lowering labour costs to restore 'competitiveness' rather than injecting competition into product markets. Moreover, even open and flexible economies such as Ireland's can get blown off course by a surge of capital inflows that inflates a bubble that then pops. The danger, then, is that economies will get out of joint and not be able to snap back.

To try to prevent and remedy that, the European Commission has acquired new powers to co-ordinate economic policies and has devised a scoreboard that seeks to provide an early warning of dangerous economic imbalances. It can also demand that governments try to correct excessive imbalances, such as excessive credit growth or large current-account imbalances, with sanctions on recalcitrant ones, unless a big enough majority of EU governments objects.

Monitoring imbalances seems like a good idea, but in practice such surveillance tends to be ineffective. It often raises false alarms – hence the joke that economists have predicted ten of the last three recessions. It often fails to warn (or warns too late) about big crises: the IMF missed the 1997–98 Asian financial crisis; the IMF, ECB and the European Commission were all blindsided by the current financial crisis and its eurozone offshoot. Even when risks are correctly identified, political

interference and lobbying by special interests often ensure that concerns are watered down or ignored. Last but not least, the resulting policy recommendations may be flawed or poorly implemented.

The EU's macroeconomic imbalance procedure is flawed. Its "early-warning system" is based on old data to which it responds slowly.[20] It is unbalanced, since it is more lenient on countries with current-account surpluses than on those with deficits and treats Germany's surplus equivalently to tiny Luxembourg's.[21] It is distorted by politics: hence it goes easy on Germany. There is also a danger that the Commission will try to stamp out beneficial 'imbalances' such as temporary foreign borrowing to cushion the blow of a recession or sustained capital inflows to finance productive investment and catch-up growth. Above all, it is based on the misconception that economies are predictable and perfectible and policy-makers omniscient.

20: An early-warning system ought to be based on current information and in particular on leading indicators – economic data that tends to provide early indications of future trends.

21: The Commission's definition of an excessive imbalance is one where "the degree of the macroeconomic imbalances is considered severe or may jeopardise the proper functioning of the Economic and Monetary Union". http://europa.eu/rapid/press-release_MEMO-13-318_en.htm

Chapter 3

Blueprints for reform

The euro has evolved a lot during the crisis, often in the wrong direction. Many reports have suggested how it might be improved. This section outlines five of the leading ones: the Four Presidents' Roadmap, the Commission's Blueprint, and the reports by the Padoa Schioppa Group, Glienicker Group and Eiffel Group.

The Roadmap, prepared by European Council President Herman Van Rompuy together with the presidents of the European Commission, the European Central Bank and the Eurogroup, was the official programme for creating a 'genuine economic and monetary union'. It was first launched in June 2012, when the euro seemed on the brink of breaking up. The intention was to flesh out the outline with a detailed, time-bound roadmap in a final report in December 2012. However, the ECB's intervention to quell the panic in July 2012 took away the sense of urgency, causing governments to backslide on their commitment to deeper integration. As a result, the final report failed to deliver what had been promised and momentum towards closer integration has stalled.

Jealous of the fact that Van Rompuy was taking the lead in crafting a Roadmap towards closer union, the European Commission tried to regain the initiative by publishing its own Blueprint for a 'deep and genuine economic and monetary union' in November 2012. Unfortunately, this is a somewhat confused catalogue of mostly existing ideas whose main purpose seemed to be positioning: to allow the Commission to claim that it had suggested whatever emerges as the next steps in eurozone integration. For example, the Blueprint jumbles together four proposals: a further centralisation of budget controls; a 'proper' fiscal capacity for the eurozone; a debt redemption fund, as suggested by the German Council of Economic Experts; and commonly issued Eurobills, as suggested by the IMF chief economist Olivier Blanchard. One or two of these proposals may be desirable, but not all four together. The section on the long term, which adds the word 'full' to banking union and fiscal and economic union, conflates a central budget – a federalist vision where the eurozone itself can borrow, tax and spend – with Eurobonds, which are commonly issued by member states.[22]

22: http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52012DC0777

"All five proposals agree on the need for a comprehensive banking union."

The Notre Europe-Jacques Delors Institute's Tommaso Padoa Schioppa Group brings together centre-left luminaries from many eurozone economies, led by Henrik Enderlein of the Hertie School of Governance in Berlin. Its June 2012 report on 'Completing the euro – A Roadmap towards fiscal union in Europe' proposes 'as much fiscal federalism as necessary for its appropriate functioning, but as little as possible.'[23] In October 2013, the Glienicker Group of eleven German economists, political scientists and legal experts published a short proposal entitled 'Towards a Euro Union'.[24] This has much to commend it, not least that it comes from German thinkers prepared to question the German government's approach. In February 2014, the Eiffel Group of fourteen French scholars came up with its own proposal 'For a Euro Community': 'a political and democratic Community based on the euro'.[25] This goes furthest in recognising that the current system of eurozone governance is economically and politically flawed.

Comparative analysis

All five proposals, summarised in Tables 1 and 2 (see pages 44-46), have several common elements. They all agree on the need for a comprehensive banking union with an effective single resolution mechanism, unlike the limited banking union that is being created, although only the Padoa Schioppa Group proposes European deposit insurance. They all ignore the need for reform of the ECB – for instance, to make it a lender of last resort to governments or adjust its mandate.

But the proposals differ widely in other areas. On fiscal union, the Roadmap and the Blueprint favour a continuation of the current trend towards centralised fiscal controls on national governments, ultimately leading to the common issuance of Eurobonds, joint and severally guaranteed by eurozone governments. The others all favour forms of limited fiscal federalism: the creation of eurozone-level fiscal authorities. The Padoa Schioppa Group proposes a hybrid system: a European Debt Agency, in effect an enhanced ESM, would partly finance national governments' debt in normal times by issuing bonds jointly and severally guaranteed by eurozone governments and provide limited liquidity assistance to governments on relatively easy terms, but with further financial assistance in return for a big loss of national

23: http://www.notre-europe.eu/media/completingtheeuroreportpadoa-schioppagroupnejune12summary.pdf?pdf=ok
24: http://www.bruegel.org/nc/blog/detail/article/1173-towards-a-euro-union/
25: http://www.bruegel.org/nc/blog/detail/article/1250-for-a-euro-community/

budget sovereignty. As an alternative to this loss of sovereignty, governments would be allowed to restructure their debts. A 'cyclical adjustment insurance fund' would also cushion against asymmetric shocks and facilitate adjustment. The Glienicker Group favours an 'economic government', albeit without tax-raising or borrowing powers, instead funded by a national 'membership fee'. This authority would have the right to limit the sovereignty of governments that borrow too much, while also ensuring the provision of public goods in crisis-hit countries. The Eiffel Group's proposal is the most ambitious. The Euro Community's Treasury would have tax-raising and eventually borrowing powers, and be responsible for ensuring that national governments respect their joint commitments. The eurozone budget, financed from corporation tax or a carbon tax, would act as an automatic stabiliser, providing a common unemployment insurance, as well as spending on training, measures to increase worker mobility and infrastructure. Only the Padoa Schioppa Group, explicitly, and the Eiffel Group, cagily, discuss the possibility of sovereign debt restructuring. Immediately, EDA bonds would provide a common 'safe' asset for banks (Padoa Schioppa); as would, eventually, Eurobonds (Blueprint and Roadmap) or eurozone bonds (Eiffel). The issue is not mentioned by the Glienicker Group.

On economic union, the Roadmap and the Blueprint both favour Chancellor Merkel's proposal of forcing governments to sign up to contracts committing them to reforms to boost 'competitiveness' in exchange for limited financial support. They also favour completing the single market, as does the Padoa Schioppa Group. The latter supports complementing this with domestic reforms to increase wage and price flexibility, but takes a less intrusive approach to achieving them. A 'cyclical adjustment insurance fund' would facilitate adjustment. The Glienicker Group would provide a growth fund to assist with domestic reforms (a softer version of Germany's compulsory 'contracts for reform') and encourage greater labour mobility. The Eiffel Group favours measures to improve labour mobility and a partial harmonisation of tax and labour market policies.

On democracy, the Roadmap and the Blueprint make bland statements about the importance of democratic accountability and legitimacy but basically favour the status quo: limited accountability to the European Parliament, albeit with a nod in the Roadmap towards also involving national parliaments. They both ignore the issue of democratic choice. The Padoa Schioppa Group does not directly address democratic issues

at all, although it would allow a national government to choose to default. Both the Glienicker and Eiffel Groups propose a democratically elected eurozone executive accountable to, and dismissible by, an elected eurozone assembly – requiring major, democratically-sanctioned treaty change. The Glienicker Group suggests that a eurozone parliament be made up of MEPs from eurozone countries or national parliamentarians, ensuring that control over governmental spending remains in their hands.

On the relationship with non-eurozone members, the Blueprint emphasises that while the eurozone needs to deepen its integration, this must preserve 'convergence with future members of the eurozone as well as the integrity of the policies conducted at EU-level, notably the single market. This means that, wherever appropriate, the euro area measures should be open for participation of other member states.' Likewise the Padoa Schioppa Group underlines that the banking union should not undermine the single market. The Glienicker Group says 'pre-ins' (EU countries that intend to join the euro eventually) should be consulted (but not have voting rights) in drawing up the new euro treaty that it proposes to enact all its institutional reforms, but makes no mention of Britain or Denmark. The Eiffel Group is most dismissive of the interests of non-eurozone countries, arguing that these have no right of veto over eurozone countries' decisions and only a limited right to object.[26] The Euro Community would cohabit with a broader EU, whose single market might become a form of associate membership that would welcome countries such as Turkey, Ukraine, Moldova and Albania.

Categorising the various proposals, the Eiffel report is the most political and the most explicitly federalist, while the Glienicker report is more economic and a bit less federalist; both take proper account of democracy. The Padoa-Schioppa Report is the most intellectually impressive, albeit narrowly focused on economics. Of the two official reports, the Roadmap is more coherent than the Blueprint, but both are overly technocratic. The Blueprint and the Padoa-Schioppa Report are most respectful of non-eurozone countries, the Eiffel Report least. In terms of the models for reform presented in the next section, the Roadmap and the Blueprint could be categorised as Germanic with a technocratic edge, as befits proposals made by EU institutions where Berlin holds sway. The Eiffel Group favours fully-fledged fiscal federalism, the Glienicker Group a weaker form of it with a Germanic edge. The Padoa Schioppa Group proposal is a hybrid.

26: 'Member-states who make the sovereign decision to not share the currency must bear all the consequences without complaining about alleged discrimination. Additionally it is absolutely legitimate that the member-states of the eurozone equip themselves with further common tools or joint policies because they need to compensate the fact that they have given up certain instruments, such as exchange rate policy.'

Chapter 4
Four futures

There is a kaleidoscope of potential future institutional arrangements and policy settings in the eurozone, but only a few are politically possible or economically sensible. Broadly speaking, there are four possible futures: a Germanic eurozone, a technocratic one, a fiscally federal one and a flexible one. These are just archetypes; one could readily imagine variants of them, such as a flexible federal eurozone. What emerges in practice may be a messy political compromise between them.

(i) A Germanic eurozone

At the moment, we are heading towards a predominantly Germanic eurozone. That is one whose rules, institutions and policies are shaped by Germany's ideas and interests, rather than by a coherent vision of the interests of the eurozone as a whole. Officially, the German government supports 'more European integration – a genuine transfer of sovereignty and a significant strengthening of European institutions' in financial, fiscal and other matters, as finance minister Wolfgang Schäuble has put it.[27] German officials even claim to favour a 'political union', without defining it, before hastily adding that since others are not willing to go that far, any steps towards it are not possible. But in practice, Germany tends to want more controls over others but not itself. So it wants rules that automatically curb governments that borrow too much (its budget is in balance), a move that also suits its interests as a creditor. But, confident that it will always be strong and therefore a contributor rather than a beneficiary, it resists any form of risk-sharing – be it commonly issued debt or pan-eurozone unemployment insurance – which it views as a backdoor to open-ended German transfers to Southern Europe. The German government has also sought to stymie moves towards a banking union and has been determined to retain control of its regional and savings banks. It believes that other eurozone members should be more like Germany and boost their 'competitiveness' – which is neither feasible nor desirable – and wants the EU to impose 'contracts' on recalcitrant governments, while resisting pressure to reform its own unbalanced and often hidebound economy. Historical taboos – the fear that that even a little inflation is a precursor to hyperinflation – rule out

27: Wolfgang Schäuble, "How to protect EU taxpayers against bank failures", *Financial Times*, August 31st 2012.

acceptance of ECB reform, a stance that also benefits German creditors (at least, in the short-term).

While all governments generally pursue what they perceive as their own interests, it is one thing if Luxembourg does so and quite another if Germany does. What made the European club work well until recently was that Germany perceived its national interest as creating a more European Germany rather than a more German Europe. In other words, it sought to embed itself in European institutions rather than use those institutions to reshape Europe in its own image. While Germany may now feel it is entitled to behave more like a 'normal' country and define its interests in a more selfish way, the bigger issue is how the European club can cope with a hegemonic Germany that has the power to impose its positions on others. That issue is particularly stark in the eurozone, from which Britain has excluded itself, in which France is enfeebled, where the European Commission is politically weak and which – crucially – is increasingly polarised between creditors and debtors. If rules, institutions and policies in the eurozone, which is meant to be a club of equals, increasingly become instruments for Germany as a creditor to impose controls on debtors, the eurozone is likely to remain an unhappy marriage that might eventually end in divorce. To put it differently, a Germanic eurozone is not a desirable future for the eurozone and is unlikely to be a viable one either. If the German government wants the euro to survive and succeed – as it undoubtedly does – it would be wise to take more account of the interests of the system as a whole, as the United States did during the Cold War in supporting an open multilateral trading system. For a more integrated eurozone to be both effective and legitimate, the new rules and institutional arrangements must reflect every country's interests and apply equally to each member.

A Germanic eurozone might also be uncomfortable for the rest of the EU. Germany's Wolfgang Schäuble recently penned a piece in the *Financial Times* with his British counterpart George Osborne which reassuringly states that "as the eurozone continues to integrate, it is important that countries outside the eurozone are not at a systematic disadvantage in the EU. So future EU reform and treaty change must include reform of the governance framework to put eurozone integration on a sound legal basis, and guarantee fairness for those EU countries inside the single market but outside the single currency."[28] In practice, though, a Germanic eurozone would most likely dominate the EU.

28: George Osborne and Wolfgang Schäuble, 'Protect Britain's interests in a two-speed Europe', *Financial Times*, March 28th 2014.

(ii) A technocratic eurozone

Another possible future is a technocratic eurozone. This would involve a genuine, comprehensive banking union. It would also include tighter, centrally enforced fiscal rules that limit governments' discretion and a mechanism to limit macroeconomic imbalances – in the hope of preventing future crises. These would eventually be complemented by commonly issued Eurobonds that would pool fiscal risks across the eurozone and provide a 'safe' asset for banks – in the hope that this would provide stable funding for governments and end the doom loop between banks and governments. The single market would be completed, domestic reforms implemented and economic policies more closely controlled from Brussels. Reforming the ECB or establishing a mechanism for restructuring the debts of insolvent governments would remain taboo. Democratic accountability would remain limited and be primarily through the European Parliament.

A technocratic eurozone is preferable to a Germanic one. It would involve rules that apply to all – not least a genuine banking union – and the hope that they might be enforced impartially. The interests of non-eurozone members would be protected. A fiscal straightjacket would be more tolerable if complemented by commonly issued debt. A more integrated and competitive EU single market would be a boon. But the disadvantage of a technocratic eurozone is that it involves a big centralisation of powers in Brussels. That would give too much power to remote, unelected, and sometimes incompetent EU bureaucrats, place too many constraints on national governments' economic flexibility and varying political priorities, and as a result not be democratic enough. It is a fallacy that economies are predictable, mechanical systems that can be fine-tuned by an ever more elaborate system of rules and likewise that wise and impartial technocrats are best-placed to run economies centrally. They lack the information to do so properly. They are too detached from those whose lives they seek to shape. And there is no single 'right' way of doing things that they know best. Competing visions of what governments should (and should not) do are the essence of politics, not a matter for arbitrary rules and technocratic enforcement. And without the possibility of throwing out EU officials and changing course, a technocratic eurozone would be undemocratic.

(iii) A fiscally federal eurozone

A more ambitious vision is a federal eurozone – or at least a fiscally federal one.[29] This would involve creating a common eurozone treasury with a budget that automatically smoothed economic upturns and

29: For a more detailed description of how limited fiscal federalism might work, see Shahin Vallée, 'From mutual insurance to fiscal federalism: Rebuilding the Economic and Monetary Union after the demise of the Maastricht architecture', *International Economics*, Volume 138, August 2014, pages 49–62.

downturns across the eurozone and which could also provide a discretionary fiscal stimulus if necessary. It would have tax-raising powers and the right to issue its own bonds, guaranteed not by national governments but by its tax revenues (or hypothecated ones from national governments).[30] The ECB would, in effect, agree to act as lender of last resort for this single fiscal authority, whose bonds would also serve as a common 'safe asset' for eurozone banks, which would be regulated, supervised and resolved at eurozone level. The no-bailout rule would be restored and democratically elected national governments would regain greater discretion over their budgets. Proper democratic accountability of the eurozone treasury would be ensured through the European Parliament and, potentially, a committee of national parliamentarians.

"Unfortunately, a fiscally federal eurozone may not be politically feasible for now."

A fiscally federal eurozone is greatly preferable to a technocratic one. It would create common supranational institutions where they are needed – a fiscal authority and banking authorities as equal counterparts to the ECB – while leaving ample discretion for democratically elected national governments. It would also do away with the complex and over-stringent fiscal rules and meddlesome bureaucracy that are suffocating the eurozone. As experience in the US, Germany, Switzerland, Canada and Australia shows, various forms of fiscal federalism can cope with a variety of circumstances and policy mistakes. Runs on national government bonds would be limited by the ECB continuing its OMT programme.

Unfortunately, a fiscally federal eurozone may not be politically feasible for now. While it does not require creating a federal state, it may be seen as a leap too far by increasingly EU-sceptic voters – although it would be more respectful of national democracy than either a Germanic or a technocratic eurozone. For non-eurozone members, however, the situation might be chillier since a fiscally federal eurozone would most likely dominate the EU. Political leaders would need to explain its merits, leading to open and vigorous debates, followed in some cases by referendums. The biggest obstacle may be national finance ministers and European Commission officials who feel threatened by it. For the former, fiscal federalism is a double-edged sword: they would no longer have to play supplicant to Brussels and submit to German-inspired fiscal rules, but they might feel upstaged by a eurozone

30: In effect, these would be like bonds issued by the German or Swiss federal governments, whereas Eurobonds would be equivalent to the Länder or Cantons issuing mutually guaranteed debt.

finance minister. Shorn of their powers, European Commission officials would face returning to more mundane bureaucratic tasks. They would doubtless fight a rearguard action, arguing that creating eurozone-only institutions would undermine the EU – an argument that might also resonate in Britain – when it is the undemocratic centralisation of fiscal powers and other policy mistakes that are responsible for this. As a fallback, they might be bought off by housing the new eurozone treasury at the European Commission. While fiscal federalism may not yet be feasible, it ought to be a long-term goal.

(iv) A flexible (or decentralised) eurozone
That leaves a final option: a flexible (or decentralised) eurozone. This would combine the bare minimum of integration needed to strengthen the eurozone with much greater national discretion over fiscal policy and hence democratic choice. It could be seen as a step back from the inflexible and undemocratic centralisation of fiscal powers in Brussels and a step towards a fiscally federal eurozone, once this becomes politically feasible.

A flexible eurozone would involve a genuine and comprehensive banking union, with tougher common rules, a truly independent single banking watchdog and an effective common mechanism for restructuring and resolving banks without taxpayers taking a hit. Even in a decentralised monetary union, financial issues cannot properly be handled locally. Ideally, the supervisor for all eurozone banks should be an authority other than the ECB. The resolution authority could be modelled on the United States' Federal Deposit Insurance Corporation (FDIC), as the Padoa Schioppa Group report suggests.

The no-bailout rule would be restored and with it much greater freedom for national governments to respond to varying economic circumstances and changing political preferences, constrained by markets' willingness to lend to them and ultimately by the possibility of default. In effect, rather than a collective eurozone budget cushioning the blow of downturns, national governments would do so individually. To prevent liquidity crises, the ECB would be mandated to act as a lender of last resort to solvent governments. To address solvency crises, government debts would be promptly restructured, initially under IMF direction and ideally later by creating an independent mechanism for doing so, with the IMF also providing conditional loans until a government regains market access. Since solvent eurozone governments would be protected against a run on their bonds by the

ECB, any 'contagion' effects could quickly be contained. Banks that were bankrupted by a sovereign debt restructuring would need to be recapitalised by their creditors (if viable) or closed down (if not). This would give banks an incentive to hold fewer government bonds in the first place.

"The ECB needs a broader mandate and greater democratic accountability."

Ideally, the ECB would also be reformed. Its statute could be rewritten to stipulate that its primary objective is to promote the welfare of all citizens in the eurozone, by maintaining price stability while supporting the general economic policies of the Union and maintaining financial stability.[31] It would be required to co-operate with fiscal authorities, acting together in the Eurogroup. These would set its inflation target, which should be symmetrical. It would be accountable to a committee of European and national parliamentarians who would be able to compel the ECB's president and governing board to provide regular testimony and to censure the ECB when it oversteps its mandate or fails to meet its target. For a gross breach of its mandate – for example, threatening to deprive some citizens in the eurozone of their right to continue using the euro as legal tender – the president of the ECB could be disciplined and ultimately dismissed. Together with completing the single market, reforms would focus on boosting productivity so as to sustainably raise living standards, rather than lowering wages in a mercantilist pursuit of 'competitiveness'. Collective decisions – whether by the Eurogroup, the European Commission or the ECB – would be much more democratically accountable, to both European and national parliamentarians, with a joint committee set up for that purpose, while most decisions would remain in national hands.

The advantages of a decentralised eurozone are clear: greater economic freedom for national policy-makers, genuine responsiveness to changing political preferences, insolvent banks and sovereigns dealt with promptly and fairly. Since this involves the least integration within the eurozone, it has relatively few implications for non-members. Is this more politically feasible than a fiscally federal eurozone? If Germany opposed changes to the ECB's mandate, a decentralised Europe would be hostage to the ECB's willingness to continue with its ad hoc, conditional lender-of-last-resort role. Since the other reforms to the ECB suggested above are unlikely to be acceptable to Germany, the eurozone may need to struggle on without them. Given the capture of

31: http://www.ecb.europa.eu/ecb/legal/pdf/en_statute_from_c_11520080509en02010328.pdf

governments by the banking system, it is also questionable whether a mechanism for resolving banks could operate independently and effectively; and whether eurozone governments would allow the IMF to oversee a restructuring of an insolvent government's debts. In practice, these processes might unfortunately prove messier and more political.

In conclusion, a fiscally federal eurozone is probably the best long-term option, but may not be politically possible for now. If so, a decentralised eurozone would be the best way of combining the economic and political flexibility needed for the euro to thrive with an overarching framework to hold it together. A Germanic eurozone with a technocratic edge is where we seem to be heading for now. But tightly circumscribing national governments' discretion over tax and spending decisions is likely to prove economically and politically unsustainable. This may ultimately cause the euro to disintegrate or, with luck, provide the political momentum to create a fiscally federal eurozone.

Chapter 5

Conclusion

The success of the eurozone is vitally important not just to the people who use the euro as their currency but also to those whose economies are tied to it by trade, financial linkages and membership of the European Union. Unfortunately, the eurozone has taken a wrong turn in recent years. A banking and economic crisis that exposed flaws in its financial governance and stabilisation policies was misdiagnosed as a fiscal crisis, leading to an economically damaging and politically divisive centralisation of fiscal controls in Brussels. The ECB has used its unprecedented independence to meddle in political questions, for example by backing the interests of banks in creditor countries at the expense of debtor countries and the eurozone economy as a whole. What began as a community of equals is starting to resemble a glorified debtors' prison where creditors call the shots. To live up to its initial promise – and to restore battered support for European integration more broadly – the eurozone needs root-and-branch reform.

A more integrated, more federal eurozone would be the most desirable outcome for the eurozone itself, even if it posed difficulties for non-eurozone members – especially Britain, which has no intention of joining. But for now the dash towards closer integration in the eurozone seems to have stopped. The financial panic has removed the sense of urgency – plenty of rules have been agreed but these have not been accompanied by a pooling of sovereignty. Such a eurozone will remain divided between creditors and debtors, a deeply unsatisfactory outcome for Southern Europe and arguably an unsustainable one. If this eventually leads to a break-up of the currency union, the consequences could be hugely damaging.

The advance of anti-EU parties in the upcoming European elections ought to be a wake-up call. While their diagnosis is flawed and the solutions they propose undesirable, their rise and the broader collapse in support for the EU are symptomatic of genuine problems. As Kevin O'Rourke, a professor of economic history at All Souls College, Oxford

has rightly remarked, 'Europe is now defined by the constraints it imposes on governments, not by the possibilities it affords them to improve the lives of their people. This is politically unsustainable.' The eurozone needs to change course before it is too late.

Table 1: Five reform proposals compared

	4 Presidents' Roadmap	Commission Blueprint	Padoa Schioppa Group	Glienicker Group	Eiffel Group
Banking union	Comprehensive (all banks)	Comprehensive	Comprehensive	Comprehensive and 'robust'	Yes[32]
Effective bank resolution mechanism	Yes	Yes	Yes, through independent agency modelled on America's Federal Deposit Insurance Corporation (FDIC)	Yes	Yes
Common deposit insurance	Yes (June 2012), then no (December 2012)	No	Yes	No mention	No mention
Common safe asset	Eurobonds, eventually	Eurobonds, eventually	European Debt Agency bonds	No mention	Eurozone bonds, eventually
Fiscal union	Greater centralised fiscal controls leading to Eurobonds; common insurance to cushion blow of asymmetric shocks	Centralised fiscal controls, eventually Stability Bonds (Eurobonds)	European Debt Agency would partly finance national budgets, with stricter budget controls and the right to limit sovereignty of governments that borrow too much	Economic government with membership fee of 0.5 per cent of GDP providing unemployment insurance, public goods and growth fund to support reforms; right to limit sovereignty of governments that borrow too much	Eurozone budget with tax-raising powers and eventually borrowing powers
Eurozone budget	Eventually, a limited fiscal capacity to improve the absorption of country-specific economic shocks, through a central insurance system	Perhaps	Sort of: 'cynical adjustment insurance fund' to cushion against asymmetric shocks and facilitate adjustment	Yes	Yes
Sovereign debt restructuring	No mention	No mention	Yes, as alternative to losing sovereignty to EDA	No mention	Yes

Monetary union	No change	No change	No change	No change	No change
ECB as lender of last resort to governments	No mention	No mention	No mention	No mention	No mention
Economic union	Completed single market plus mandatory contracts for domestic structural reforms[33]	Completed single market plus 'convergence and competitiveness instrument' (aka contracts for reform)	Completed single market plus domestic reforms to increase wage and price flexibility	Growth fund to assist domestic reforms; increased labour mobility	Increased labour mobility; partial harmonisation of taxes and labour-market policies
Democratic legitimacy and accountability	Primarily through European Parliament, as well as enhanced co-operation with national parliaments	Primarily through European Parliament	EDA accountable to joint committee of national and European parliamentarians; cyclical adjustment fund controlled by national parliaments	Yes: Euro-government chosen by and accountable to the European Parliament	Yes: democratically elected executive and assembly
Democratic choice	No	No	Some: can choose to borrow independently of EDA and ultimately to default	Yes	Yes
Relationship with non-eurozone countries	No mention	Eurozone arrangements should be open to others and not jeopardise integrity of the single market	Banking union should not distort competition in single market; parallel legal structure for EDA	Pre-ins consulted; no mention of UK, Denmark	No right of veto for non-eurozone countries

32: 'Common solutions are starting to be put in place in order to monitor and clean up the banking sector, without requiring money from tax payers. These solutions need to be implemented seriously so that banks are once again in a position to finance companies and households, at reasonable rates, throughout the EU.' http://www.bruegel.org/nc/blog/detail/article/1250-for-a-euro-community/

33: A mechanism for stronger co-ordination, convergence and enforcement of structural policies based on arrangements of a contractual nature between member-states and EU institutions on the policies countries commit to undertake and on their implementation. On a case-by-case basis, they could be supported with temporary, targeted and flexible financial support.

Table 2: Reform models

	Germanic	Technocratic	Fiscally federal	Flexible
Banking union	Limited	Comprehensive	Comprehensive	Comprehensive
Effective bank resolution mechanism	No	Yes	Yes	Yes
Common deposit insurance	No	Yes	Could be	Could be
Common safe asset	No; German Bunds?	Eurobonds	Eurozone bonds	No
Fiscal union	Centralised fiscal controls plus fiscal compact in national constitutons	Centralised fiscal controls, Eurobonds	Eurozone treasury plus restored no-bailout rule	Restored no-bailout rule, much greater national flexibility
Eurozone budget	No	No	Yes	No
Sovereign debt restructuring	No provision	No provision	Yes	Yes, involving IMF
Monetary union	No change	No change	Co-operation between eurozone treasury and ECB	Reform of ECB mandate
ECB as lender of last resort to governments	No; OMT?	No; OMT?	Yes	Yes
Economic union	Contracts for reform to promote 'competitiveness'	Completed single market; enhanced macroeconomic imbalances procedure	More flexible domestic prices and wages	Completed single market; enhanced labour mobility; more adaptable domestic product and labour markets
Democratic legitimacy and accountability	Little	Little, primarily to European Parliament	Yes	Yes
Democratic choice	No	No	Yes, at eurozone and national level	Yes, at national level
Relationship with non-eurozone countries	German dominance of EU too?	Interests of non-eurozone countries protected	Eurozone dominance of EU?	Only banking union affects non-eurozone countries

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How to finish the euro house

Philippe Legrain

The euro was supposed to facilitate economic convergence between the countries using it and foster the development of a stronger 'European' identity. Philippe Legrain argues that the reverse is now happening. European policy-makers share much of the blame for this because of their attempt to create a Germanic and technocratic eurozone. They have damaged the currency union by failing to address the root causes of the crisis. And by further constraining governments' scope to respond to democratic pressures, they have eroded the legitimacy of both national and EU institutions. The eurozone needs to change direction, argues Legrain. So long as a fiscally federal eurozone remains out of reach, governments should work towards a flexible one comprising a genuine banking union, a reformed ECB and greater fiscal flexibility for governments.

Philippe Legrain was economic adviser to the President of the European Commission from 2011 to February 2014.

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