European Economics

Eurozone Reform: Beyond Institutionalism

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The Eurozone, and the EU more generally, now stands at a crossroads with regard to its future as an economic union and political entity. Conor Judge examines the reforms needed for the Eurozone to effectively function as a stable and prosperous economic zone. He highlights the need for consideration regarding the political and social situations when analyzing possible economic solutions to the issues facing the Eurozone. He then proposes three possible policy responses, and evaluates them both in terms of economic impacts and political viability. He concludes with the insight that the key to reform is the generation of the desire and will to change, not only among officials, but more importantly among the wider population of the Eurozone.

Introduction

The rise of Macron, Merkel's coalition with the Social Democratic Party and the demise of Great Britain suggest that the EU is set to enter another period of integration. This integration must be juxtaposed against the recent Eurozone Crisis and the reforms it called for. While other European policies may fall in or out of political favour, the stability of the Eurozone remains central and any further integration must acknowledge this. In order to effectively analyse the reforms needed to improve the economic strength of the Eurozone project, we must first recognise that the economy does not function in a vacuum, but rather it is intrinsically linked with the political and sociological fabric of society. Society is not made up of rational actors, we do not have all the information and it would not only be naive but foolish to believe that a solution lies solely in the realm of economic theory. The structure of the paper is devoted firstly to explaining some of the key issues with the Eurozone's institutional framework both pre and post crisis. Building upon these concerns, various options are laid out and their implications made clear. Finally, the paper will conclude that the Eurozone and EU in general suffers from a defined, fully supported raison d'etre and without it,

whatever policy or institutions chosen are unquantifiably hamstrung.

The question of Eurozone reform would not be on the agenda were it not for the Eurozone crisis and therefore, some inspection of the causes is warranted. I have drawn heavily on the work of Baldwin and Giavazzi and their collection of pre-eminent critics with regards to the causes of the Eurozone crisis (Baldwin and Giavazzi, 2015). The consensus being that the Eurozone crisis began in the amalgamation of European currencies into one, which gave rise to no interest rate spread across national debts due to the combination of the elimination of currency risk and the ECB collateral policy for Euro denominated debt. This allowed certain nations, especially Greece, Ireland, Portugal and Spain to borrow at a rate that did not reflect macroeconomic principles on the correct pricing of risk by financial markets. This cheap borrowing allowed for cheap credit booms to induce highly leveraged private sector debt in the form of real estate in Spain and Ireland while contributing directly to public sector debt in Portugal and Greece (Feld, Schmidt, Schnabel and Wieland, 2015). Private sector debt grew to levels that were multiples of GDP but due to the Initial Stability and Growth Pact's focus on fiscal discipline, the Creditor Nations incurred no penalties before the crisis struck (Beck and Peydro, 2015).

However, when the Global financial system destabilised in 2008, and given the level of financial interdependence, the highly privately leveraged countries suffered liquidity issues in their financial institutions. In an effort to prevent insolvency, the governments of these Nations, Ireland in particular guaranteed the debt of their Banks in order to restore confidence to the markets. However, as the extent of the Balances became known, while congruently, no European institution existed to deal with a liquidity crisis which could become speculative and therefore an insolvency crisis, trust between lenders ebbed away. (Corsetti, 2015) Thus began a "Diabolic Loop" whereby Bank losses led to sovereign debt, which led to public accounts deficits and lower tax intake that prevented counter-cyclical fiscal policy, which compounded the situation further (Corsetti, 2015). The fact that nations who avoided the public debt crisis through being net lenders did not pursue an expansionary fiscal policy due to a lack of incentive also added to the ineffectiveness of fiscal policy at the depths of the recession and a deflationary bias in program countries (Bénnassy-Quéré, 2015). In addition to this, the lack of effective and timely action by institutional figures without a political consensus to act prevented speculative attacks on debt and allowed them to be self-fulfilling or in other terms, a 'sudden-stop' crisis (Baldwin and Giavazzi, 2015).

A Eurozone responded with expansionary monetary policy aimed at reversing the downturn but the ineffectiveness soon gave rise to unconventional meas-

ures that circumvented the zero lower bound. It was not truly until the political will became clear in the ECB to 'do whatever it takes' and Outright Monetary Transactions began that any type of turnaround became clear (Draghi, 2012). It must be remembered that this was an institutional action that if taken sooner, or if the mandate for it existed before the crisis would have had a significant benefit early in the Euro crisis. Given this success, the Eurozone has responded by introducing other institutional reform, or rather introduction of wholly new institutions. Financial regulation that formally existed at a national level is now ensured co-operation with the ECB in order for those who set monetary policy to have a better idea of the risk being shared across the financial institutions they affect. The DeLarosiere Report gave way to the European System of Financial Supervision that oversees financial firms in the Union and the Banking Union which sets baseline target for all banks to meet and the supervisory mechanism which keeps the largest institutions under surveillance (De Larosiére et al., 2009). In addition to this is the 'strengthening' of the Stability and Growth Pact yet again which allows for medium term balanced budgets over the business cycle, pivots towards debt-to-GDP ratios instead of deficits but also can fine countries for violation. As numerous commentators have pointed out, this is a narrow re-entrenchment of the earlier failed SGP's and is doomed to fail. Manasse argues that there exists no incentive to act correctly in 'good' times, the definitions of growth figures are vague and open to statistical failure and crucially, the imposition of fines remains counter cyclical which given the interconnected structure of the EU, only adds to further recessionary pressure (Manasse, 2010).

This is the crux of the paper EU leaders, ECB economists and European figureheads likely knew this in advance; so why are we left with inadequate institutions and what does the future hold? The answer lies in the complexities of political and sociological decision-making. The 'animal spirits' that govern the workings of the bond markets also govern the workings of democracy. Economists, as much as their belief institutions and policy is warranted, are always constrained by this. It is these social externalities of the decision that must be factored into the following policy concerns for they are worthless without it. I will begin by looking at what needs the Eurozone has after the crisis before evaluating methods of solving these issues.

Given that public debt was a 'consequence, not cause' of the crisis, a method of controlling private debt leverage is essential. The failure of nations to act in concert with each other when recession affected some but not others calls for a strong internal coordination mechanism (Beck and Peydro, 2015). This would seek to solve the divide of Debtor vs Creditor nations, and European interests vs

domestic interests. In order to do so, some shared sovereignty may be required in order to force fiscal transfers in times of asymmetric shocks without political consternation (Micossi, 2015). If fiscal transfers are not possible, then a framework for adjustment is also required one that would not be as severe or deflationary as the austerity programs in candidate countries. This should also include a framework for insolvency for, if for no other reason, to avoid uncertainty and speculation in times of crisis. Debt restructuring need also be accommodated in order to avoid the Transfer Problem that the debt itself changes the terms of trade and has a secondary impact on the heavily indebted (Pesenti, 2015).

What options exists to deal with these legacy issues of the Eurozone crisis? The obvious answer is a Political Union that has the advantage of a guaranteed common fiscal policy and eventual economic convergence. However as Wyplosz states, the fiscal union is intellectually lazy (Wyplosz, 2015). Economists cannot argue or exist in a vacuum outside of the reality of political forces against the European project. Scope exists for some type of shared sovereignty but at present, it will not be common to every member state nor will it be particularly viable given the position of the European Parliament.

A good start would be to strengthen the Stability and Growth Pact in the correct manner, not in terms of the narrow reliance on fiscal discipline but rather on the viability of sanctions particularly that of the 'No Bailouts Clause' as was envisaged in the initial Maastricht Treaty. This would require credibility at a European level and would need to also provide a framework for what exactly no bailouts mean in the context of the euro. It removes uncertainty to defaulting European Nations and protects against the moral hazard of ill-disciplined fiscal spending. This could allow some type of fiscal transfers as the largest political hurdle, especially in the North in regards to the South, is removed. However, reform of the SGP on its own is not enough, it does not protect against the mutual risk that private debt often brings as a by-product.

What is likely is a continuation of the neo-functionalist school of European co-operation whereby co-operation could be sought on smaller, more numerous issues with less political contention (Mitrany, 1948). These would address the structural imbalances that exist in European economies and allow for some form of economic convergence and eventual, fiscal convergence as a result but not aim. Papaioannou lays out some possibilities concerning investor protection, excess regulation and efficient judiciaries as some areas where economies in Europe greatly differ (Papaioannou, 2015). This has the advantage of slow but gradual highly probable reform but on the other hand, it is difficult to envisage an effect large enough to ever match the fiscal transfers required to garner true economic

convergence. It is also a rather weak way of bringing the Eurozone into the OCA criteria and will not entice a mandate on its own merits.

A possible compromise between the weakness of existing institutions and the political implausibility of Union is a system of weighted Fiscal transfers. This allows for the trilemma of financial integration, financial stability and national fiscal policy to be overcome without a guaranteed complete initial rejection (Obstfeld, 2013). This circumvents the issue of risk sharing but weighing the risk by country. It is a view advanced by some commentators (Tabellini, 2015). Claeys and Darvas (2015) who are cognizant of the issues of moral hazard between the net lenders and net borrowers of Europe. Claeys and Darvas for instance call for an easily managed system of tying public expenditure to GDP growth (excluding certain items) and public debt. This allows for counter cyclical fiscal policy when required while limiting excessive fiscal spending in inflationary periods. Tabellini's input is also useful in overcoming the opposition to public risk sharing. He states that even by virtue of the possibility of risk sharing, liquidity speculation is eradicated. Secondly, even if it were not and risk sharing is required, a mechanism can be devised that weights the riskiness of the country for those who support it. Here, the incentive (and subsequent answer to moral hazard) is for countries who are relatively riskier to lower this in the long term or pay a higher premium instead.

A further method that is relatively politically uncontentious is to merge banks so that national domestic risk is not concentrated so narrowly on the balance sheets of any one bank and the larger lenders are better able to suffer systemic shocks (Neumann, 2016). This helps to sever the sovereign-bank loop and thus allow for further weighted risk sharing. It also contributes to realize the effectiveness of the single financial services market but these are goals that private shareholders do not hold in high esteem (Gilbert, 2016). One possible option is an EU-led movement that causes Nationalized Banks to merge across international borders (Carletti, Hartmann and Spagnolo, 2003). This overcomes the lack of current reform and sets the tone for further mergers as competition is artificially distorted. However, the main issue is that any Banks currently Nationalized are most likely not in a position where a merger of their balance sheets would be a viable outcome due to legacy debt and may in fact lead to further systemic risk. However, this factor could be overcome through correct institutional guidance from either the ECB or the ESFC. Regardless of whether debt restructuring comes through fiscal agreement or private restructuring, it is essential for the continued stability of the Eurozone. At present, the highly leveraged European nations together with heavily domesticised banks will be unable to withstand an-

other asymmetric shock since once trust evaporates, lending will freeze due to no common fiscal policy, no confidence to counter failing monetary policy and default risk due to high debt making a bank and thus country potentially insolvent.

The above is perhaps one of the more politically feasible options concerning institutions and policy reforms that the EU will require in the coming years. A risk-weighted method of fiscal transfers allows for common fiscal policy and economic convergence which would bring the Eurozone into the OCA framework (Marelli and Signorelli, 2017). A merged financial sector delinks the sovereign from domestic banks and shares risk across national lines. This again forces economic convergence as there is less of a divide between national interests and European interests, and between creditors and debtors. The strengthening of the ECB's role to enforce banking regulation and correct oversight is also important but the current framework is not sufficient. It must decide whether bailouts are an option or not due to the financial risk pricing of such an eventuality is itself a key component of systemic risk. If they are, it must devise a clear and viable method for insolvency, including Euro exit as an option. Finally, it must build upon the instruments and institutions that were born in the crisis in order act efficiently next time.

All of these would be an economist's dream but they forget that the EU is not a textbook model but a real thriving population of 500 million with diverging views and outlooks. Reform based on solely on policies or institutions such as that of the Centre for European Reform miss ignoring reality. (Grant, 2013) I argue that the EU lacks a real and credible 'Why?' Economists forget that policies and reform do not engender action. It is difficult to endear voters to institutional reform where the needs are not overt and more difficult still were it to involve complicated risk weighting and financial interconnection. This may be possible but not as the sole propellant. The biggest barrier to Eurozone reform is that of conveying to voters why reform or integration is needed and overcoming divergent fears. The Eurozone lacks a reasoning that goes beyond economic theory or vague allusions to 'Europe'. It does not have the same clear goals that other integrative process had such as the CEEC's aim of distributing Marshall Aid, or the ECSC's goal of tying heavy industry for security or the wider allure of nationalism even where economic improvement is not assured. The EU exists in a vacuum somewhere between economic integration and political integration, it needs to decide where its goal is and allow citizens to decide also beyond the limit effectiveness of the European Parliament. This may envisage fragmentation and a two speed Europe (Maurice, 2017) and the further promulgation of Brexit era crises. A decision needs to be made, not just by European technocrats (Gillingham and

Tupy, 2016) but by European people (Evans, 2017) for without 'Why,' the 'What' of reform and policies lack the weight that they truly require.

In summary, this paper has laid out the problems that allowed the Eurozone crisis to happen before summarizing the responses and further issues that need resolution. It then provided three options with their benefits and barriers a neo-functionalist restructuring sector by sector, an outright political and fiscal Union and a compromise candidate of private risk sharing through interdependent financial institutions together with a risk weighted fiscal co-ordination of transfers. All of these seek to solve the issues that the Eurozone crisis has imparted before a final comment on the wider, immeasurable significance of externalities outside of economic thought.

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