

End of previous Forum article

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Minimal Conditions for the Survival of the Euro

In this paper, we set out minimal conditions for the survival of the euro. Typically, this issue is framed as whether European monetary integration, which reached its apogee with the euro, will now be complemented by the political integration needed for the single currency to survive. This is how the technocrats and political intelligentsia responsible for the euro's creation saw things: since monetary union is not possible without political union, creating the euro was a way of forcing the pace of political integration.

This is not how we see things. Over the time frame relevant for the euro's survival, political integration in Europe has its limits. This is what historical comparisons suggest. It took the United States more than a century, including the experience of a devastating civil war, before it became a true, irrevocable political union, and Europe is only a

short way down that path. The euro's existential crisis is likely to be resolved one way or the other long before that political destination is reached.

Economic theory similarly suggests limits to European political integration. Public finance theory points to the existence of economies of scale in the provision of public goods (integration allows public goods like fiscal coinsurance and a well-regulated banking system to be provided more cheaply),¹ underscoring the advantages of political integration and centralization. But it also highlights the costs of centralized provision, since populations are heterogeneous and preferences for public goods differ across groups and regions – costs that create understandable resistance to pooling responsibility for provision.

This tension is evident in how Europe has responded to its crisis. In some areas where evidence of increasing returns is overwhelming, Europe has moved toward centralized provision. Examples include centralized provision of backstop facilities for sovereign debt markets (the European Central Bank's Outright Monetary Transactions) and creation of the Single Supervisor (with responsibility for oversight of the banking system).

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¹ See e. g. W. Buchanan: An Economic Theory of Clubs, in: *Economica*, Vol. 32, No. 125, 1965, pp. 1-14.

In other areas, however, the benefits of centralized provision are dominated by the costs of uniformity, creating resistance to further centralization. This is true most obviously of fiscal policy, where different countries have different tastes (insofar as countries, as distinct from individuals, have tastes) for fiscal rectitude and stabilization, and different degrees of tolerance of debt and deficits. This heterogeneity in turn creates a problem of trust. Can those formulating and executing the common policy be trusted to do so in a manner consistent with a group's tastes? This is analogous to the problem that results in an undersupply of public goods like policing and schools in localities where the population is heterogeneous, wherein each group is reluctant to pay additional taxes for fear that the resources so mobilized will go to pay for public goods valued by other groups but not by their own.²

In what follows we use these insights from theory and history to guide our discussion of the minimal conditions for the survival of the euro. The conclusion we reach is that for the single currency to survive, Europe needs both more political integration and less political integration. The trick is to understand when less is more.

The European Central Bank

The first of our four minimal conditions for the survival of the euro is a normal central bank that is able to pursue flexible inflation targeting and to backstop financial markets in government bonds, thereby protecting the euro area from potentially self-fulfilling crises. These are functions in a monetary union that must be provided at a centralized level if they are to be provided at all. Given the existence of a single monetary policy, there is little scope for governments to influence domestic inflation rates. National central banks (which partner with the ECB in the European System of Central Banks) can advance credit to domestic banks requiring liquidity only against eligible collateral and with the approval of the ECB to provide emergency liquidity assistance (ELA). Sovereigns, not having recourse to a national central bank, have limited ability to backstop their financial markets unilaterally.

As conceived initially, the ECB did not provide these functions. The bank's two-pillar strategy focused not just on inflation but also on growth of a talismanic monetary aggregate that bore no stable relationship to inflationary outcomes. Rather than adopting a symmetric inflation target, it pursued a target of less than but close to two per cent, dangerously skirting deflationary territory. Under the presi-

dency of Jean-Claude Trichet, it concentrated on headline rather than core inflation, leading it to raise interest rates in 2008 and 2011, when deflation was the fundamental underlying danger. It threatened to terminate ELA for Ireland in 2010 unless its government applied for a bailout and agreed to a program of austerity and bank recapitalization.³ It stopped ELA for Greece in 2015 until the government agreed to a program rejected by voters in a referendum. It hesitated to adopt unconventional monetary policies when interest rates fell to the zero lower bound. It was reluctant to intervene with purchases of government bonds when investors doubted the "essential cohesion" of the euro area,⁴ fearing that the German Constitutional Court would rule such action incompatible with that country's Basic Law.

Hearteningly, the ECB has now moved some distance in the direction of becoming a normal central bank. The commencement of quantitative easing operations in March 2015 demonstrated that the members of its Governing Council understood the special, and especially dangerous, nature of deflation. In its day-to-day operations, the ECB has effectively shelved the monetary pillar and now more carefully and systematically distinguishes core from headline inflation. While a symmetric inflation target and a smaller, nimbler monetary policy committee are still required, these are steps in the requisite direction.

What is now required to cement this progress? First, the ECB needs to heighten its transparency to correspond with its greater discretion and the breadth of powers invested in a normal central bank. Transparency is a mechanism for holding an independent central bank accountable in the court of public opinion. It is a way of communicating to constituents that policies are being implemented with the common good and not particular national interests in mind. If the presence of national representatives on the Governing Council is an obstacle to taking and publishing formal votes, then this is an argument for reorganizing the Council to reduce the presence of those national representatives. Doing so would be a very limited step in the direction of greater political integration but, in our view, a necessary one for the survival of the euro.

Second, the ECB, when undertaking purchases of government bonds in the context of quantitative easing, or conventional open market operations, needs assurance that its decisions will not be disallowed by the German Constitutional Court. This may require a change in Germany's Basic Law or an unambiguous statement by its Constitutional Court that it will accept the judgment of

2 A. Alesina, R. Baqir, W. Easterly: Public Goods and Ethnic Divisions, in: Quarterly Journal of Economics, Vol. 114, No. 4, 1999, pp. 1243-1284.

3 European Central Bank: Irish Letters, 6 November 2014.

4 M. Draghi: Stability and Prosperity in Monetary Union, Speech at the University of Helsinki, 27 November 2014.

the European Court of Justice on ECB-related matters. Changing this aspect of the Basic Law to conform to EU jurisprudence would be a limited step in the direction of political integration.

Europe's banking union

A second minimal condition for the survival of the euro is completing Europe's banking union. The crisis has underscored how banking system stability is a euro-area-wide public good which provides strongly increasing returns. One need only recall how lax regulation of French and German banks allowed these institutions to lend hand over fist to Southern European countries, which helped to set the stage for the crisis, or how the subsequent problems of some banks then threatened to destabilize others via the interbank market and related mechanisms. For good and bad reasons, member states harbor somewhat different tastes about precisely how they prefer to supervise and resolve their banks. But experience has shown that this is an area where the strongly increasing returns from centralized provision dominate the costs of uniformity. As the point is sometimes put, monetary union without banking union will not work.

To this end, euro area member states (and other EU member states that choose to opt in) have created a single supervisor of financial institutions, locating the Supervisory Board within the ECB. The Single Supervisory Mechanism (SSM) oversees large financial institutions and works closely with national supervisors overseeing other intermediaries. The SSM has already intervened to enhance the public good of financial stability, for example by limiting the exposure of Greek banks to the Greek government and more generally by pressing the banks it supervises to reduce home bias in their sovereign bond portfolios.⁵

In addition, the European Parliament and Council have adopted a common mechanism for resolving failed financial institutions, the Bank Recovery and Resolution Directive. This obliges all EU governments to bail in unsecured creditors before tapping taxpayer funds, requiring members to implement these rules through national legislation. Again, these are limited but necessary steps in the direction of financial and political centralization.

A political "bridge too far" has been the creation of a common bank deposit guarantee fund in which money from all euro area members will be pooled to guarantee that bank accounts up to €100,000 are fully insured. Under the terms of the banking union, member states are now required to

establish conforming insurance schemes for accounts up to this ceiling – the crisis having shown that non-uniformity and, in some cases, the absence of deposit insurance can threaten confidence and financial stability throughout the monetary union. But deposit insurance is only confidence-inspiring if the funds standing behind it are adequate to meet potential claims, and the members of a monetary union, not being able to resort to central bank finance, may find it difficult to come up with the necessary funds in extremis. This is why deposits in the United States, following experience with state bank holidays in the 1930s, are federally rather than state-insured.

Some countries, notably Germany, worry that other members will be more prone to draw on the fund (German commentators regularly cite Greece as a case in point). They reject mutualization of deposit insurance as a de facto fiscal transfer. The response comes in three parts. First, banking stability is a valuable public good which generates sufficiently increasing returns so as to warrant centralization of the deposit insurance function. Second, all member states, not least Greece, are required to implement the banking union's new resolution rules to limit taxpayer liability. Third, this is a limited and specific mutualization of fiscal powers targeted at a specific financial problem intimately associated with monetary union, not the wholesale centralization of fiscal control at the level of the European Union or the euro area.

Centralization of fiscal functions

This of course begs the question of whether the wholesale centralization of fiscal functions is desirable – or whether monetary union without fiscal union will work. Since the Maastricht Treaty and the Stability and Growth Pact, there have been repeated efforts to centralize EU fiscal policies. These early attempts have now been supplemented by further initiatives by the European Commission, including the Six Pack, the Two Pack, the European Semester, and a new treaty (the Treaty on Stability, Coordination and Governance in Europe).

The one thing these measures have in common is that they do not work. EU member states have profoundly different preferences with regard to fiscal policy. They are reluctant to mutualize fiscal resources or delegate decisions over national fiscal policies to the Commission and the European Parliament, since the consequent decisions would differ markedly from the preferences of some members. The framework in which taxes are raised and public spending is structured is intimately bound up with the details of each nation's culture and history. Fiscal policy is fundamentally political and distributive, limiting delegation even at the national level. From the start, it was evident that EU members

⁵ N. Véron: Europe's Radical Banking Union, Bruegel Essay and Lecture Series, 2015.

were reluctant to allow interference in such matters.⁶ It is unclear why the future should be different from the past.

To be sure, fiscal policy has some of the characteristics of a public good. Its macroeconomic effects spill across borders, and fiscal instability in one country can create instability in other countries insofar as one country's banks invest heavily in other countries' bonds and fiscal crises are met with multilateral bailouts. But the notion that there are strongly increasing returns from centralization can be questioned. The magnitude of direct cross-border spillovers is limited: more deficit spending by Germany raises the demand for Italian exports but also drives up interest rates in Italy, partially offsetting the first effect. If cross-border spillovers result from the bank-sovereign doom loop, then the solution is to prevent banks from holding concentrated positions in sovereign bonds, as the SSM seeks to do. If spillovers result from pressure for multilateral bailouts, then the solution is a no-bailout rule.

Is there an alternative to this doomed effort to centralize fiscal policy at the level of the Union? We would answer yes: it is to renationalize fiscal policy. This is our third minimal condition for the survival of the euro. The fiction that fiscal policy can be centralized should be abandoned, and the euro area should acknowledge that, having forsaken national monetary policies, national control of fiscal policy is all the more important for stabilization. If reckless national fiscal policies endanger the banks, then the banks should be prohibited from holding sovereign bonds. There is no reason why a no-bailout rule of the sort enforced for U.S. state governments since the mid-19th century would not then be credible. Absent expectations of a bailout, investors will pay better attention, and market discipline will be more intense. Governments in turn will have more incentive to strengthen their fiscal institutions and procedures so as to deliver better outcomes.

Removing inherited debt overhangs

Making effective use of fiscal policy for stabilization presupposes removing inherited debt overhangs in whose presence fiscal policy is unavailable. Removing those overhangs is thus our fourth precondition for the survival of the euro.

The question is whether this process is best organized at the national or EU level. Arguments can be made for both approaches. On the one hand, fiscal positions and thus preferences with regard to restructuring differ across member states. Countries with unsustainable debts will prefer to

see them restructured, whereas more lightly indebted countries will fear losses and reputational consequences. Public choice theory points to the existence of costs of uniformity and centralization in the presence of such heterogeneity.

On the other hand, the benefits of a centrally coordinated, encompassing approach are compelling when the survival of a public good, the euro itself, hinges on the outcome. A piecemeal approach in which a few countries regain fiscal flexibility but others do not is unlikely to permit the repatriation of fiscal policy to the national level, violating another of our key conditions for the survival of the euro. Individual countries may be discouraged by the stigma attached to restructuring and by the associated poor credit ratings and risk premia, with the predictable result that no country will want to go it alone, or even to go first. An encompassing approach in which debt overhangs are reduced across the euro area, allowing fiscal control to be delegated to the governments of all participating member states, will help to restore the macroeconomic and financial stability on which the euro's survival depends.

A centrally coordinated approach can also help to surmount two further obstacles to restructuring. First, it may be better able to overcome resistance from debtors. Banks in one eurozone country will typically hold bonds issued by the government of another, and European institutions like the ECB hold national debts. If one country restructures its debts, it will impair the balance sheets of its own banks but also of banks in other countries. Isolated debt restructurings do not take this externality into account, whereas a collective approach can do so. It can distribute losses due to these externalities in many ways, including assigning them entirely to the country doing the restructuring. Whatever the solution chosen, the point is that under the collective approach there will be an agreement on burden-sharing. If the agreed solution involves transfers – which is not necessarily the case, as shown below – then it will have to be agreed by officials of each country on behalf of its taxpayers rather than being imposed by a foreign authority.

The second obstacle is that debt restructuring may be seen as an encouragement to accumulate large debts in the future in the expectation that they will be restructured again. Weakening the bonding role of debt is therefore a source of moral hazard. Collective action may help to remove these objections. Member states will be aware of the risk and will demand incentives or require guarantees that countries will not act unilaterally and opportunistically in the future. The guarantees, which may take various forms – an example is provided below – may not be ironclad, but they should be compared to how the issue is dealt with under the unilateral approach.

⁶ B. Eichengreen, C. Wyplosz: The Stability Pact: More than a Minor Nuisance?, in: *Economic Policy*, Vol. 13, No. 26, 1998, pp. 67-113.

Several proposals have been advanced along these lines.⁷ Pâris and Wyplosz, for example, propose replacing a significant part of all outstanding public debts with zero-coupon perpetuities. Under their proposal, the cost of the restructuring to European institutions like the ECB can be fully financed by seigniorage income. If debts are retired in proportion to the shares of national governments in the capital of the ECB, then the benefit (debt write-down) for each country is exactly matched by the cost it incurs (the seigniorage income it relinquishes). In this case, there is no loss to debtholders and no transfer across countries. Enforcement is guaranteed by a commitment to convert the perpetuities back into debts in the event of non-compliance with the agreement. Since all countries participate, there is no stigma.

One can imagine other schemes for collectively restructuring the debt overhang of eurozone members. But irrespective of the details, some scheme must be adopted to restructure public debts comprehensively enough for eurozone countries to recover the use of their national fiscal policies. The general point is that this kind of comprehensive restructuring is easier and less costly when carried out collectively.

Once fiscal discipline and low national public debt are achieved, the no-bailout clause will have to be completed by a prohibition on ECB dealings in an individual country's debt instruments. If the ECB is able, even in theory, to purchase the debts of a government that gets into fiscal trouble, fis-

7 See inter alia L.C. Buchheit, A. Gelper, M. Gulati, U. Panizza, B. Weder di Mauro, J. Zettelmeyer: *Revisiting Sovereign Bankruptcy*, Committee on International Economic Policy and Reform, 2013; G. Corsetti, L.P. Feld, P.R. Lane, L. Reichlin, H. Rey, D. Vayanos, B. Weder di Mauro: *A New Start for the Eurozone: Dealing with Debt, Monitoring the Eurozone 1*, London 2015, CEPR; and P. Pâris, C. Wyplosz: *PADRE: Politically Acceptable Debt Restructuring in the Eurozone*, Geneva Report on the World Economy Special Report No. 3, 2014, CEPR.

cal discipline enforced by the no-bailout rule will be incomplete. There is no need for such a prohibition in the United States, since the Federal Reserve deals in federal government bonds, not the bonds of particular states. Creating the equivalent regime in the eurozone would require limiting ECB bond-market transactions to the institution's own debt instruments, Eurobonds, and bonds purchased in proportion to the central bank's capital key. Thus, the new regime would permit quantitative easing (under which bonds are purchased according to the capital key) and open market operations structured analogously, but not Outright Monetary Transactions, under which the ECB purchases the bonds of an individual troubled economy, on that country's request.

Conclusions

The eurozone crisis has shown that monetary union entails more than just sharing monetary policies, and that the common central bank must aim at more than just price stability. While completing the architecture is challenging, doing so does not require a forced march to political union. Club theory suggests that a political union is not justified at this stage.

That theory also sheds light on desirable ways of addressing the problems exposed by the crisis. We have identified four minimal conditions for solidifying the monetary union. In the case of fiscal policy, this means a decentralized solution. For the conditions of financial supervision and monetary policy, centralization is unambiguously the appropriate response. For the fourth condition, debt restructuring, either approach is possible, but we prefer a solution that involves centrally restructuring debts while allocating costs at national level.

These conditions, while necessary, are sufficient as well, or at least we hope. They should be enacted as quickly as possible.