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End of previous Forum article

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The Eurozone's Flaws Are Not Intrinsic

There seem to be two typical responses to the failure of the euro project that the last five years have exposed. The first, mostly from those outside the eurozone, is that the whole project was doomed from the start and should be abandoned. The second is that the only way forward is further political integration. Both appear politically impractical if democracy is preserved, but both are also unnecessary. The problems of the eurozone are not intrinsic to any attempt at a monetary union, but rather reflect design flaws in the particular version of monetary union that was embodied in the euro project.

Understanding the source of the crisis

To understand these design flaws, you first need an account of the problems that have emerged. This account has to be consistent with what the majority of macroeconomists around the world understand, rather than with the view of those in a particular country which serves some national interest. Luckily, we have a recent and clear presentation of that consensus, which is contained in a VoxEU article entitled "Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative", signed by 16 eminent economists and endorsed by many more.[1]

This article argues convincingly that the 2010 crisis "should not be thought of as a government debt crisis in its origin – even though it evolved into one". While Greece's economic crisis clearly was the result of government profligacy, in Ireland and Spain the problem was private sector excess, leading to a banking crisis which the government was forced to socialise. Governments in both Ireland and Spain were running financial surpluses in the years leading up to the Great Recession, and their debt-to-GDP ratios were low. This suggests that if we can do something to mitigate the extent of periods of private sector excess, we will be able to make any subsequent fiscal crises more manageable.

The article also stresses the importance of the ECB's decision (with its Outright Monetary Transactions (OMT) programme introduced in September 2012) to become a sovereign lender of last resort in eventually ending the crisis. This leads to a conclusion which those in charge of the eurozone appear very reluctant to acknowledge, namely that the reason the debt funding crisis spread beyond Greece in 2010 was because of a failure by the ECB to act as a sovereign lender of last resort at the time. This helps explain why the debt funding crisis only hit eurozone countries, even though some countries outside the eurozone had more vulnerable fiscal positions. This suggests that the eurozone crisis could have been contained (and become simply a Greek crisis) if OMTs had been in place as part of the eurozone's original design architecture.

However, the Greek crisis was in large part initiated by fiscal profligacy, and it was subsequently handled very badly. It is doubtful whether simply resorting to OMTs in 2010 would have avoided this. It now seems clear (and was clear to many economists at the time) that Greece should have defaulted immediately in 2010 and only subsequently received OMT support. Yet eurozone governments failed to insist that Greece default in 2010, and if the OMT programme had existed in 2010, it would have been inappropriately extended to Greece without insisting upon a Greek default. Furthermore, much of the source of the 2015 Greek crisis was the potential for conflict inherent in eurozone governments lending to each other. One way of avoiding this, which becomes possible with the OMT programme in place, is to enforce the idea of no bailouts. My proposal would prohibit any intergovernmental lending of the EFSF/ESM type.

If the 2010 crisis outside Greece was a result of private sector excess and the failure of the ECB to act as a lender of last resort, the policy response led by Germany, which treated it as a general problem of government profligacy, was a mistake – one which had disastrous consequences, as it helped lead to a second eurozone recession. The

1 R. Baldwin, T. Beck, A. Bénassy-Quéré, O. Blanchard, G. Corsetti, P. De Grauwe, W. den Haan, F. Giavazzi, D. Gros, S. Kalemli-Ozcan, S. Micossi, E. Papaioannou, P. Pesenti, C. Pissarides, G. Tabellini, B. Weder di Mauro: Rebooting the Eurozone: Step 1 – Agreeing a Crisis narrative, VoxEU, 20 November 2015.

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evidence for this, from model-based analyses, including the Commission's own model, is by now overwhelming.[2]

Another major cause of the second eurozone recession was monetary policy. There were two failures by the ECB. First, it failed to cut rates below one per cent after the first financial crisis and then actually *raised* rates twice in 2011. Given that rates are now effectively zero, I have seen no one try to defend these mistakes. Second, the ECB spent five years resisting the introduction of a comprehensive quantitative easing (QE) programme of the type that had been introduced by the US Federal Reserve and the Bank of England. In short, poor monetary policy decisions combined with inappropriate fiscal rules helped create the second eurozone recession.

A good case can be made that these mistakes, together with the failure to introduce OMTs in 2010, indicate a fundamental design flaw in the governance of the ECB. Any reform of the eurozone architecture should also include reform of the ECB. That makes three main areas where the architecture can be improved without resorting to fiscal or political union: countercyclical policy, the OMT mechanism with no bailouts and the structure of the ECB. In the following, I consider each in more detail, and then "rerun history" to see how these improvements would have radically diminished the magnitude of the crisis.

Introducing countercyclical policy for national governments

When economists look at the pros and cons of a monetary union, the only significant cost is the loss of monetary policy at the national level. There is also a standard partial remedy for this loss: the use of fiscal policy as a countercyclical tool. Many economic studies at around the time the euro's formation recommended the use of countercyclical fiscal policy at the national level. One of my own calculated that a countercyclical fiscal policy could make up for about half the costs of losing an independent monetary policy.[3]

The Stability and Growth Pact (SGP), by contrast, essentially ignored this countercyclical role, focusing instead on deficit limits. It is often suggested that allowing for a countercyclical fiscal policy means giving up control over the medium term of government debt or deficits. This is simply incorrect, as it is quite possible to design fiscal rules that require a deficit which, if the economy is internally balanced, will gradually reduce debt levels.

In a monetary union, there is an easy and straightforward way of measuring the internal balance of nations, as long as the union as a whole is in internal balance. One must simply look at the inflation rate in the individual nation relative to the union as a whole.[4] Once again, such a rule significantly reduces the cost of asymmetric shocks. This rule can be imposed at the union level (although without fiscal and political union, it has to be enforced by national governments, just as with the SGP), or it can be left in the hands of national governments.

In either case, experience suggests that a national independent fiscal council can improve fiscal policy making.[5] It can alert the public when governments are using underhand methods to subvert a fiscal rule, but it can also legitimise temporary departures from those rules when unexpected events reveal the rule's limitations (as will always be necessary for simple fiscal rules). One silver lining to the otherwise confusing and misconceived changes in the eurozone's fiscal rules brought about by the crisis has been that every eurozone country has to have such a council, and these councils have formally established a network, which can function as a forum for exchanging ideas and best practices as well as provide one means of interacting with the Commission.

This countercyclical fiscal rule, which targets a deficit level modified by countercyclical action when national inflation exceeds average inflation, could simply replace the many rules that form part of the Fiscal Compact and the SGP. The exact form of the rule could be chosen and enforced – to the degree they are able to do so – by the usual Brussels institutions, although I would hope that they would take account of the academic evidence before choosing a rule.[6] However, I also think that such rules could be chosen and enforced by national governments, working with their independent councils. I will briefly explain why, but please note that such a move towards subsidiarity is not a necessary condition for the use of countercyclical fiscal rules.

One great advantage of national ownership of fiscal rules is that it avoids what can happen when rules are enforced by Brussels, which is that domestic politicians play the nationalist card to justify bad practice. One disadvantage of national rules, which the eurozone's architects thought

2 See the studies discussed in S. Wren-Lewis: The entirely predictable recession, mainly macro blog, 26 September 2014.

3 R.L. Driver, S. Wren-Lewis: European Monetary Union and Asymmetric Shocks in a New Keynesian Model, Oxford Economic Papers, 1999.

4 An example of such a rule, which achieves a target for debt in the medium term but which also acts in a countercyclical way, is provided in T. Kirsanova, M. Satchi, D. Vines, S. Wren-Lewis: Optimal Fiscal Policy Rules in a Monetary Union, in: Journal of Money, Credit and Banking, Vol. 39, No. 7, 2007, pp. 1759-1784.

5 L. Calmfors, S. Wren-Lewis: What should fiscal councils do?, in: Economic Policy, Vol. 26, No. 68, 2011, pp. 649-695.

6 See, for example, J. Portes, S. Wren-Lewis: Issues in the Design of Fiscal Policy Rules, Manchester School, University of Manchester, Vol. 83, 2015, pp. 56-86.

ought to rule them out, was that individual governments would free-ride on the union as a whole, because the markets would no longer impose the same discipline on individual governments in a monetary union.

This at first appeared to be the case, as interest rates on national government debt converged in the first years of the euro. However, we now know that this was the result of markets misreading the eurozone's willingness to act as a sovereign lender of last resort. Without that lender of last resort role, individual eurozone countries are *more* vulnerable to market pressure than they would be with their own currencies and central banks. It is to this issue that we now turn.

OMTs and a real no-bailout rule

If a country has too high a level of debt, which it needs to bring down, it must be willing and able to generate the primary budget surpluses that will achieve this debt reduction. That will involve either government spending cuts or tax increases, which are likely, other things being equal, to reduce aggregate demand and therefore increase unemployment. In a monetary union member, this will in time reduce wage and price inflation relative to other union members, which will increase net exports, raise aggregate demand and bring unemployment back down.

In the eurozone crisis of 2010, this process was triggered by an unwillingness of the market to buy the debt of periphery countries. That unwillingness was in large part due to the absence of an OMT mechanism. Once the ECB initiated OMT operations in September 2012, the crisis went away. Even when Greek problems flared up again in 2015, OMTs ensured that there was no contagion to other periphery countries.

In the absence of OMTs, the eurozone put together various EFSF/ESM adjustment programmes, which involved the majority of eurozone countries lending to the periphery. It is quite possible that an adjustment programme of this type would not have been necessary for some of these periphery countries if the OMT programme had already been operational. That seems much less likely for Greece, but this raises another difficult question: should OMTs have been extended to Greece?

It was fairly obvious early on to most economists, particularly after the country's true fiscal position had been revealed, that OMTs should not have been extended to Greece until after an immediate and substantial default. In contrast, eurozone governments initially believed otherwise. One of the reasons they were reluctant to allow an immediate default is that Greece's creditors included a large number of eurozone banks, and there were legitimate concerns over the health of this banking system. There is therefore a strong danger that in any future crisis, creditor pressure, both on eurozone governments and on the ECB itself, might allow an extension of OMTs to a country whose government debt is essentially unsustainable. This concern has led some to question the desirability of OMTs, but to me it simply suggests the need for a better mechanism to decide when they should be applied.

Some have suggested simple rules for deciding whether a government is solvent. This is unlikely to work, because in most cases solvency is essentially a political issue. Some governments are prepared to run the primary surpluses required to sustain high levels of public debt, while others are not. It is therefore a difficult and politically sensitive decision. Fellow eurozone governments would be quite reluctant to declare another member state insolvent if they also want to preserve European solidarity.

Luckily, there is an international body with long experience of taking such decisions: the IMF. It may seem odd to have the ECB contract out such a decision to the IMF, but it would seem less odd if it were combined with a firm no-bailout rule. The Greek experience shows the dangers that lending by eurozone member states can bring. If you think the same process in Ireland and Portugal has been a success (in terms of encouraging European solidarity), you need to talk to people in both countries!

The way this reformed OMT mechanism would work is as follows. If market interest rates on a eurozone country's debt started rising significantly because of default fears, the country would itself apply to the IMF for assistance, in the normal way. An effective no-bailout provision would preclude them asking for financial aid from other eurozone countries. If the IMF thought that the country's fiscal position was fundamentally sound, perhaps with certain conditions, it could simply recommend to the ECB that OMTs should be applied, in which case the ECB would do so. However, if the IMF thought that the country's fiscal position was not sound without a default of some form, it would recommend that OMTs should only be applied after that default.

The IMF has a wealth of experience in deciding when default is necessary. In the case of Greece, that experience was put aside as a result of political pressure from the eurozone. Whether Europe should have such great political influence within the IMF is a moot point. However, the situation might have been different if, as suggested here, an effective no-bailout rule had meant that the IMF alone would have been providing transitional finance to Greece. It seems unlikely that the IMF would have been prepared to increase its own lending to Greece in order to bail out Greece's creditors.

Would Greece have been substantially worse off if it had been forced to default in 2010 and had only received financial assistance from the IMF? Probably not. The amount of money provided by the IMF as part of the Troika is of the same order of magnitude as the amount that has actually gone to Greece to fund a transition to a primary surplus: the rest went to bail out the creditors of the Greek government.

In effect, the primary accomplishment of eurozone financial assistance to Greece was to bail out eurozone banks because of fears about the fragility of the banking system – fragility which would have been exposed by an immediate Greek default. In that context, these eurozone loans should have been regarded as a temporary expedient, which would be written off once the position of the banking system improved. Greece was taking a temporary hit for the sake of the rest of the eurozone. But eurozone politicians proved incapable of subsequently writing off these loans, which led to further unnecessary austerity being imposed on Greece. One of the advantages of having the IMF alone providing any financial assistance is that it would be much less prone to these political pressures.

Reforming the ECB

Was the delay in implementing OMTs, the delay in introducing quantitative easing and the raising of interest rates in 2011 just a series of unfortunate mistakes? I think they suggest instead a systemic problem with those in charge of the ECB. There seem to be three interrelated problems. First, there is an excessive fear of inflation, which helped encourage the raising of rates in 2011 and which delayed the use of QE. The ECB persists in targeting inflation at two per cent or *less*, rather than a straight two per cent. Second, there is a primitive fear of the consequences of buying government debt, which led to delays in implementing both OMTs and QE. In reality, the ECB is probably in less danger of fiscal dominance than any other central bank! Third, there seems to be an obsession with the need for austerity. Whereas Ben Bernanke was clear that fiscal austerity made his own job as chairman of the US Fed more difficult, Europe witnessed the strange spectacle of ECB central bankers encouraging austerity at just the time they were unable to raise output or meet their inflation target.

Going through the problems with the current ECB is easier than working out solutions. But the ECB could learn two obvious lessons from the Bank of England. First, the inflation target should be a simple two per cent, with a clear statement that inflation below this target is viewed with equal seriousness as inflation above. Second, the ECB's decision-making body could be supplemented with some outside economists (preferably academics) with excellent international reputations. It could also adopt a dual mandate as the US Fed has.

A comparison with the Bank of England and the US Fed also reveals another clear deficiency with the ECB, and that is the ECB's lack of accountability. In theory, the ECB has the same kind of accountability to parliament as in the UK or US, but occasional briefings to the European Parliament seem largely ineffective. Experience suggests that the ECB should be made much more accountable to the public; any fears that this could threaten the ECB's commitment to low inflation are unfounded.

Rerunning history

Suppose countercyclical fiscal and macroprudential policy, OMTs with no bailout, and a reformed ECB had been in place in 2000. The first element would have led to much tighter fiscal policies in the periphery in the years leading up to the global financial crisis. Policy makers and commentators in countries other than Greece often say that fiscal policy could not have been tighter in those years, but this reflects a focus on deficits, encouraged by the Stability and Growth Pact. Countercyclical policy would have focused on inflation relative to the rest of the union, which was consistently positive. This fiscal policy should have been complemented by an active countercyclical macroprudential policy.

It seems likely, however, that we would still have had a debt-funding crisis in Greece in 2010, although perhaps not quite as large in terms of deficits and debt. An effective no-bailout clause would have prohibited eurozone lending to Greece. Greece would have had to survive with IMF help alone, which would have made an immediate default much more likely. However, given that most of the eurozone government money went to bail out Greece's creditors, Greece would not have been significantly worse off. OMTs would have been extended to Greece once the IMF was sure that any further default was extremely unlikely. Extending OMTs to other (solvent) periphery countries could well have allowed them to retain market access.

A reformed ECB would have acted more like the central banks of the US and UK. It would have had a QE programme in place by 2010 and would also have cut interest rates much closer to zero. Interest rates would not have been raised in 2011. Would this, together with a debt-funding crisis confined to Greece, have been enough to prevent a second eurozone recession?

Study after study has shown that it was the generalised tightening of fiscal policy after 2010 which was the major cause of the second recession.[7] Would this still have occurred if the 2010 crisis had been limited to Greece? It is quite possible that both Germany and the Commission would still have taken the opportunity to tighten fiscal rules. So in this case, the outcome may depend on the extent to which fiscal rules are determined by national governments as opposed to by the Commission.

To sum up, with countercyclical fiscal and macroprudential policy rules in place, the fiscal and competitiveness problems that emerged after 2007 would have been reduced. If these rules had been chosen by national governments, then the second eurozone recession would have been avoided. Even if these rules had remained under central control and the Commission had demanded substantial tightening across the eurozone in 2010, a more active monetary policy implemented by a reformed ECB would still have dampened if not altogether avoided a second eurozone recession. Finally, an effective no-bailout clause plus an OMT programme implemented from 2010 – triggered by the IMF and not the eurozone – would have limited the 2010 crisis to Greece and would have yielded a better outcome for the Greek people.

What this alternative history suggests is that the major problems with the eurozone are not intrinsic to a monetary union, but instead are a function of the particular version of a monetary union that eurozone governments chose to implement. A eurozone that implemented the kind of reforms suggested here would have no need to embark on the politically hazardous path to fiscal and political union.

7 See the studies cited in S. Wren-Lewis: The Knowledge Transmission Mechanism and Austerity, Social Europe Research Essay, No. 7, 2015.