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Why stricter rules threaten the eurozone

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1 Introduction

On October 27th, European leaders agreed a 'comprehensive solution' to the eurozone debt crisis at an emergency summit in Brussels. The back-slapping that followed the summit was more wearied than usual – and the euphoria even shorter-lived. Within days, the agreement lay in tatters, as Italian borrowing costs surged above their pre-summit levels and markets began to contemplate the prospect of a disorderly Greek default and exit from the eurozone. Given the political chaos in Greece and Italy, it is tempting to conclude that a workable solution to the eurozone crisis was foiled by the dysfunctions of Mediterranean politics.

This essay argues that this seemingly obvious conclusion is unwarranted. The most that can be said is that Greek and Italian politics have made a bad situation worse. For the reality is that the eurozone's comprehensive solution was nothing of the kind. True, eurozone leaders finally accepted what they had spent two years denying: that the Greek government was insolvent and would need to write off more of its debts; and that many banks were under-capitalised. But the comprehensive solution did nothing to correct the eurozone's institutional flaws, or to reverse the increasingly perverse and self-defeating policies that the region is pursuing.

European policy-makers have been reluctant to concede that the eurozone is institutionally flawed. Even now, many assert that the crisis is not one of the eurozone itself, but of errant behaviour within it. If certain countries had not broken the rules, they argue, the eurozone would never have run into trouble. The way to restore confidence, it follows, is to ensure that rules are rigorously enforced. These claims are wrong on almost every count. It is now clear that a monetary union outside a fiscal union is a deeply unstable arrangement; and that efforts to fix this flaw with stricter and more rigid rules are making the eurozone less stable, not more.

The reason the eurozone is governed by rules is that few of its member-states – least of all its wealthier North European ones – have any appetite for fiscal union. Crudely, rules (*gouvernance*) exist because common fiscal institutions (*gouvernement*) do not. But rules are no substitute for common institutions. And tighter rules do not amount to greater fiscal integration. The hallmark of fiscal integration is mutualisation – a greater pooling of budgetary resources, joint debt issuance, a common backstop to the banking system, and so on. Tighter rules are not so much a path to mutualisation, as an attempt to prevent it from happening.

The time for ambiguity and muddling through is over. If Europe's leaders want to restore the financial markets' flagging faith in the eurozone, they must do two things: commit themselves to rectifying the currency bloc's institutional flaws (in the medium to long term); and (in the shorter term) obsess less about rigidly adhering to rules. The legal, political and democratic obstacles to such a course of action are huge, however. So the eurozone is more likely to get the opposite: no attempt to rectify the institutional flaws, and an insistence on sticking to rigid rules. This course of action is more likely to precipitate the euro's disintegration than its survival.

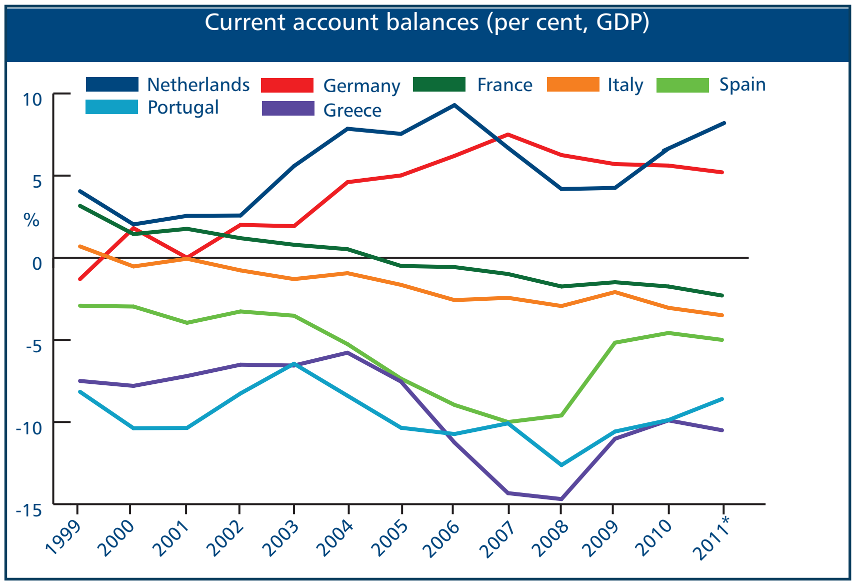
2 The origins of the crisis

How did the eurozone come to find itself in its current predicament? The short answer is that the introduction of the euro spurred the emergence of enormous macroeconomic imbalances that were unsustainable, and that the eurozone has proved institutionally ill-equipped to tackle. North European policy-makers have been reluctant to accept this interpretation. For them, the crisis is not one of the eurozone itself, but of individual behaviour within it. If the eurozone is in difficulty, it is because of a few 'bad apples' in its ranks. In this interpretation, neither the design of the eurozone nor the behaviour of the 'virtuous' in the core were at fault.

Ever since the eurozone crisis broke out, the North European interpretation of it has prevailed. It essentially sees the crisis as a morality tale, pitting those who sinned against those who stuck to the path of virtue. The major sins of the periphery were government profligacy and losses of competitiveness. The way out of the crisis, it follows, is straightforward. It is to emulate the virtuous core by consolidating public finances and improving competitiveness (by raising productivity, reducing wages, or both). If the periphery can achieve this, then the eurozone debt crisis can be resolved without an institutional leap forward to fiscal union.

The North European interpretation is by no means all wrong (no serious observer disputes that Greece grossly mismanaged its public finances). But it is damagingly partial and self-serving. It skates over the contribution played by the euro's introduction to the rise of indebtedness in the periphery; it wrongly assigns all the blame for peripheral indebtedness to government profligacy; it makes no mention of the far from innocent role played by creditor countries in the run-up to the crisis; and it does not acknowledge how the absence of fiscal integration has exacerbated financial vulnerabilities and made the crisis harder to resolve.

How did the euro's introduction contribute to the current crisis? The answer is that the removal of exchange rate risk inside the eurozone encouraged massive sums of capital to flow from thrifty countries in the 'core' to countries in the 'periphery' (where private investors thought the rates of return were higher). The influx of foreign capital cut borrowing costs in the periphery, encouraging households, firms and governments to spend more than they earned. The result was an explosion of current-account imbalances inside the eurozone. As a share of GDP, these imbalances were far bigger than those between, say, the US and China.



* *January-June 2011. Source: OECD*

The rise in peripheral indebtedness would not have mattered if the capital had been productively invested. The trouble is that much of

it was wasted (perhaps unsurprisingly, given how much capital was flooding in). It is wrong, however, to blame government profligacy for the rise in peripheral indebtedness: Greece is the only country where this holds true. In Ireland and Spain, it was the private sector (particularly banks and households) that was to blame. Indeed, in 2007, the Spanish and Irish governments looked more virtuous than Germany's: they had never broken the fiscal rules, had lower levels of public debt and ran budget surpluses.

Creditor countries cannot be absolved of all blame. Not only was export-led growth in countries like Germany and the Netherlands structurally reliant on rising indebtedness abroad. But creditor countries in the core harboured plenty of vice: the conduits for the capital that flowed from core to periphery were banks, and these were more highly leveraged in countries like Germany, the Netherlands and Belgium than they were in the periphery (or the Anglo-Saxon world). The eurozone crisis is as much a tale of excess bank leverage and poor risk management in the core as of excess consumption and wasteful investment in the periphery.

If the eurozone had been a fully-fledged fiscal union, it would not be in its current predicament. Its aggregate public debt and deficit ratios, after all, are no worse than the US's. But it is not a fiscal union – which is why it faces an existential crisis, and the US does not. The absence of a fiscal union explains why economic imbalances between Germany and Spain matter in a way that those between Delaware and New Jersey do not. And it explains why some eurozone members face sovereign debt crises, while states in the US do not (unlike them, members of the euro did not assume joint liability for rescuing banks).

The current crisis, then, is not simply a tale of fiscal irresponsibility and lost competitiveness in the eurozone's geographical periphery. It is also about the unsustainable macroeconomic imbalances to which the launch of the euro contributed (in creditor and debtor countries); about the epic misallocation of capital by excessively leveraged banks, notably in the core; about the way in which financial vulnerabilities in distressed countries have been exacerbated by the absence of fiscal integration at European level; and about the difficulties of adjustment in a monetary union that is politically (and therefore institutionally) incomplete.

3 Why Plan A failed

Ever since the Greek sovereign debt crisis broke out, the thrust of eurozone policy has been to try and turn the region into a less Mediterranean and more Germanic bloc – that is a shared currency held together by increased discipline among its members. The centrepiece of the framework that has emerged is a 'grand bargain' between creditor and debtor countries. Creditor countries have assented to the creation of a European Financial Stability Facility (EFSF) to extend bridging loans to countries that are temporarily shut out of the bond markets. In return, debtor countries have agreed to much stricter membership rules.

The grand bargain (or Plan A) has failed. The reason is that its underlying philosophy – that of 'collective responsibility' – is flawed. There are three problems. First, the demands of collective responsibility have been asymmetric: self-defeating medicine has been prescribed to debtor countries, while problems in creditor countries have been allowed to fester. Second, too much virtue has become a collective vice, resulting in excessively tight macroeconomic policy for the region as a whole. Third, stricter rules are no substitute for common institutions: they have left solvent countries vulnerable to catastrophic death spirals.

The asymmetry of collective responsibility

The challenges presented by Greece were always going to be daunting, given the dysfunctional nature of its political economy. But the medicine prescribed to the country – which was partly motivated by an urge to punish it and to take a stand against moral hazard – was doomed to failure. The policy consisted in giving an insolvent country liquidity support, in return for a more brutal than normal IMF-type austerity programme (because Greece could not devalue). The policy, inevitably failed. Although the government has slashed public spending, the economy has contracted even faster, further weakening the country's public finances.

The punishing (and self-defeating) economic adjustments imposed on debtor countries contrasts with the self-righteous complacency shown in the creditor countries. Not only have the latter insisted that debtor countries implement the kind of structural reforms for which they have shown no enthusiasm themselves (like opening services to greater competition). But they have also been reluctant to accept the potential for write-downs among their banks. So the very countries that have insisted on wrenching economic adjustments in debtor countries have often been the ones that have done the most to conceal the fragility of their own banks.

This asymmetry in treatment has deepened the crisis and increased the cost of resolving it. A year's worth of punishing austerity and contracting activity has only succeeded in pushing Greece deeper into insolvency. Contagion has spread to Ireland and Portugal (which have been forced to accept bail outs and swallow the same medicine as Greece). And foot-dragging in a number of countries has condemned the region to a series of weak 'stress tests' which have given clean bills of health to under-capitalised banks. Eurozone policy has therefore actively contributed to the vicious feed-back loop that has developed between banks and sovereigns.

Individual virtue has become a collective vice

The emphasis on shared discipline has had perverse consequences on macroeconomic policy. 'Bailed out' countries have implemented fiscal austerity programmes; countries at risk of contagion (like Spain) have done likewise; and, perhaps to be seen to be setting a good example, creditworthy countries have done so too for good measure. The collective outcome has been a sharp tightening of fiscal policy at a time of weak private sector demand. Germany and

the European Central Bank (ECB) believe that the faster budget deficits are cut, the faster private consumption and investment will pick up. The reverse has been the case.

The ECB, meanwhile, has done too little to offset this synchronised fiscal tightening (in July, it actually raised its key official interest rate, citing "upside risks to price stability"). For a variety of reasons, the ECB has been deeply uncomfortable straying from the narrowest interpretation of its mandate. At times, the ECB has looked to be more concerned about inflation than about the eurozone's survival. The ECB's reluctance to act as lender of last resort to governments, for example, has raised doubts in the financial markets about its commitment to the eurozone, and weakened confidence in solvent countries like Spain and Italy.

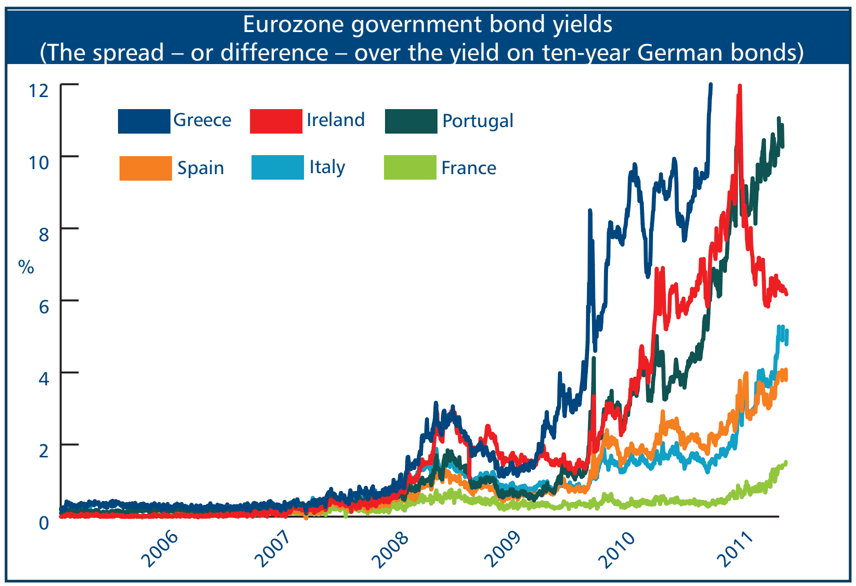
The eurozone will not emerge from the debt crisis without economic growth. The region's growth problem cannot be resolved by productivity-enhancing supply-side reforms in the Mediterranean alone (important though these are). Demand is also critical. But it is hard to see how demand can grow when private spending is being reined in and public spending is being cut. The current policy mix condemns the region to stagnation or worse: the ECB is reluctant to use what little room it has left to ease monetary policy further; and public spending cuts in a low interest rate environment are amplifying the contractionary impact on GDP.[1]

[1] *IMF, 'Will it hurt? Macroeconomic effects of fiscal consolidation', World Economic Outlook, October 2010.*

Financial vulnerability in an incomplete monetary union

It is now clear that a currency shared by fiscally sovereign member-states is more vulnerable to losses of confidence than a monetary union that is more fully integrated. One reason is that macroeconomic imbalances that emerge across the region as a whole are more likely to be transformed into sovereign debt crises in parts of it. If the eurozone had assumed joint responsibility for guaranteeing Ireland's banking system (as the federal government did in the US), the country would not have faced a sovereign debt crisis. However, fiscal backstops remained national, so Irish taxpayers were held liable for Irish banks' excesses.

Another reason for increased vulnerability in a monetary union that is not fiscally integrated is that countries do not fully control the currency in which they issue their debt. Financial markets punish such countries particularly severely if they worry about its fiscal position. (This is why Japan pays far less to borrow than Italy, even though Japan's ratio of government debt to GDP is much higher.) Such worries explain the dramatic reversal of long-term interest rate spreads over the past couple of years: after narrowing between 1999 and 2008, government bond yields inside the eurozone are now more polarised than before the euro's launch.



Source: Bloomberg

Some observers welcome this reversal, on the grounds that it imposes market discipline on profligate governments. The trouble is that it makes governments more vulnerable to death spirals that push them closer to insolvency. Consider Italy. Its government is solvent, but markets no longer trust it. Since July 2011, this loss of trust has pushed up borrowing costs – so making insolvency more likely. This negative feed-back loop has been amplified by the links between sovereigns and banks: fears about sovereigns have weakened confidence in banks, raising their potential rescue costs and consequently the risk of sovereign insolvency.

4 The 'comprehensive package': new wine in old bottles?

Despite the numerous changes they have signed up to since mid-2010 – new governance rules, the establishment of the EFSF, and so on – European leaders have conspicuously failed to contain the spread of the debt crisis. A familiar pattern has now set in. Under market duress, leaders hold an emergency summit and announce an agreement designed to restore confidence once and for all. After an initial bout of euphoria, financial markets digest the contents of the agreement, conclude that it does not resolve the underlying problems, and the cycle starts all over again. Each agreement buys less time and the stakes become larger with every summit.

The latest EU emergency summit, held in late October, stuck faithfully to this script. Billed as a 'comprehensive package' that would staunch the crisis, it did nothing of the sort. The ambition of the summit was three-fold: to persuade the financial markets that Greece could be restored to solvency (by writing off more of its public debt); to restore confidence in European banks (by arranging for their recapitalisation); and to build a firewall to prevent contagion to Italy and Spain. The best that can be said about the summit is that it marked the end of a prolonged period of denial about the Greek government's solvency and the state of eurozone banks.

If it had been held a year earlier (when the political stakes and the economic cost of stabilising confidence were lower), the summit might have had plenty to commend it. As it is, what European leaders agreed to was too little, too vague and too late. Once again, initial market euphoria rapidly gave way to disillusion. Perhaps the best measure of the market's verdict on the summit is the difference (or 'spread') between the German and Italian governments' borrowing costs. The spread, which stood at 380 basis points pre-summit, widened to over 450 basis points after the 'comprehensive solution' was announced – an unequivocal thumb's down.

It is tempting to blame this negative verdict on Greece's decision to call a referendum on the latest 'bail-out' package. There is no question that Greece's decision surprised its eurozone partners and unsettled markets, making a bad situation worse. But it would be wrong to assume that Greece unsettled what was an otherwise viable package. The truth is that there were good grounds for scepticism about what European leaders agreed to even before Greece took its fateful step: indeed, the spread between German and Italian borrowing costs had started widening before the Greek government announced its (now abandoned) referendum.

Aside from the lack of detail on key specifics, there are four reasons why the summit's 'comprehensive package' was nothing of the kind. First, eurozone leaders failed to convince financial markets that they had done enough to stem contagion to other countries. Political factors in Greece and Italy are only partly to blame. The broader reason is that financial markets doubt the will or capacity elsewhere too. The financial markets do not see a leveraged EFSF as a credible instrument for stemming contagion. And they do not think that the ECB has the will (or political backing) to serve as lender of last resort to governments facing a liquidity crisis.

A second reason for market scepticism was the summit's belated and bungled approach to banks. Having spent two years denying that many European banks were under-capitalised, eurozone leaders finally relented – but at a terrible time. Fresh capital is much harder to raise from the private sector than it was a year ago, and several eurozone governments (including France) can ill afford to step in with taxpayer funds. The EFSF can theoretically be tapped, but only on terms that are too onerous for banks and governments.

Banks will therefore seek to improve their capital ratios by shrinking their assets, provoking a credit crunch in 2012.

The third shortcoming of the summit is that it had little to say on economic growth. The eurozone's inter-connected problems of weak sovereigns and banks would be eased by stronger growth. Instead, it looks increasingly likely that these problems will be aggravated by the absence of growth. European leaders have rightly emphasised the need for productivity-enhancing reforms across Southern Europe. But such reforms will only lift growth in the long term. In the meantime, the eurozone faces a slump in demand as governments across the region simultaneously slash public spending at a time when private spending is ominously weak.

Finally, the 'comprehensive package' did not rectify any of the eurozone's institutional flaws. European leaders did increase the EFSF's firepower (by resorting to the sort of financial engineering that many of them have become accustomed to decrying when it happens in the private sector). But they made no mention of, let alone attempted to fix, the eurozone's central design flaws – that it is a currency shared by fiscally independent member-states, and that the ECB is a central bank that (for a combination of theological, legal and political reasons) is openly reluctant to stray beyond the very narrowest interpretation of its mandate.

5 What is needed to save the euro

The eurozone crisis is chronic in character and requires far-reaching reforms. If the euro were a currency within a state, the zone's economic difficulties would be formidable, but still manageable. But European leaders have been strikingly reluctant to provide the eurozone with the institutional framework that it needs to succeed. The euro is a currency union without a Treasury or a lender of last resort. The macroeconomic policy framework is ill-suited to a big, largely closed, economy, and the national markets are insufficiently flexible and imperfectly integrated.

Policy-makers now face a choice. They must either address the eurozone's institutional underpinnings or risk a disorderly break-up. They need to agree on a number of long-term steps. The first is a partial mutualisation of sovereign borrowing costs, via the adoption of a common bond. The second is the adoption of a eurozone-wide backstop for the banking sector. The third is growth-orientated macroeconomic policy: the European Central Bank needs a broader mandate, member-states' fiscal policy must be co-ordinated, and trade balances narrowed symmetrically. And finally, the participating economies must agree to deepen the EU's single market – a shared currency cannot rest on a patchwork quilt of national markets. None of these reforms is sufficient. But each is necessary.

Debt mutualisation

The attempt to run a common monetary policy without a common treasury has failed. Investors do not know what they are buying when they purchase an Italian bond – is it backstopped by the eurozone as a whole or not? The best credit must stand behind the rest, or 'bear runs', such as those that have derailed Greece, Ireland

and Portugal and which threaten to do the same to Italy and Spain, are inevitable. Debt mutualisation alone will not save the euro, but without it the eurozone is unlikely to survive intact.

Borrowing costs within the eurozone are now highly polarised. The German government can borrow at record lows, reflecting investors' flight to perceived safety, while borrowing costs for the struggling economies have ballooned. Unless borrowing costs for the latter fall, they will suffocate economically and be pushed closer to insolvency. The ECB could certainly bring down borrowing costs by announcing that it is ready to buy unlimited volumes of government debt (see section on Growth-orientated macroeconomic policy below). But in the longer-term only the mutualisation of debt issuance will generate the low (risk-free) interest rate needed to enable them to put their public finances on a sound footing and lay the basis for a return to economic growth. All eurozone countries should therefore finance debt by issuing bonds which would be jointly guaranteed by all of them.

The obvious problem with eurobonds is moral hazard: how to prevent fiscally irresponsible countries free-riding on the credit-worthiness of other member-states. A possible solution would be for member-states to issue debt as eurobonds up to a certain level – for example, 60 per cent of GDP – but be individually responsible for any debt above it. This would give countries with high levels of public debt an incentive to consolidate their public finances. However, for a number of economies, the additional borrowing would simply be too expensive. A better solution would be for a new, independent fiscal body to establish borrowing targets for each member-state and for a European debt agency to issue eurobonds (up to an agreed level) on behalf of the member-states.

How would these rules be designed? A dogmatic target of budgetary balance four years hence, irrespective of a country's position in the economic cycle, would achieve little: targets are

meaningless if they are impossible to implement, as the Greek debacle has demonstrated. These fiscal rules should be set with reference to the cyclically-adjusted fiscal position for each member-state. The OECD already produces estimates for these. Member-states have to be permitted to run deficits when their cyclical positions demand it. Inappropriately pro-cyclical fiscal policies and ruinous interest rates depress economic activity and with it the investment needed to boost productivity.

The eurozone's member-states would no doubt struggle to agree on the composition of the new fiscal body. A board of 17 people, one from each eurozone economy, would be unwieldy, and unlikely to win the support of the eurozone's principal creditor countries. At the same time, a board dominated by the creditor countries would be unlikely to win the backing of the debtor countries. A board of nine economists, from the big eurozone economies, the European Commission, the European Central Bank (ECB) and the OECD might form a good basis.

However, the issuance of eurobonds will not prevent debt crises in the absence of steps to reduce trade imbalances within the eurozone. If these imbalances remain substantial they will drain demand and employment from the deficit countries, forcing their governments to run big budget deficits. Unsustainable levels of borrowing and debt in the deficit countries will raise borrowing costs for all eurozone governments, depressing economic growth across the currency union, and bringing the creditworthiness of the core into question. The eurozone has a choice: either it establishes a symmetric framework for reducing trade imbalances between the participating economies or the fiscally stronger member-states have to transfer money to the weaker ones on an on-going basis – that is, the eurozone would require a fully-fledged transfer union of the sort that exists within the US (see section on Growth-orientated macroeconomic policy below). Such a step would require a high level of political integration, including a eurozone budget and revenue-raising powers.

A single backstop for a common banking system

The first decade of the eurozone's existence coincided with greater financial integration and a sharp increase in cross-border capital flows. Yet regimes for supervising, rescuing and 'resolving' banks remained resolutely national. Banks were supervised by authorities in their home countries, on the basis of common minimum standards agreed at EU level. This national locus was, of course, the counterpart to the fiscal independence of the eurozone's members: it is precisely because home countries were responsible for providing the fiscal backstop to their banking systems that they were also in charge of supervising the banks that they authorised.

The eurozone crisis has shown that a shared currency with an increasingly integrated financial sector cannot comfortably co-exist with national regimes for supervising, rescuing and 'resolving' banks. The problem is not just that the supervisory architecture is not sufficiently effective, but also that the system is more prone to banking and sovereign debt crises that feed on each other. Under such a system, conservatively-run banks that are located in countries with weak sovereigns are vulnerable to runs on their deposits – particularly if the countries concerned are, like Greece, perceived to be at risk of defaulting or of leaving the eurozone.

Important reforms have been made to the EU's supervisory architecture since 2008. In addition to a plethora of new regulatory rules, several new institutions have been created. A new European Systemic Risk Board (ESRB), under the aegis of the ECB, has been established to track 'macro-prudential' risks within the financial system. And the EU has established three European Supervisory Authorities (ESAs) for banking, insurance and securities firms respectively. The main tasks of the ESAs are to develop common rules, mediate between national authorities when conflicts arise, settle disputes if mediation fails and co-ordinate risk management.

Many of these changes are steps in the right direction, but they do not reduce the eurozone's vulnerability to the lethal feed-back loop

between sovereigns and banks in indebted countries. The reason is that member-states have not pooled responsibility for the banking system. In this respect, little has changed since October 2008, when European leaders rejected calls to establish a region-wide bank 'bail-out' fund. Although the ECB provides liquidity support to eurozone banks, national authorities are still responsible for supervising and, if necessary, recapitalising them. Likewise, deposit protection schemes are nationally funded and administered.

The eurozone's susceptibility to destabilising and costly vicious cycles would be reduced if the various backstops to the banking sector were 'Europeanised' (or mutualised). A critical step would be to set up a jointly-funded, eurozone-wide deposit protection scheme. The most stable arrangement would be for the pan-regional scheme to cover all banks; at a minimum, it would have to cover all systemically important banks. In the interim, the EFSF could guarantee all national deposit protection schemes. This would help to reduce the vulnerability of sound banks in highly indebted countries such as Greece and Italy to runs on deposits.

Although the adoption of a common European bond is usually thought of as way of stabilising confidence in weakened sovereigns, it would do the same for banks. The reason is that it would reduce the negative feed-back loop that can ensnare banks and sovereigns under current arrangements. A common bond would stabilise banks by making them less vulnerable to the fiscal position of the state in which they are domiciled. The failure of an individual sovereign would be less likely, and banks' balance sheets would also be more diversified because eurobonds would effectively give them exposure to a greater variety of underlying issuers.

If fiscal backstops to the eurozone's banking sector were to be 'Europeanised', then banking supervision might have to be as well. This would not necessarily require banking supervision to be carried out by a European institution. But it would require that the European Banking Authority (EBA) have greater powers over national authorities than it does at present. A strengthened EBA would help to weaken the unhealthily close relationships that often prevail between local politicians, banks and national supervisors in the member-states (which encourage damaging policies of regulatory forbearance and act as impediments to reform).

Growth-orientated macroeconomic policy

One of the biggest challenges facing the eurozone is how to generate economic growth. Whatever its leaders agree in terms of fiscal targets and surveillance will achieve little in the absence of growth. The struggling eurozone economies will not be able to restore their public finances to health or recoup competitiveness within the eurozone unless the currency union as a whole grows robustly. At present, growth prospects are poor. Fiscal policy is highly contractionary across the eurozone. And monetary policy is still too restrictive, given the depth of economic weakness. Structural reforms could certainly boost growth. But they can only do so in the medium to long term. In any case, such reforms need to be accompanied by investment if they are to deliver on their potential – and with demand so weak, investment plans will be put off. The region as a whole cannot export its way out of trouble. So if the currency bloc is to avoid slump and deflation, a number of reforms are necessary.

Broadening the ECB's mandate

The ECB's mandate is too restrictive. The central bank must guard against excessive inflation. But its fear of inflation blinds it to the much more serious threats confronting the eurozone economy. If policy continues to be directed at ensuring inflation of "below, but close to 2 per cent", countries such as Spain and Italy will struggle to regain competitiveness within the currency union. Since they cannot devalue, they can only improve their 'competitiveness' by cutting their wages and costs relative to Germany. Such a strategy risks slump and deflation unless German inflation rises more quickly than the current IMF projections of around 1.5 per cent per annum.

An inflation target of under 2 per cent might have been appropriate for the Bundesbank, but it is ill-suited to the eurozone. Unlike Germany, the eurozone is a largely closed economy (exports account for a similar proportion of GDP as they do in US). It cannot therefore rely to anywhere near the same extent as Germany on exports to close the gap between output and expenditure. The currency union as a whole cannot expect to export its way out of trouble – it needs robust growth in domestic demand. The eurozone would be better off with a symmetrical eurozone inflation target of 3 per cent with inflation allowed to deviate by 1 percentage point in either direction. Such a target would make it much easier for a member-state to hold its inflation rate (and wage growth) below the eurozone average without risking economic stagnation and deflation.

If the ECB had to take economic activity into account, not only would eurozone interest rates be lower, but the central bank would also be pumping money directly into the eurozone economy. Much like the US Federal Reserve, the Bank of Japan and the Bank of England – all of which face economies struggling with the aftermath of financial crises and the associated collapse in aggregate demand – the ECB would engage in so-called quantitative easing (QE), the unsterilised purchasing of government debt and other assets. By bringing down public and private borrowing costs and boosting the volume of credit, QE could strengthen economic activity and guard against the risk of deflation.

Fiscal policy and macroeconomic imbalances

Another obstacle to economic growth is un-coordinated pro-cyclical fiscal policy. Eurozone policy-makers, from German finance minister, Wolfgang Schäuble, to ECB president, Jean-Claude Trichet, all maintain that fiscal austerity, even if pursued by all member-states simultaneously, will not be contractionary. According to this belief, fiscal austerity will boost household and business confidence by reassuring households and businesses that government finances are sustainable, leading to a recovery in consumption and investment. But they are unable to cite any historical precedent in support of this belief, which appears to boil down to little more than faith. There are, of course, examples of fiscal austerity preceding economic growth, but they all include currency devaluation and/or big cuts in interest rates. Neither option is open to eurozone economies.

Unsurprisingly, the collective outcome of all member-states tightening fiscal policy has proved brutally contractionary for the region as a whole. Household and business confidence is crumbling rapidly across the currency union, depressing economic activity, and with it the scope for governments to reduce borrowing. Member-states' fiscal policies must be co-ordinated to ensure the maintenance of demand across the eurozone. This requires an acknowledgement of the connection between countries' fiscal positions and their external balances in a monetary union that lacks fiscal transfers.

Until recently eurozone policy-makers argued that trade imbalances within the eurozone did not matter. They now recognise that in the absence of a transfer union, these imbalances are incompatible with eurozone stability. But so far the approach has been to treat them as a matter for the deficit countries alone, which are being exhorted to pay-down debt, save more and 'live within their means'. The risks of such an asymmetric approach are obvious. Households and firms in the deficit countries are cutting spending (saving more), but there has been no offsetting increase in spending (decline in savings) in the surplus countries. If every country simultaneously saves more, aggregate demand across the eurozone will weaken further, hitting already weak public finances.

The eurozone clearly needs to agree fiscal targets and a regime to monitor them effectively. But the announcement of tough targets without any action to create the conditions under which they can be met will do nothing to restore investor confidence in the eurozone. It is almost impossible for economies to deleverage against a

backdrop of economic stagnation or contraction. A new fiscal regime needs to be accompanied by a symmetric imbalances procedure. Countries with imbalances will have to demonstrate how they intend to close them, with the onus being as much on those running trade surpluses as those with deficits.

Greater market integration

The euro lacks the traditional shock absorbers to compensate for the loss of the exchange rate as an instrument of economic adjustment. Three such 'shock absorbers' are indispensable. The first – a federal budget to transfer funds to struggling economies – has been discussed above.

The second is factor mobility. Factors of production do not move as freely between Germany and France as say between New Jersey and Delaware. If factors cannot move freely, differences in prices and productivity will become entrenched and difficult to reverse, increasing the risk that interest rates will be too high for some member-states and too low for others. Within the eurozone, trade in goods is highly integrated, but this is not the case for services and labour. The more integrated economies are, the more likely it is that differences in the strength of demand or supply between member-states can be cushioned by factor mobility. If labour was more mobile within the eurozone, differences in wage growth between the member-states would be less marked, addressing one of the reasons for the large trade imbalances.

The third shock absorber is flexible and dynamic product and labour markets. In the absence of exchange rate adjustment, everything else has to be more flexible. Wages have to respond quickly to changes in supply and demand and economies have to be quick to create new jobs in new sectors. Some eurozone member-states have flexible labour markets and some have economies characterised by high levels of competition, but few have both.

If governments are to make their countries' membership of the euro a success, they have to embrace the liberalising reforms that many have spent the past decade postponing or decrying. The eurozone should launch an aggressive campaign to break down barriers to integration, especially in the area of services. The remaining obstacles to the flow of capital such as barriers to cross-border takeovers also need to go. Increased labour mobility within the currency union may be difficult to bring about due to language barriers, but that does not mean that eurozone governments should not try.

6 Why what is necessary will not happen

The eurozone's latest package of measures to stem the crisis – agreed at October's EU summit – failed to address any of the underlying issues clouding the future of the currency union. And even this modest deal required a Herculean diplomatic effort to bridge gaps between the eurozone leaders. The gap between what is politically possible and what needs to happen in order to secure the future of the euro – debt mutualisation, pan-European deposit insurance, growth-orientated macroeconomic policy and closer market integration – is as wide as ever.

Debt mutualisation

The obstacles to debt mutualisation are formidable. Eurobonds would require a new treaty, as any move to shared liabilities would contravene the no bail-out clause of the Lisbon Treaty (article 25). This treaty would need to be eurozone-only, or to provide caste-iron opt-outs for the likes of Britain. The German Constitutional Court would most probably consider the issuance of eurobonds without a fiscal union unconstitutional. Debt mutualisation would therefore require a much higher degree of integration, including some central control over the spending decisions taken in all the participating countries. This process would be messy and time-consuming, but there is nothing to stop the member-states from taking such steps.

The reality, however, is that a number of member-states are implacably opposed to mutualisation. Countries with low borrowing costs, such as Germany and the Netherlands, fear that the issuance of eurobonds would involve them sharing their creditworthiness with countries that have mismanaged their public finances. The Dutch and German governments also argue that debt mutualisation would reduce market pressure on member-states to run sustainable fiscal policies. The promise of tighter control over budgets could go some way to assuaging the concerns of countries such as Germany or the Netherlands. But the northern member-states fear that the southern governments may not be able to deliver on what they promise because of the weakness of their governance mechanisms and institutions, raising borrowing costs for everyone.

These fears are understandable. After all, for the first six years of the euro, every member of the eurozone could borrow at similarly low rates of interest, and some of the fiscally weaker countries failed to use that opportunity to strengthen their public finances. But countries such as Germany and the Netherlands ignore the connection between the structures of their economies and the indebtedness of others. As countries that habitually live 'within their means' (that is, run structural trade surpluses) they are one of the causes of the eurozone's fiscal woes. In a depressed economic environment, the external demand upon which they depend relies implicitly on unsustainable fiscal policies in the deficit countries. Large trade imbalances within a monetary union require a transfer union, at least if slump and default is to be avoided. But transfers between member-states of the kind that take place between regions of individual member-states would erode political support for EMU membership in the creditor countries.

Growth-orientated macroeconomic policies

There is scant chance of the eurozone embracing expansionary fiscal and monetary policies. Fiscal policy across the currency bloc as a whole is set to remain highly restrictive, even in the teeth of renewed recession. There will be no co-ordination of fiscal policy to ensure that the overall stance is consistent with the maintenance of an adequate level of demand across the eurozone. There is little sign that policy-makers have drawn lessons from the Greek debacle. Far from easing off the pace of austerity, the eurozone's new governance

procedures promise an intensification of it: pro-cyclical fiscal policies are to be hard-wired into the governance of the currency union as a quid pro quo for northern members support for a bigger EFSF.

Germany, for its part, is tightening fiscal policy considerably, despite the fact that its economic recovery has ground to a halt and that it can borrow at record lows. This is partly because it wants to set an example to the other eurozone member-states and partly because it is striving to abide by a constitutional requirement to balance its budget by 2016. Fiscal tightening will militate against a rebalancing of the German economy – Germans need to spend more and save less if the country's export dependence is to be lowered and the country is to contribute to a recovery in the eurozone economy. But less government spending threatens to boost Germany's savings rate, exacerbating the weakness of the country's domestic demand. The European Commission's support for synchronised fiscal austerity shows that it has no intention of ensuring that the new excessive imbalances procedure, is symmetric.[2] Big trade surpluses will remain a powerful drag on economic activity in the eurozone and put a big obstacle in the way of the needed adjustments between member-states.

[2] As part of the reforms of eurozone governance, the Commission will monitor imbalances within the eurozone. Countries at risk of running excessive levels of private sector indebtedness and current account deficits being placed in a so-called 'excessive imbalances position'. Countries with excess savings and large current account surpluses will also be deemed to be suffering from structural imbalances, but it is unclear whether they will be compelled to take corrective policy action.

The outlook is no better when it comes to monetary policy. There is little chance of Germany and other like-minded countries agreeing to a reform of the ECB's mandate. The central bank enjoys a very high degree of independence, and any attempt to compromise that could fatally undermine German support for continued membership of the euro. The most that can be hoped for is that the ECB, chastened by terrible decisions to raise interest rates ahead of recessions in the summer of 2008 and 2011, will exercise more caution in future. The ECB's decision-making will no doubt become much more conflictual, as the indebted southern economies slide into deflation and social instability while monetary policy remains relatively restrictive in the face of higher, though still very low, inflation across the north of the eurozone.

A number of governments, led by Germany and the Netherlands, remain steadfastly opposed to allowing the ECB to carry out the full range of lender of last resort functions to eurozone sovereigns and banks. For example, they do not want the ECB to announce that it will buy unlimited amounts of government debt in order to demonstrate to investors that their fears over insolvency are unfounded. Their opposition could soften once they become fully aware that the alternative is the collapse of the eurozone. Alternatively, the ECB could opt to act in the face of national opposition. The outcome of such a strategy cannot be predicted. However, it is unlikely to involve countries such as Germany and the Netherlands backing-down (at least, not far enough), opening the way for a damaging stand-off and speculation that they could withdraw from the currency union.

Market integration

The need to deepen the EU's single market and liberalise labour markets has played little role in the debate over how to solve the eurozone crisis. Few eurozone governments accept that insufficient market integration contributed to the crisis or that a concerted move to deepen the single market is a necessary prerequisite for the success of the euro in the future. The emergence of a eurozone core could compound this problem, as it will not include countries that have been most in favour of more single market, such as Sweden and the UK and the Czech Republic and Poland among the newer member-states. The French government has persistently opposed moves to deepen market integration, and the German one is ambivalent at best. Their increasing readiness to bypass the Commission and forge agreements between themselves also makes closer market integration even less likely.

The crisis-hit member-states of the currency union are under pressure to liberalise their labour markets and implement structural reforms. More flexible labour markets should eventually boost the proportion of the working age population in employment (on the assumption that these countries eventually return to growth), while structural reforms will open more sectors to competition. But the process is again asymmetric. They are under pressure to implement reforms in order to correct their lack of 'competitiveness', whereas the core is considered 'competitive', so is not judged to need reform. This is problematic. The case for reform should not be couched in terms of 'competitiveness' (itself a very misleading concept), but in terms of fostering closer integration and higher productivity growth.

Germany is lauded for its reforms, and the impact these have allegedly had on improving its 'competitiveness'. These reforms focused on making the country's labour market more flexible, and boosted labour market participation. But they also exacerbated an already rapid fall in the proportion of national income accounted for by wages and salaries, which is now well below the eurozone average. This trend has boosted the price competitiveness of German exports, but depressed domestic demand and left Germany with a big structural trade surplus. Crucially, in the run-up to the crisis German productivity growth was almost as weak as in the eurozone's southern member-states.[3]

[3] *Simon Tilford, 'Germany's brief moment in the Sun', CER, June 2011.*

Cutting the proportion of national income accounted for by wages and raising the proportion of national income accounted for by corporate profits is no way to deliver sustainable economic growth. If practiced by all eurozone economies, it would lead to slump and a popular backlash against the market economy. What the eurozone needs is higher productivity across the bloc as a whole. This would open the way for sustainable economic growth and facilitate the necessary adjustments between member-states. But in too many sectors, incumbents are protected. With the eurozone economy in recession and eurozone electorates widely attributing the crisis to economic liberalism and too much 'market', governments will struggle to win the argument for market-driven reforms, even if they believe them to be necessary.

7 The alternative: a default union

On current policy trends, a wave of sovereign defaults and bank failures are unavoidable. Much of the currency union faces depression and deflation. The ECB and EFSF will not keep a lid on bond yields, with the result that countries will face unsustainably high borrowing costs and eventually default. This, in turn, will cripple these countries' banking sectors, but they will be unable to raise the funds needed to recapitalise them. Stuck in a vicious deflationary circle, unable to borrow on affordable terms, and subject to quixotic and counter-productive fiscal and other rules for what support they do get from the EFSF and ECB, political support for continued membership will drain away.

Faced with a choice between permanent slump and rising debt burdens (as economic contraction and deflation leads to inexorable increases in debt), countries will elect to quit the currency union. At least that route will allow them to print money, recapitalise their banks and escape deflation. Once Spain or Italy opts for this, an unravelling of the eurozone will be unstoppable. Investors will not believe that France could continue to participate in a core euro: the country has weak public finances and a sizeable external deficit. Participation in a core eurozone would imply a potentially huge real currency appreciation and a corresponding collapse in economic activity. Investors will calculate that the wage cuts (to restore competitiveness) and cuts in public spending (to rein in the fiscal deficit) would be politically unsustainable. In short, France will effectively be in the same position as Italy and Spain are at present. While it is impossible to put a time-scale on this, the direction of travel is clear.

What would happen if European leaders agreed some, but not all, of the steps required to stabilise the eurozone? Debt mutualisation, let alone a fully-fledged transfer union, will not happen, at least for the foreseeable future. The political basis for such a step is absent and a deepening of the crisis is not going to change that. The creditor countries might withdraw from the euro, while the debtors could balk at the loss of sovereignty implied by ceding control over crucial planks of economic policy. But what if the ECB were allowed to fulfil the full range of lender of last functions and launched a concerted drive to reflate the eurozone economy; the eurozone responded to the slide into recession by easing back on the pace of fiscal austerity and agreed a symmetric imbalances procedure; the eurozone governments moved to introduce a pan-European deposit insurance for banks; and governments got serious about developing a single economy to go with their single currency? Could the eurozone survive under such circumstances?

A big programme of quantitative easing would reassure investors that something does, indeed, stand behind the sovereign debt of the eurozone economies (the latest plan to leverage the EFSF has done nothing to dispel their doubts). Combined with the introduction of a pan-European deposit guarantee, this would take the sting out of the poisonous feedback loop between sovereigns and banks. Quantitative easing, lower official interest rates and an end to the currently pro-cyclical fiscal strategy would lessen the risk of the eurozone as a whole sliding into slump and deflation, and hence lower fears over debt sustainability in the hardest-hit member-states. Such a growth-orientated macroeconomic policy strategy would arrest the rapid decline in financial conditions in the periphery – where big falls in money supply suggest a deep slump next year – lowering the risk of other countries going the way of Greece.

Combined with a higher inflation target, symmetric governance procedures – under which unsustainably weak domestic demand is considered as much of a problem as excessively strong domestic demand – could help assuage investors' concerns about eurozone imbalances. Higher inflation would help facilitate the necessary adjustments in wages and costs between the member economies,

while a symmetric imbalances procedure would at least exert some pressure on creditor countries to rebalance their economies. A concerted drive to deepen the single market would have little short-term impact on resolving the crisis. But a commitment to market-led reforms would go some way to reassuring sceptical investors about the currency union's long-term growth prospects as well as help prevent differences in costs becoming so entrenched in the future.

Under these circumstances – admittedly very different from the present ones – the immediate existential threat to the eurozone might dissipate. But doubts over the long-term sustainability of the single currency would remain. The ECB could not buy large volumes of sovereign debt indefinitely in order to hold down borrowing costs; the underlying disequilibria would still need to be addressed. Even under the positive scenario outlined here (where all the criteria aside from debt mutualisation are met) the outlook for a big chunk of the eurozone would remain poor. It would still have hugely overvalued real exchange rates, which would exert a drag on economic growth. Real interest rates would remain high as investors continued to demand a higher risk premium for lending to the struggling member-states because of doubts over the sustainability of their debts and the possibility of default. Higher borrowing costs would depress investment and with it productivity growth compared with the core, compounding fears over solvency.

Debt mutualisation is the very minimum degree of fiscal supra-nationalism required to facilitate adjustment within a currency union, especially one as imperfect as the eurozone. Without it countries risk getting caught in death spirals – situations where the only policies countries have at their disposal deepen their predicament rather than alleviate it. For a currency union to survive without a fiscal union would require a degree of integration and flexibility beyond what is possible in the eurozone. The eurozone without debt mutualisation will remain prone to instability and crises. However, if eurozone governments did everything to get the eurozone economy growing and addressed less contentious institutional issues – such as bank deposit insurance – they would at least give themselves some time to develop the necessary political consensus for a fiscal union.

8 Conclusion

When the euro was launched, critics worried that it was inherently unstable because it was institutionally incomplete. A monetary union, they argued, could not work outside a fiscal (and hence a political) union. Proponents of the euro, by contrast, believed that a currency union could survive without a fiscal union provided it was held together by rules to which its member-states adhered. If, however, a rules-based system proved insufficient to keep the monetary union together, many supporters assumed (as faithful disciples of Jean Monnet) that the resulting crisis would compel politicians to take steps towards greater fiscal union.

Initially, proponents of the euro seemed to have been vindicated. The euro enjoyed a remarkably uneventful birth, and a superficially blissful childhood. But its adolescence has been more troubled, lending increasing weight to the euro's critics. If anything, a shared currency outside a fiscal union has turned out to be even less stable than the critics imagined. Common fiscal rules did not guarantee the stability of the system – not just (as North European politicians like to claim) because they were broken, but also because they were inadequate. The eurozone now faces an existential crisis – and EU politicians their 'Monnet moment'.

At root, the eurozone's sovereign debt crisis is a crisis of politics and democracy. It is clear that the eurozone will remain an unstable, crisis-prone arrangement unless critical steps are taken to place it on a more sustainable institutional footing. But it is equally clear that European politicians have no democratic mandate in the short term to take the steps required. The reason is that greater fiscal integration would turn the eurozone into the very thing that politicians said it would never be: a 'transfer union', with joint debt issuance and greater control from the centre over tax and spending policy in the member-states.

Eurozone leaders now face a choice between two unpalatable alternatives. Either they accept that the eurozone is institutionally flawed and do what is necessary to turn it into a more stable arrangement. This will require some of them to go beyond what their voters seem prepared to allow, and to accept that a certain amount of 'rule-breaking' is necessary in the short term if the eurozone is to survive intact. Or they can stick to the fiction that confidence can be restored by the adoption (and enforcement) of tougher rules. This option will condemn the eurozone to self-defeating policies that hasten defaults, contagion and eventual break-up.

If the eurozone is to avoid the second of these scenarios, a certain number of things need to happen. In the short term, the ECB must insulate Italy and Spain from contagion by announcing that it will intervene to buy as much of their debt as necessary. In the longer term, however, the future of the euro hinges on the participating economies agreeing at least four things: mutualising the issuance of their debt; adopting a pan-European bank deposit insurance scheme; pursuing macroeconomic policies that encourage growth, rather than stifle it (including symmetric action to narrow trade imbalances); and lowering residual barriers to factor mobility.

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CENTRE FOR EUROPEAN REFORM

Why stricter rules threaten the eurozone

Simon Tilford and Philip Whyte

Many European leaders believe that the eurozone is an essentially sound arrangement which has been undermined by errant behaviour within its ranks. The lesson, they conclude, is that rules must be more strictly enforced. This reading is both wrong and damaging. It is now clear that the eurozone as currently constituted is flawed. A monetary union outside a fiscal union is a highly unstable arrangement; and attempts to mend this flaw with stricter rules are making the eurozone less stable, not more. To restore confidence in the eurozone, leaders must fix its institutional defects and be prepared to break some rules in the interim. Instead, European leaders are doing the opposite – a course of action that is more likely to cause the euro's disintegration than ensure its survival.

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