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Design Failures in the Eurozone  
- can they be fixed?

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# Design Failures in the Eurozone - can they be fixed?

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## **Abstract**

I analyze the nature of the design failures of the Eurozone. I argue first that the endogenous dynamics of booms and busts that are endemic in capitalism continued to work at the national level in the Eurozone and that the monetary union in no way disciplined these into a union-wide dynamics. On the contrary the monetary union probably exacerbated these national booms and busts. Second, the existing stabilizers that existed at the national level prior to the start of the union were stripped away from the member-states without being transposed at the monetary union level. This left the member states “naked” and fragile, unable to deal with the coming national disturbances. I study the way these failures can be overcome. This leads me to stress the role of the ECB as a lender of last resort and the need to make macroeconomic policies more symmetric so as to avoid a deflationary bias in the Eurozone. I conclude with some thoughts on political unification, and the dangers of unification without democratic legitimacy.

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## **1. Introduction**

The Eurozone looked like a wonderful construction at the time it was built. Yet it appeared to be loaded with design failures. In 1999 I compared the Eurozone to a beautiful villa in which Europeans were ready to enter. Yet it was a villa that did not have a roof. As long as the weather was fine, we would like to have settled in the villa. We would regret it when the weather turned ugly (De Grauwe(1999)). With the benefit of hindsight, the design failures have become even more manifest as the ones that were perceived before the start. In this paper I analyze these design failures, and I ask the question of whether these can be fixed.

## **2. Booms and busts in capitalism**

Capitalism is a wonderful human invention that manages to steer individual initiative and creativity towards capital accumulation and ever more material progress. It is also inherently unstable, however. Periods of optimism and pessimism alternate, creating booms and busts in economic activity. The booms are wonderful; the busts create great hardship for many people.

Booms and busts are endemic in capitalism because many economic decisions are forward looking. Investors and consumers look into the future to decide to invest or to consume. But the future is dark. Nobody knows it. As a result, when making forecasts, consumers and investors look at each other. This makes it possible for optimism of one individual to be transmitted to others creating a self-fulfilling movement in optimism. Optimism induces consumers to consume more and investors to invest more, thereby validating their optimism. The reverse is also true. When pessimism sets in, the same herding mechanism leads to a self-fulfilling decline in economic activity. Animal spirits prevail (Keynes(1936), Akerlof and Shiller(2009)).

The role of banks and financial markets is key to understanding the unstable nature of booms and busts. When during a boom optimism, even euphoria, prevail, households and firms cheerfully take on more debt so as to profit from high perceived rates of return. Bankers, who are equally gripped by euphoria are

happy to oblige. As a result, a boom in consumption and investment is set in motion fueled by debt and excessive bank credit (Minsky(1985)).

When it becomes obvious that optimism was excessive and that debt is unsustainable, the inevitable crash occurs. Firms and household have to reduce their debts, banks with bloated balance sheets have to deleverage. The economy turns into a downward spiral.

This dynamics of booms and busts has been repeated so many times in history. Yet so many people are surprised when the crash occurs. This may have something to do with the fact that during the boom and the bubble, many people think “this time is different” as Reinhart and Rogoff(2009) argued (see also the wonderful classic of Kindleberger(2005)).

### **3. Stabilizers in the system: only at national level**

Since the Great Depression of the 1930s many countries have introduced stabilizing features in their economies. I will discuss two of these, i.e. the role of the central bank as a lender of last resort and the automatic stabilizers in the government budgets. These will also play a central role when I discuss the fragility of the Eurozone.

Central Banks were originally created to deal with the inherent instability of capitalism. They were not primarily set up to maintain price stability. The concern for price stability came only much later. As argued earlier, the instability of capitalism arises because of the involvement of financial institution in the booms and busts. Thus, the central bank was given the role of lender of last resort, i.e. a backstop needed to inject liquidity in financial markets when panic after a crash leads everybody to sell assets and to scramble for liquidity (Goodhart and Illing(2002)).

Right from the start the role of lender of last resort was not restricted to injecting liquidity in the banking sector. It also extended to the government bond markets. The reason is very simple and quite fundamental. It has to do with the existence of a “deadly embrace” between the sovereign and the banks. When the sovereign gets into problems the falling government bond prices threaten the

banks, which are the main holders of government debt. When the banks collapse, governments that do not want to let down the banks are threatened with insolvency. If one of the two falls off the cliff the other one is pulled down also. As a result, when central banks took on the responsibility of lenders of last resort it was understood that restricting this responsibility to the banks would be unworkable and would not stabilize the financial system. I will return to this issue when I discuss the European Central Bank as this idea was totally disregarded when that institution was created.

There is another reason why the lender of last resort commitment of the central bank was given to both the banks and the sovereign. This has to do with the fact that both suffer from a similar fragility. Their balance sheets have a similar unbalanced maturity structure. Banks borrow short and lend long, i.e. their liabilities (demand and saving deposits) are highly liquid while their assets (mortgages, long-term loans) are illiquid. As a result, in the absence of a lender of last resort, distrust in banks can trigger a run on the bank. Such a collective movement of distrust will bring down the banks even those that are solvent.

The government balance sheet has a similar unbalanced maturity structure. The liabilities of the government consist mainly of bonds that are highly liquid and can be sold almost instantaneously. The assets consist of infrastructure and more importantly of tax claims. The latter however are illiquid, i.e. the government has to go through a democratic decision process to increase tax revenues; a process that can take a lot of time. As a result, in the absence of a lender of last resort, a collective movement of distrust can lead to a liquidity crisis that can push the government into default.

The second stabilizing feature of the dynamics of booms and busts in capitalism was gradually introduced through the government budget that increasingly built in stabilizing features. These stabilizing features were essential to stabilize an otherwise unstable system for the following reason. When after the crash the private sector is in need to deleverage there is a high potential for a deflationary dynamics. This was first recognized by Keynes(1936) and by Fisher(1933).

When the private sector is in need to reduce its debt it will try to do two things. First it will attempt to save more. But as Keynes stressed this will lead to the

savings paradox. By saving more (and consuming less) output declines and so does national income. In the end less can be saved by the private sector, increasing the desire to save more. This can only be solved if the government sector is willing to save less, i.e. to increase its borrowing. Put differently if some (the private sector) wishes to save more, others (the government sector) must be willing to borrow more. If the latter does not want to do this, it prevents the former to save more and to unwind its debt.

The second way to reduce the debt is by selling assets. Thus if the private sector as a whole sells assets so as to reduce its debt, asset prices decline, thereby creating solvency problems of agents that were in no need to deleverage. These will now have to do the same and sell assets. In order to stop this downward spiral somebody (the government) has to be willing to take over the debt of private agents. In doing so, it helps the private sector to deleverage and puts a floor on the downward deflationary forces that follow a crash.

These two stabilizers, the lender of last resort and the automatic budget stabilizers, were introduced in the system at the national level. They are now relatively well organized at the level of nation states. They were not organized at the international level, nor at the level of a monetary union such as the Eurozone. This has led to the major design failures of the Eurozone, to which we now turn our attention. These design failures were only recognized after the financial crisis, also because mainstream theory about how to organize a monetary union (the optimal currency area theory) was pre-occupied with exogenous shocks not with the endogenous dynamics that is embedded in capitalism. And even then in many countries, especially in Northern Europe these design failures are still not recognized mainly because of a dramatic diagnostic failure that focuses on government profligacy as the sole source of the euro-crisis. (I will have more to say about this diagnostic failure in section 4).

#### **4. The Eurozone's design failures**

The design failures of the Eurozone find their origin in the two factors discussed in the previous section. In this section I will argue first that the endogenous



dynamics of booms and busts continued to work at the national level and that the monetary union in no way disciplined these into a union-wide dynamics. On the contrary the monetary union probably exacerbated these national booms and busts. Second, the existing stabilizers that existed at the national level prior to the start of the union were stripped away from the member-states without being transposed at the monetary union level. This left the member states “naked” and fragile, unable to deal with the coming national disturbances. Let us expand on these two points.

#### ***4.1 Booms and busts dynamics***

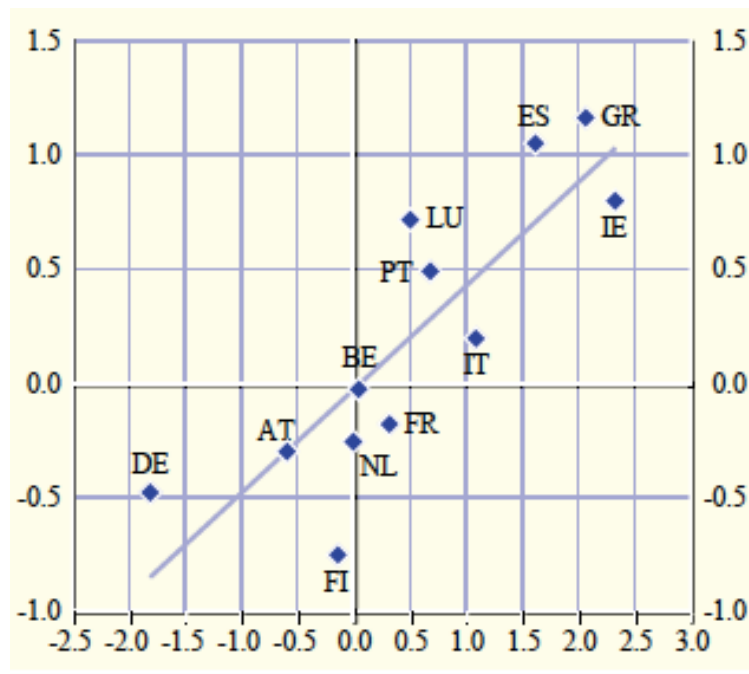
In the Eurozone money and monetary policy are fully centralized. However, the rest of macroeconomic policies has remained firmly in the hands of national governments, producing idiosyncratic movements unconstrained by the existence of a common currency. As a result, there is very little in the monetary union that can make the booms and busts converge at the Eurozone level. The effect of all this is that booms and busts originate at the national level and have a life of their own at the national level without becoming a common boom-and-bust dynamics at the Eurozone level.

In fact it is even worse. The existence of the monetary union can exacerbate booms and busts at the national level. The reason is that the single interest rate that the ECB imposes on all the member countries is too low for the booming countries and too high for the countries in recession. Thus, when in Spain, Ireland, Greece the economy started to boom, inflation also picked up in these countries. As a result, the single nominal interest rate led to a low real interest rate in the booming countries, thereby aggravating the boom. The opposite occurred in the countries experiencing low growth or a recession.

Thus, the fact that only one interest rate exists for the union exacerbates these differences, i.e. it leads to a stronger boom in the booming countries and a stronger recession in the recession countries than if there had been no monetary union.

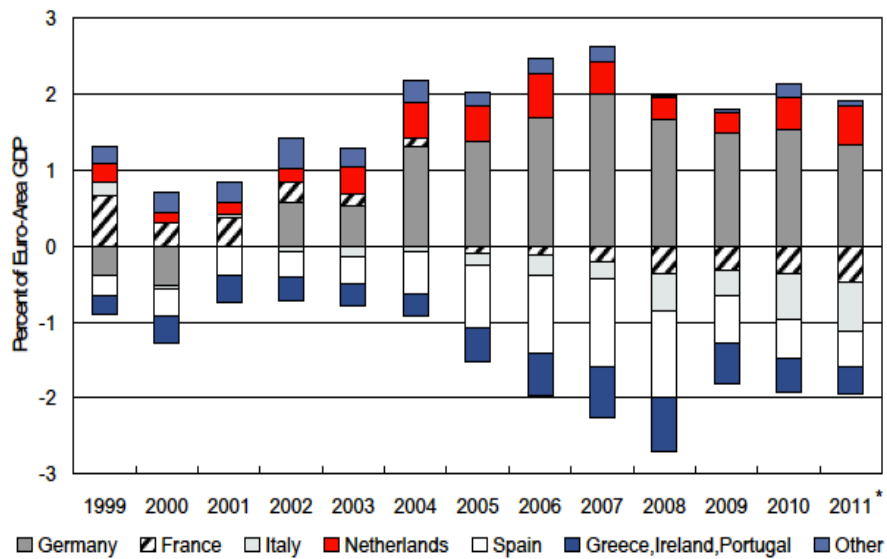
The effects of these divergent macroeconomic movements have by now been well documented. In figures 1 and 2 I show how these led to divergences in inflation and relative unit labour costs and to current account imbalances. Figure 1 shows how the booming Southern European countries (including Ireland) experienced systematically higher inflation rates and increases in unit labour costs than in the rest of the Eurozone. Figure 2 shows how these booms led to large current account deficits in the South and surpluses in the North. It is important to stress here that the booms in the South allowed the Northern European countries to accumulate large current account surpluses. These were financed by credit that the Northern European countries granted to the South. Thus in a way it can be said that Northern Europe behaved like the automobile salesman who sells cars to his customers by providing them with cheap credit. It is important to recognize this because in the North of Europe the irresponsibility of Southern countries to take on too much debt is often stressed. The truth is that for every foolish debtor there must be a foolish creditor.

**Figure 1: Average yearly inflation differential (y-axis) and average change in relative unit labour cost (x-axis) from 2002 to 2008**



Source: ECB, Monthly Bulletin, Nov. 2012

Figure 2. Euro-Area Current Accounts



Source: Citigroup, Empirical and Thematic Perspectives, 27 January, 2012

#### 4.2 No stabilizers left in place

When the Eurozone was started a fundamental stabilizing force that existed at the level of the member-states was taken away from these countries. This is the lender of last resort function of the central bank. Suddenly, member countries of the monetary union had to issue debt in a currency they had no control over. As a result, the governments of these countries could no longer guarantee that the cash would always be available to roll over the government debt. Prior to entry in the monetary union, these countries could, like all stand-alone countries, issue debt in their own currencies thereby giving an implicit guarantee that the cash would always be there to pay out bondholders at maturity. The reason is that as stand-alone countries they had the power to force the central bank to provide liquidity in times of crisis.

What was not understood when the Eurozone was designed is that this lack of guarantee provided by Eurozone governments in turn could trigger self-fulfilling liquidity crises (a sudden stop) that would degenerate into solvency problems.

This is exactly what happened in countries like Ireland, Spain and Portugal<sup>1</sup>. When investors lost confidence in these countries, they massively sold the government bonds of these countries, pushing interest rates to unsustainably high levels. In addition, the euros obtained from these sales were invested in “safe countries” like Germany. As a result, there was a massive outflow of liquidity from the problem countries, making it impossible for the governments of these countries to fund the rollover of their debt at reasonable interest rate.

This liquidity crisis in turn triggered another important phenomenon. It forced countries to switch-off the automatic stabilizers in the budget. The governments of the problem countries had to scramble for cash and were forced into instantaneous austerity programs, by cutting spending and raising taxes. A deep recession was the result. The recession in turn reduced government revenues even further, forcing these countries to intensify the austerity programs. Under pressure from the financial markets, fiscal policies became pro-cyclical pushing countries further into a deflationary cycle. As a result, what started as a liquidity crisis in a self-fulfilling way degenerated into a solvency crisis.

Thus, we found out that financial markets acquire great power in a monetary union: they can force countries into a bad equilibrium characterized by increasing interest rates that trigger excessive austerity measures, which in turn lead to a deflationary spiral that aggravates the fiscal crisis. Countries pushed into such a bad equilibrium now face long periods of economic recession that will test the political and social acceptability of a monetary system that had been presented as heaven but is now perceived to be a hell for millions of people (see De Grauwe(2011)).

The Eurozone crisis that we now witness is the result of a combination of the two design failures identified here. On the one hand booms and busts continued to occur at the national level. In fact these were probably intensified by the very existence of a monetary union. On the other hand the stripping away of the lender of last resort support of the member state countries allowed liquidity

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<sup>1</sup> Elsewhere I have argued that Greece does not fit this diagnosis. Greece was clearly insolvent way before the crisis started, but this was hidden to the outside world by a fraudulent policy of the Greek government of hiding the true nature of the Greek economic situation (see De Grauwe(2011)).

crises to emerge when the booms turned into busts. These liquidity crises then forced countries to eliminate another stabilizing feature that had emerged after the Great Depression, i.e. the automatic stabilizers in the government budgets. As a result, some countries were forced into bad equilibria (Gros(2011)).

The latter then exposed a third important design failure. Countries pushed into bad equilibria were immediately confronted with banking crises. This had to do with the “deadly embrace” between the sovereign and the banks, that we identified earlier. The collapse of the government bond prices in the countries pushed into a bad equilibrium also deteriorated the balance sheets of many banks which were holding these bonds. They were threatened by insolvency. Remarkably, only when the banks were at risk (not when the sovereigns were) did the ECB start acting and provided massive liquidity support to the banking systems of the troubled countries.

The result of the interaction between these three design failures is that the crisis in the Eurozone has degenerated into an existential crisis about the future of the union. If this existential crisis is not stopped by major structural decisions, it will work as an unstoppable dynamics destroying the Eurozone.

What are the policy implications of these insights? We analyze three of them. The first one relates to the role of the ECB; the second one has to do with macroeconomic policies in the Eurozone; the third one relates to the long-run need to move into a fiscal union

## **5. The ECB as a lender of last resort in the government bond markets**

The ECB is the only institution that can prevent market sentiments of fear and panic in the sovereign bond markets from pushing countries into a bad equilibrium. As money creating institution it has an infinite capacity to buy government bonds. The European Stability Mechanism (ESM) that became operational in October 2012 has limited resources and cannot credibly commit to such an outcome. The fact that resources are infinite is key to be able to stabilize bond rates. It is the only way to gain credibility in the market.

The ECB did buy government bonds in 2011 in the framework of its SMP program. However it structured this program in the worst possible way. By announcing it would be limited in size and time, it mimicked the fatal problem of an institution that has limited resources. No wonder that strategy did not work (De Grauwe(2012)).

The only strategy that can work is the one that puts the fact that the ECB has unlimited resources at the core of that strategy. On September 6, 2012 the ECB finally recognized this point and announced its “Outright Monetary Transactions” (OMT) program, which promises to buy unlimited amounts of sovereign bonds during crises. It is interesting to quote Mario Draghi who justified the OMT program as follows: “you have large parts of the euro area in a bad equilibrium in which you may have self-fulfilling expectations that feed on themselves” . . . So, there is a case for intervening . . . to “break” these expectations, which. . . do not concern only the specific countries, but the euro area as a whole. And this would justify the intervention of the central bank” (Financial Times(2012))

Thus, the ECB has made the right decision to become a lender of last resort, not only for banks but also for sovereigns, thereby re-establishing a stabilizing force needed to protect the system from the booms and bust dynamics. However, the credibility of the program suffers because of continuing vehement criticism. Many arguments continue to be voiced against the view that the ECB should be a lender of last resort in the government bond markets. Some of them are phony, in particular the inflation risk argument (see De Grauwe(2011), Wyplosz(2011)). Others are serious like the moral hazard risk. The latter, however, should be taken care of by separate institutions aimed at controlling excessive government debts and deficits. These are in the process of being set up (European Semester, Fiscal Pact, automatic sanctions, etc.). This disciplining and sanctioning mechanism then should relieve the ECB from its fears for moral hazard (a fear it did not have when it provided €1,000 billion to banks at a low interest rate in the context of the LTRO program at the end of 2011 and early 2012).

The continuing fierce criticism against the notion that the ECB should be a lender of last resort in the government bond markets explains why the ECB attached a

number of conditions to its OMT-program. These conditions are likely to reduce the effectiveness of that program. First, the ECB will restrict its bond purchases to bonds with a maturity of 3 years or less. There is no good economic argument to impose such a restriction. In fact, it may even increase the fragility of the sovereigns. These will now have an incentive to issue bonds with shorter maturities than they would have done otherwise, making them more vulnerable to liquidity crises.

Second, the ECB has attached as a condition to the use of the OMT-program that the countries concerned apply to the ESM which may then subject these countries to additional austerity programs. This creates the problem that countries are pushed further into a recession as a condition to obtain relief from the ECB. It is difficult to understand the economic logic of such an approach. It is in my view the result of a moralistic approach to the problem that is very popular in the North of Europe and that wishes countries applying for support to be punished first for their sins.

There is an additional danger to this second condition. The ESM will be at the center of the procedure for triggering the ECB's liquidity provision in the context of the OMT program. The decisions of the ESM, however, will de facto be subject to a veto power of Germany and other countries. The popular opposition in Germany against the ECB's lender of last resort activities may in the end prevail making it impossible for the ECB to exert these activities.

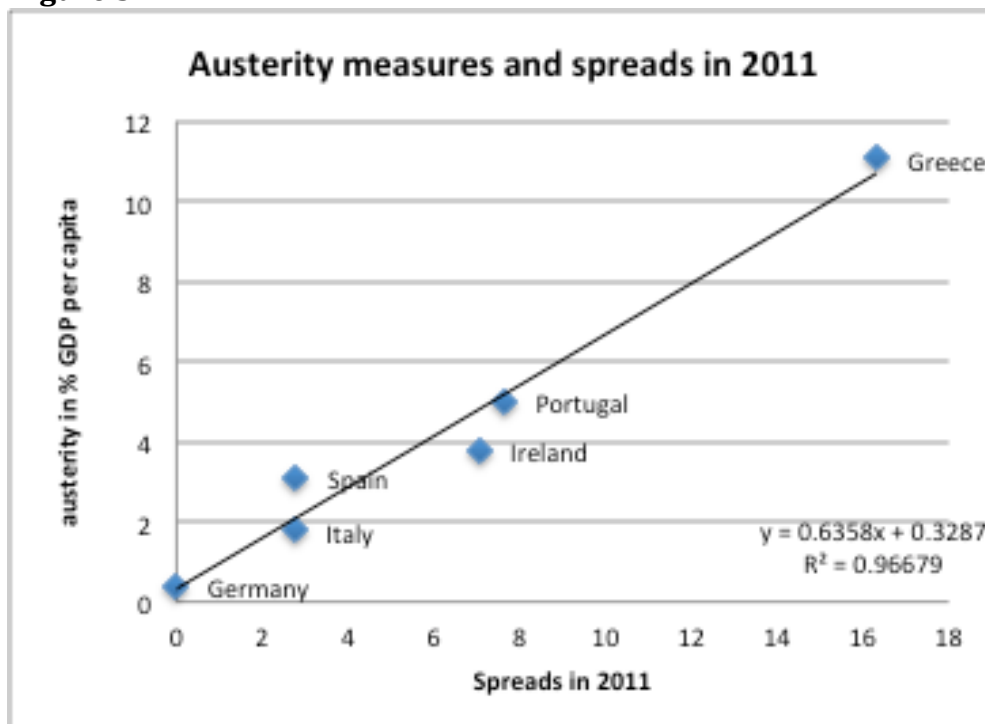
From the preceding it appears that the governance that is now being created goes against the principle of separation between liquidity provision and moral hazard control. As I argued earlier, the proper separation of responsibilities is for the ECB to act as a lender of last resort, and for the European Commission to control the moral hazard risk produced by this lender of last resort activities. The OMT program however, makes it clear that the ECB both wants to provide liquidity and for policing moral hazard risk. This also appears from the fact that the ECB is actively involved in the Troika that monitors the countries budgetary policies. This monitoring, however, is highly political. Thus the ECB gets involved in decisions about how much governments should spend, which spending cuts to apply, what taxes to raise. These are highly political decisions. A central bank

that cherishes its political independence endangers this independence if it is involved in political decision-making processes in member-countries.

## 6. Macroeconomic policies were driven by panic

Macroeconomic policies in the Eurozone have been dictated by financial markets. This is made very clear in Figure 3. This shows the average interest rate spreads<sup>2</sup> in 2011 on the horizontal axis and the intensity of austerity measures introduced during 2011 as measured by the Financial Times<sup>3</sup> (as a percent of per capita GDP). It is striking to find a very strong positive correlation. The higher the spreads in 2011 the more intense were the austerity measures. The intensity of the spreads can be explained almost uniquely by the size of the spreads (the  $R^2 = 0.97$ ). Note the two extremes. Greece was confronted with extremely high spreads in 2011 and applied the most severe austerity measures amounting to more than 10% of GDP per capita. Germany that did not face any pressure from spreads did not do any austerity.

Figure 3



<sup>2</sup> These are defined as the difference between each country's 10-year government bond rate and the German 10-year government bond rate

<sup>3</sup> Financial Times, <http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JSOwncys>



Source: Financial Times, <http://www.ft.com/cms/s/0/feb598a8-f8e8-11e0-a5f7-00144feab49a.html#axzz2JSOwncys> and Datastream

There can be little doubt. Financial markets exerted different degrees of pressure on countries. By raising the spreads they forced some countries to engage in severe austerity programs. Other countries did not experience increases in spreads and as a result did not feel much urge to apply the austerity medicine.

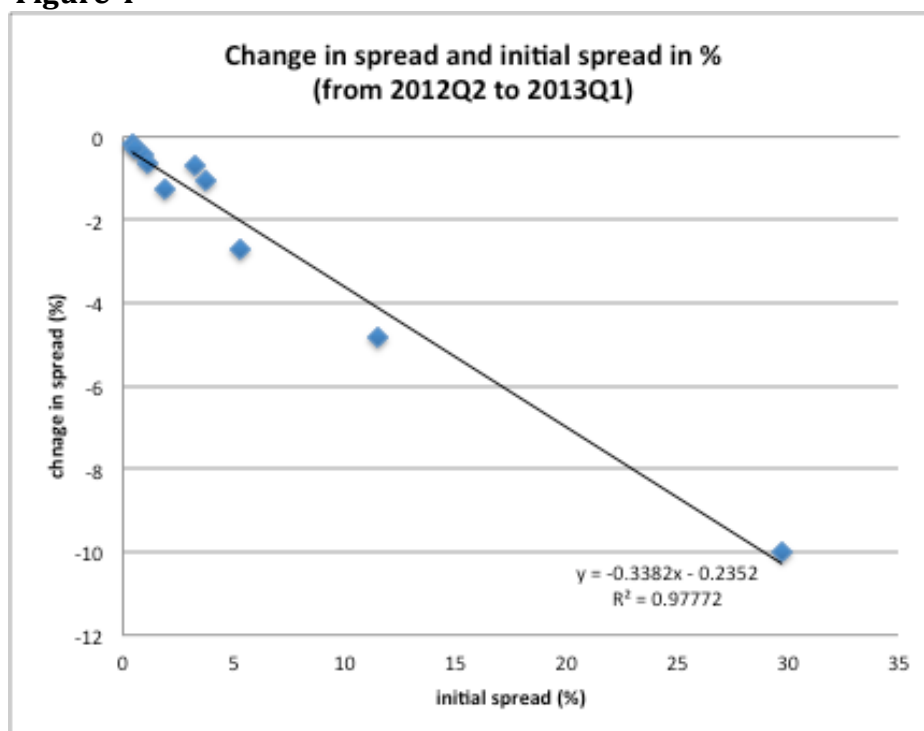
The question that arises is whether the judgment of the market (measured by the spreads) about how much austerity each country should apply was the correct one. There are essentially two theories that can be invoked to answer this question. According to the first theory, the surging spreads observed from 2010 to the middle of 2012 were the result of deteriorating fundamentals (e.g. domestic government debt, external debt, competitiveness, etc.). Thus, the market was just a messenger of bad news. Its judgment should then be respected. The implication of that theory is that the only way these spreads can go down is by improving the fundamentals, mainly by austerity programs aimed at reducing government budget deficits and debts.

Another theory, while accepting that fundamentals matter, recognizes that collective movements of fear and panic can have dramatic effects on spreads. These movements can drive the spreads away from underlying fundamentals, very much like in the stock markets prices can be gripped by a bubble pushing them far away from underlying fundamentals. The implication of that theory is that while fundamentals cannot be ignored, there is a special role for the central bank that has to provide liquidity in times of market panic (see previous section)).

The decision by the ECB in 2012 to commit itself to unlimited support of the government bond markets was a game changer in the Eurozone. It had dramatic effects. By taking away the intense existential fears that the collapse of the Eurozone was imminent the ECB's lender of last resort commitment pacified government bond markets and led to a strong decline in the spreads of the Eurozone countries.

This decision of the ECB provides us with an interesting experiment to test these two theories about how spreads are formed. Figure 4 provides the evidence. On the vertical axis I show the change in the spreads in the Eurozone from the middle of 2012 (when the ECB announced its OMT program) to the beginning of 2013. On the horizontal axis we present the initial spread, i.e. the one prevailing in the middle of 2012. We find a surprising phenomenon. The initial spread (i.e. in 2012Q2) explains almost all the subsequent variation in the spreads. Thus the country with the largest initial spread (Greece) experienced the largest subsequent decline; the country with the second largest initial spread (Portugal) experienced the second largest subsequent decline, etc. In fact the points lie almost exactly on a straight line going through the origin. The regression equation indicates that 97% of the variation in the spreads is accounted for by the initial spread. Thus it appears that the only variable that matters to explain the size of the decline in the spreads since the ECB announced its determination to be the lender of last resort (OMT) is the initial level of the spread. Countries whose spread had climbed the most prior to the ECB announcement experienced the strongest decline in their spreads. A remarkable feature.

**Figure 4**



Source: Datastream (Oxford Economics)

In De Grauwe and Ji(2012) I provided evidence that prior to the regime shift made possible by the ECB a large part of the surges in the spreads were the results of market sentiments of fear and panic that had driven the spreads away from their underlying fundamentals. The evidence provided by Figure 4 tends to confirm this. By taking away the fear factor the ECB allowed the spreads to decline. We find that the decline in the spreads was the strongest in the countries where the fear factor had been the strongest.

What about the role of fundamentals in explaining the decline in the spreads observed since the middle of 2012? In Figure 5 I provide some evidence. We selected the change in the government debt/GDP as the fundamental variable. It appears from many studies (Aizenman and Hutchinson(2012), Attinasi, et al., (2009), Beirne and Fratscher(2012), De Grauwe and Ji(2012)), that the debt/GDP ratio is the most important fundamental variable influencing the spreads. We observe two interesting phenomena in Figure 8. First while the spreads declined, the debt/GDP ratio continued to increase in all countries after the ECB announcement. Second, the change in the debt/GDP ratio is a poor predictor of the declines in the spreads (as can be seen from the regression equation). Thus the decline in the spreads observed since the ECB announcement appear to be completely unrelated to the changes of the debt to GDP ratios. If anything, the fundamentalist school of thinking would have predicted that as the debt to GDP ratios increased in all countries, spreads should have increased rather than decline.

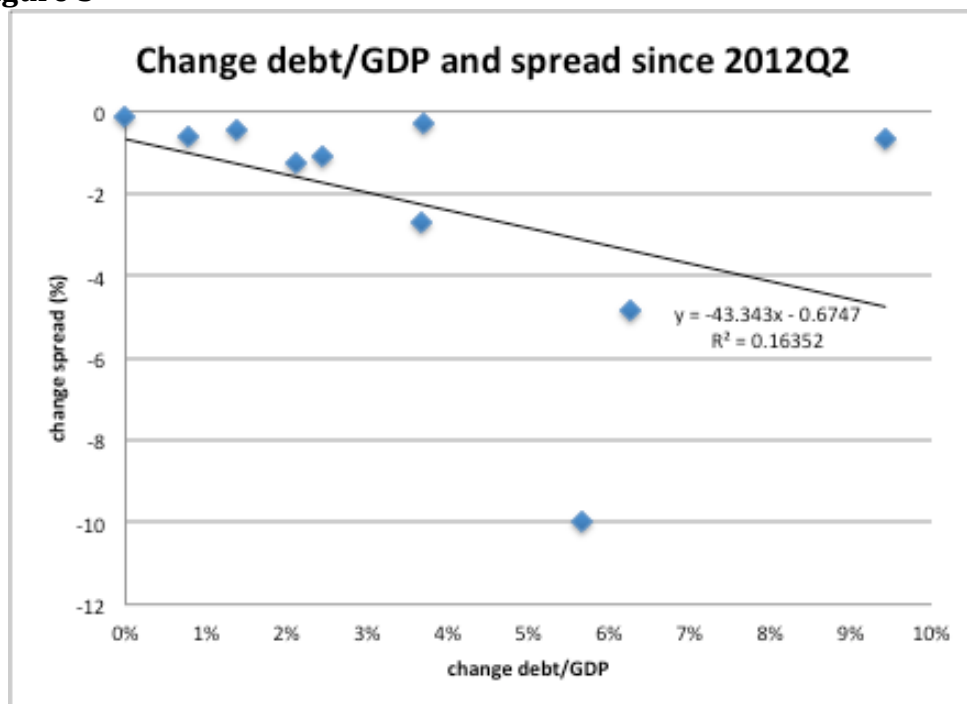
From the previous discussion one can conclude that a large component of the movements of the spreads since 2010 was driven by market sentiments. These market sentiments of fear and panic first drove the spreads away from their fundamentals. Later as the market sentiments improved thanks to the announcement of the ECB, these spreads declined spectacularly.

We can now give the following interpretation of how the spreads exerted their influence on policymakers and led them to apply severe austerity measures. As the spreads increased due to market panic, these increases also gripped policy makers. Panic in the financial markets led to panic in the world of policymakers

in Europe. As a result of this panic, rapid and intense austerity measures were imposed on countries experiencing these increases in spreads. The imposition of dramatic austerity measures was also forced by the fact that countries with high spreads were pushed into a liquidity crisis by the same market forces that produced the high spreads (De Grauwe(2011)). This forced these countries to beg “hat in hand” for funding from the creditor countries.

I am not arguing that the debtor countries do not need to return to sustainable public finances or that they can avoid budgetary austerity. What I do argue is that the budgetary austerity imposed on these countries has been too intense and has been influenced too much by panic in financial markets.

**Figure 5**



Source: Datastream (Oxford Economics)

## **7. Towards symmetric macroeconomic policies in the Eurozone**

Financial markets have split the Eurozone in two, forcing some (the Southern European countries, the “periphery”) into bad equilibria and others (mainly Northern European countries, the “core”) into good equilibria. The Southern European countries (including Ireland) are also the countries that have

accumulated current account deficits, while the Northern European countries have built up current account surpluses.

The first best policy would have been for the debtor countries to reduce and for the creditor countries to increase spending. Thus, the necessary austerity imposed on the Southern European countries could have been offset by demand stimulus in the Northern European countries. Instead, under the leadership of the European Commission, tight austerity was imposed on the debtor countries while the creditor countries continued to follow policies aimed at balancing the budget. This has led to an asymmetric adjustment process where most of the adjustment has been done by the debtor nations. The latter countries have been forced to reduce wages and prices relative to the creditor countries (an “internal devaluation”) without compensating wage and price increases in the creditor countries (“internal revaluations”). We show the evidence in Figures 6 and 7.

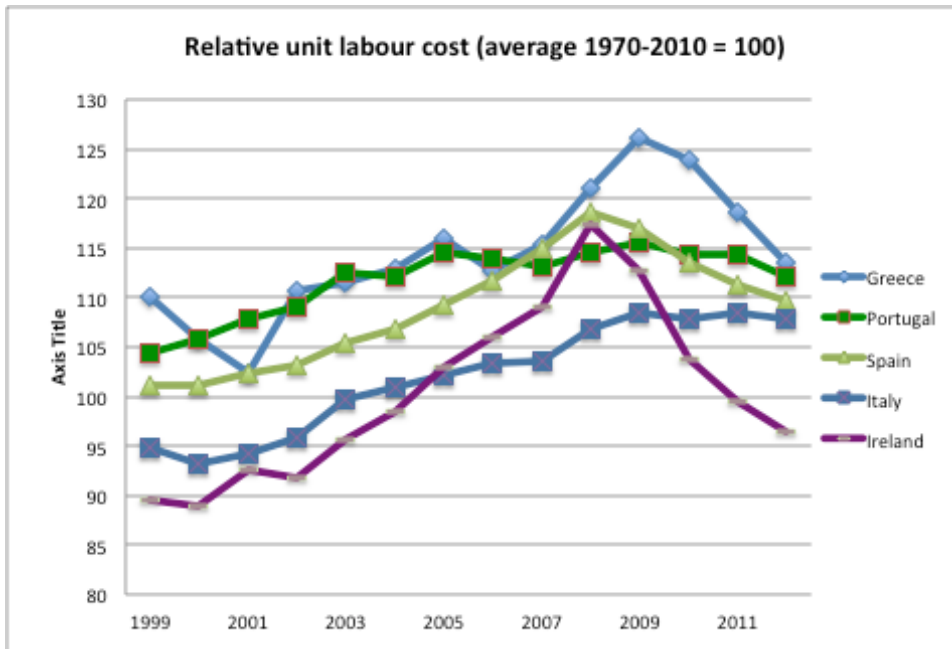
In Figure 6, I show the evolution of the relative unit labor costs of the peripheral debtor countries (where we use the average over the 1970-2010 period as the base period). Two features stand out. First, from 1999 until 2008/09, one observes the strong deterioration of these countries’ relative unit labor costs. Second, since 2008/09 quite dramatic turnarounds of the relative unit labor costs have occurred (internal devaluations) in Ireland, Spain and Greece, and to a lesser extent in Portugal and Italy.

These internal devaluations have come at a great cost in terms of lost output and employment in the debtor countries. As these internal devaluations are not yet completed (except possibly in Ireland), more losses in output and employment are to be expected.

Is there evidence that such a process of internal revaluations is going on in the surplus countries? The answer is given in Figure 7 that presents the evolution of the relative unit labour costs in the creditor countries. We observe that since 2008/09 there is very little movement in these relative unit labour costs in these countries. The position of Germany stands out. During 1999-2007 Germany engineered a significant internal devaluation that contributed to its economic recovery and the buildup of external surpluses. This internal devaluation stopped in 2007/08. Since then no significant internal revaluation has taken

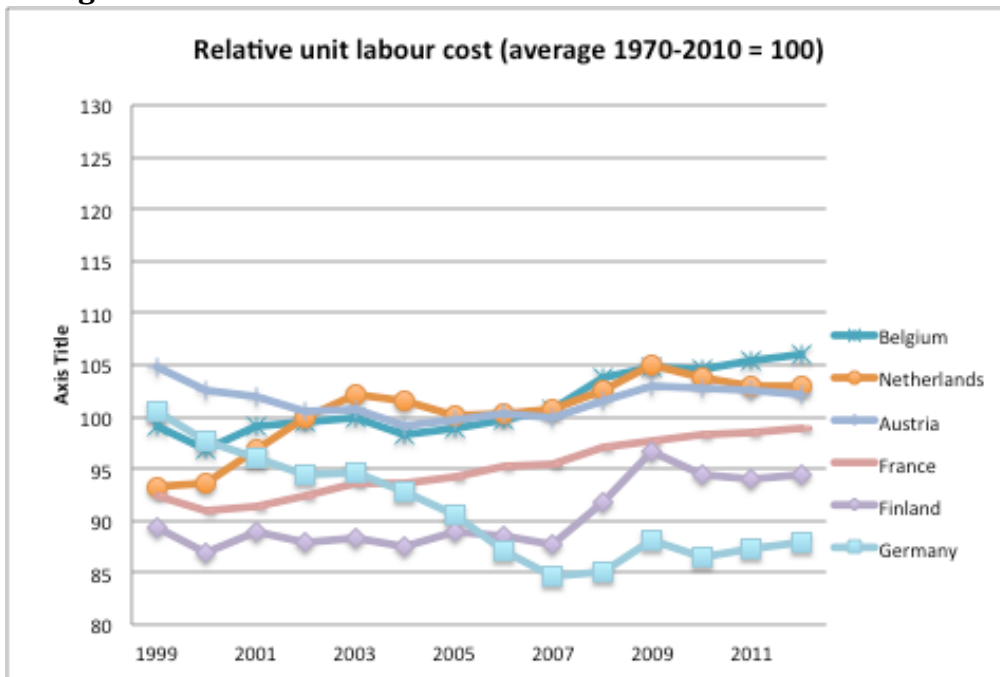
place in Germany. We also observe from Figure 7 that the other countries remain close to the long-run equilibrium (the average over 1970-2010) and that no significant changes have taken place since 2008/09.

**Figure 6**



Source: European Commission, Ameco

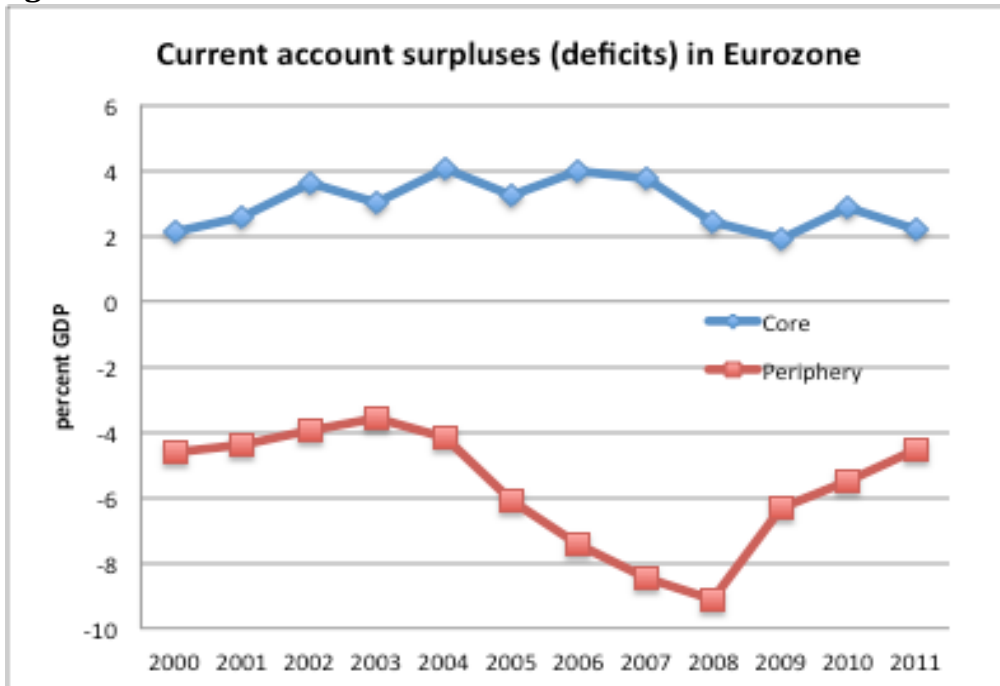
**Figure 7**



Source: European Commission, Ameco

We obtain a similar conclusion from Figure 8. There we see that the Periphery countries have started a process of reduction of current account deficits that is much more spectacular than the decline in the current account surpluses of the Core countries.

**Figure 8**



Source: European Commission

Note: Core countries are Austria, Belgium, France, Germany, Netherlands, Finland; Periphery is Greece, Italy, Ireland, Portugal, Spain

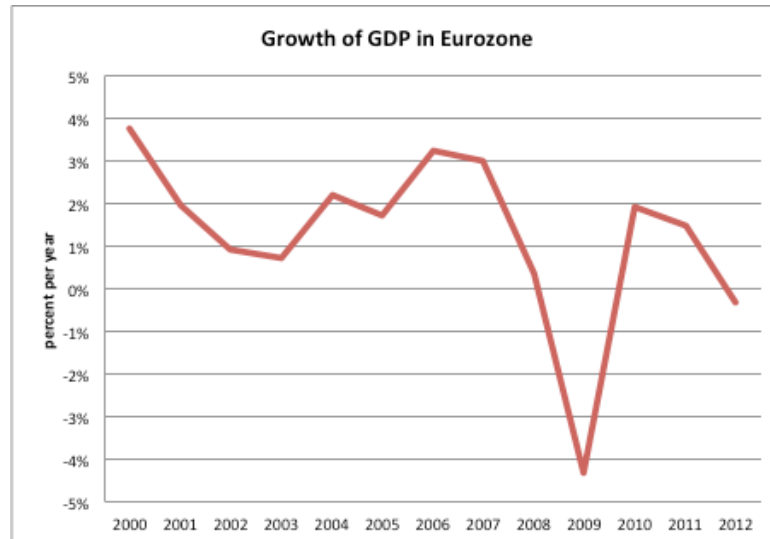
From the preceding analysis one can conclude that the burden of the adjustments to the imbalances in the eurozone between the surplus and the deficit countries is borne almost exclusively by the deficit countries in the periphery. This creates a deflationary bias that explains why since 2012 the Eurozone has been pulled into a double-dip recession as can be seen from Figure 9.

Yet macroeconomic policies in the Eurozone could be organized differently. A more symmetric macroeconomic policy could be implemented. This symmetric approach should start from the different fiscal positions of the member countries of the Eurozone. In figures 10 and 11 I show this difference. I present the government debt ratios of two groups of countries in the Eurozone, the debtor and the creditor countries. One observes from figures 10 and 11 that while the debtor countries have not been able to stabilize their government debt ratios (in fact these are still on an explosive path), the situation of the creditor countries is dramatically different. The latter countries have managed to stabilize these



ratios. This opens a window of opportunity to introduce a rule that can contribute to more symmetry in the macroeconomic policies in the Eurozone.

**Figure 9:**



Source: European Commission, AMECO

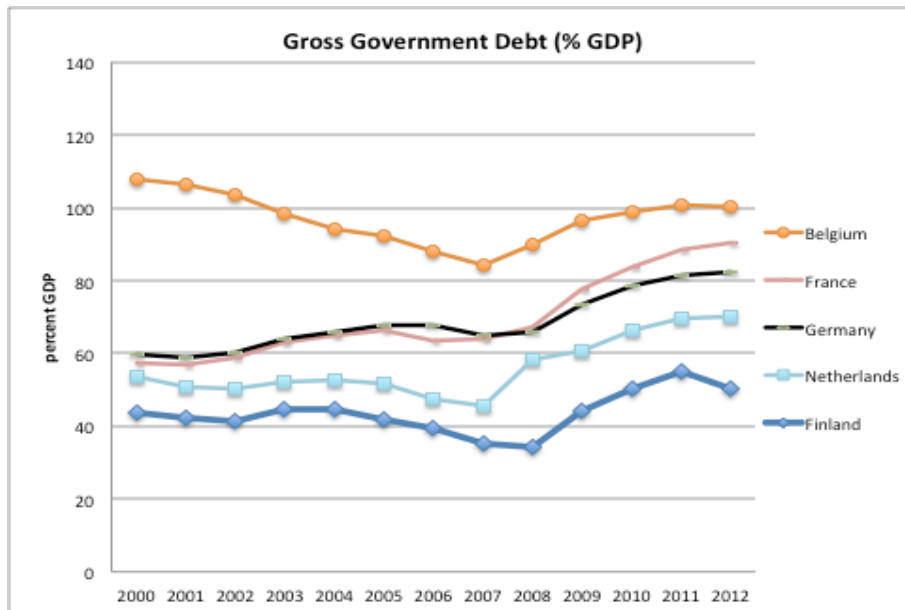
Here is the proposed rule. The creditor countries that have stabilized their debt ratios should stop trying to balance their budgets now that the Eurozone is entering a new recession. Instead they should stabilize their government debt ratios at the levels they have achieved in 2012. The implication of such a rule is that these countries can run small budget deficits and yet keep their government debt levels constant. Germany in particular which in 2013 is close to achieving a balanced budget could afford to have a budget deficit of close to 3% of GDP while keeping its debt to GDP ratio constant. This would provide a significant stimulus for the Eurozone as a whole.

It would also make it easier to deal with the current account imbalances between the North and the South of the Eurozone noted earlier. By stimulating spending the Northern countries would wind down the surpluses they have accumulated against the South. This is a necessary condition for the South to be able to reduce its current account deficits vis-à-vis the North.

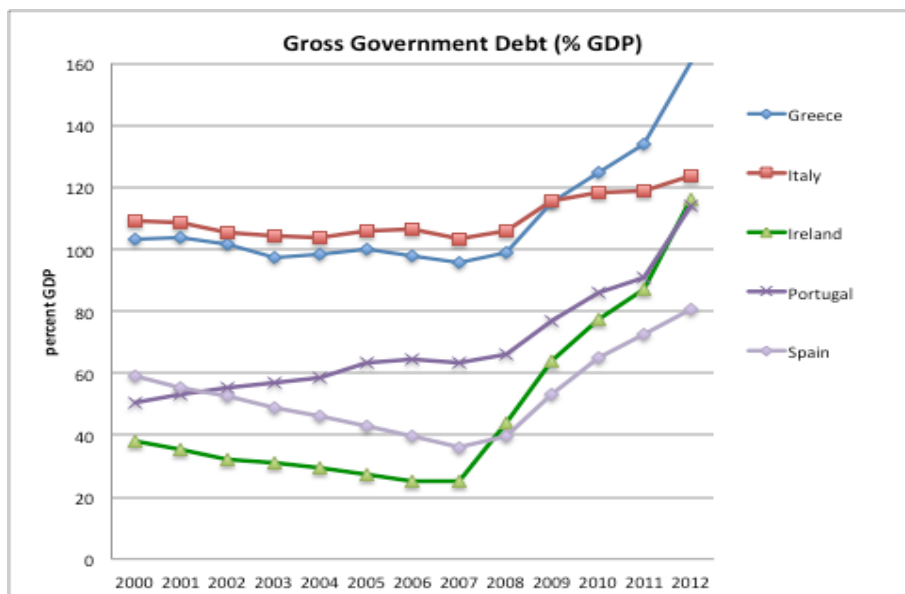
Whether the symmetric rule proposed here will be implemented very much depends on the European Commission. The latter should invoke exceptional circumstances, i.e. the start of a recession that hits the whole Eurozone and

threatens to undermine the stability of the Eurozone, and urge the creditor countries to temporarily stop trying to balance their budgets. As an alternative rule, the European Commission should convince the creditor countries that it is in their and the Eurozone's interests that they stabilize their government debt ratios instead.

**Figure 10: Gross Government debt ratios in creditor countries of the Eurozone**



**Figure 11: Gross Government debt ratios in debtor countries of the Eurozone**



Source: European Commission, AMECO

## **8. Budgetary governance in the Eurozone in search of democratic legitimacy**

I have argued that the austerity programs imposed on Southern European countries have been very much influenced by panic in the financial markets. This market panic was transmitted into policy panic that led to excessive austerity in these countries with very few favourable effects on the public finances in these countries (see De Grauwe and Ji(2013)). What is even worse is the following. The market panic that led to ill-designed austerity programs also led to ill-designed reforms in the budgetary governance of the Eurozone. These reforms (the so-called two-pack legislation) undermine the democratic legitimacy of the new decision making process in the budgetary field within the Eurozone and should be rejected.

Under the “two-pack” legislation, member governments will have to present their budget proposals to the European Commission by 15 October each year, prior to being introduced in the national parliaments. “If an examination of the draft budget reveals a serious noncompliance with the budgetary obligations laid down in the Stability and Growth Pact, the Commission will request a revised draft budget”. (European Council, Brussels, 28 February 2013, 6866/13).

This may seem innocuous, but it is a significant step that together with the powers the Commission has under the rules of the Stability and Growth Pact (SGP), including its sanctioning mechanism, undermines the democratic principle of “no taxation without representation”. The European Commission defends this procedure by stressing that it is only implementing these various budgetary rules that have been approved by the European and national parliaments, and that ultimately the national budgets are voted in the national parliaments giving it its full democratic legitimacy. There can be no doubt that there is full legitimacy in the legal sense. But that does not mean that it has political legitimacy.

The line of defence taken by the Commission overlooks another dimension of the principle “no taxation, without representation”. This is that those who take the decision to tax should bear the political cost of that decision, i.e. they should be held responsible before the population of voters who can punish them by taking

away their power to tax. The problem with the SGP and the new procedure of the “two-pack” is that the Commission which can force governments to raise taxes and/or cut spending completely escapes all political responsibility for its decision. Instead the national governments that are compelled to follow the Commission’s decisions (backed by possible sanctions that now have been made easier through the reverse majority voting system in the Council) bear the full political cost of the Commission’s decision.

The recent election result in Italy illustrates the danger of a new governance of the budgetary process that decides top down on budgetary matters without clearly defining the political responsibilities for these decisions. Under pressure of the financial markets and the European authorities, the Monti government engaged in severe austerity measures that have pushed Italy into a deep recession. The election results of February 2013 indicate that the Italian voters have punished Mario Monti, a prime minister who faithfully executed the austerity policies that others in Brussels and other capitals pressured him to apply. Those who put the pressure went unpunished by the voters, and can continue to apply these policies unchecked by any political accountability.

This is the model that is now being formalized in the Eurozone. The European leaders, in particular the European Commission are given wide-ranging powers to force countries to impose more taxes and/or to cut spending without any political control on the way this power is exerted. Instead the political control is exerted on those who have less and less power to decide about taxation and spending. This model is a step back in the historical process towards more democratic legitimacy of political decisions in the European Union. If the process of political integration implies that basic principles of democratic legitimacy are undermined it is better to have less political integration in the Eurozone.

## **9. A monetary union embedded in a fiscal and banking union**

Economists have long recognized that ultimately the monetary union will have to be embedded in a fiscal union. Put differently, the euro is a currency without a country. To make the euro sustainable a country will have to be created. An

essential component of a country is a central authority capable of raising taxes and to spend for the whole of the union. Such a fiscal union, however, is so far off that we have to think of other embedding procedures that are less ambitious, yet achieve the result of making the Eurozone sustainable in the long run. Do there exist such procedures that will strengthen the Eurozone and make it sustainable in the long run? I believe they exist. Let me list what the necessary ingredients are of such embedding procedure.

First, as the previous diagnosis of the design failure of the Eurozone has made clear, one has to look at measures that will make the national government less fragile and less subject to movements of distrust. One cannot ask the ECB to continuously extinguish fires.

This leads to the idea that some form of pooling of government debts is necessary to overcome this fragility. By pooling the government debts one shields the weakest in the union from destructive movements of fear and panic that regularly arise in financial markets of a monetary union and that can hit any country. Those who are strong today may become weak tomorrow and vice versa.

Of course, not any type of pooling of national debts is acceptable. The major concern of the strong countries that are asked to join in such an arrangement is moral hazard, i.e. the risk that those who profit from the credibility of the strong countries exploit this to reduce their efforts aimed at reducing debts and deficits. This moral hazard risk is the single most important obstacle for pooling debts in the Eurozone. The second obstacle is that inevitably the strongest countries will pay a higher interest rate on their debts as they become jointly liable for the debts of governments with lesser creditworthiness. As a result, debt pooling must be designed in such a way as to overcome these obstacles.

Here are three principles that should be followed to design the right type of debt pooling. First it should be partial, i.e. a significant part of the debt must remain the responsibility of the national governments, so as to give them a continuing incentive to reduce debts and deficits. Several proposals have been done to achieve this (e.g. Delpla and von Weizsäcker(2010)). Second, an internal transfer mechanism between the members of the pool must ensure that the less

creditworthy countries compensate (at least partially) the more creditworthy ones (De Grauwe and Moesen(2009)). Third, a control mechanism on the progress of national governments in achieving sustainable debt levels must be an essential part of debt pooling. The Padoa-Schioppa group(2012) has recently proposed a gradual loss of control over their national budgetary process for the sinners against budgetary rules. However, as I stressed in the previous section, this disciplining mechanism should not escape the rigours of democratic legitimacy. If it does, as the present two-pack legislation, it will be rejected by large parts of the population, and rightly so.

A second ingredient of an embedding procedure is a banking union. Such a banking union is necessary for two reasons. First, since the ECB is the lender of last resort for the Eurozone banking system, the regulation and the supervision cannot be kept at the national level anymore. Liquidity provisions by the central bank create moral hazard risk. These risks must be controlled at the same level as the level at which they are created, i.e. the European one. This does not necessarily mean that the ECB should be the supervisor (probably not). It implies that supervision should be organized at the European level by a European institution. The EBA was created to become such an institution. Unfortunately, it has received insufficient resources to implement its supervisory role.

The second reason why a banking union is necessary is that it allows to cut “deadly embrace” between sovereign and banks that we have stressed earlier. A common bank resolution mechanism allows the cost of resolving banking crises to be spread over the whole union. This is a key ingredient of the banking union that exists in the United States. It has allowed states like Nevada that had experienced a similar real estate boom and bust as Ireland, to escape from the deadly embrace. Many Nevada banks that, as their Irish counterparts, were heavily involved in the real estate boom, faced bankruptcy when the crash occurred. The resolution of the crisis was taken care of by the US federal government thereby shielding the Nevada state government from the budgetary fallout of these resolutions. Daniel Gros(2012) has estimated that this centralization of the cost of resolving the Nevada banking crisis amounted to a transfer from the Federal Government of more than 10% of Nevada GDP. No

such central mechanism existed in the case of Ireland. As a result, the Irish government had to bear the whole burden of the costs of bank resolution. This pulled the Irish government into a default crisis, forcing extreme austerity and depression like increases in unemployment. The same happened in Spain.

The previous discussion makes clear that a workable banking union also implies some form of fiscal union. In times of crisis there must exist one or more European institutions with sufficient resources that can be mobilized immediately to intervene and to recapitalize banks. At this moment, the only existing institution that could fulfill this role is the European Stability Mechanism (ESM). One can doubt, however, whether this institution has sufficient resources to act in times of crisis. Surely, it can deal with individual cases, but probably not with systemic banking crises, involving large parts of the Eurozone banking system.

In addition, the governance structure of the ESM risks paralyzing that institution during crises. Important rescue operations need the support of each individual member-country. The fact that countries can exert a veto, is likely to make the decision making process unworkable during crises. From an intergovernmental organization, the EMS will have to be transformed into a true European institution in which qualified majority will be the rule. In order to do this, the amount of trust within the Eurozone will have to increase. The fact that member-countries of the Eurozone have insisted on maintaining unanimity within the EMS expresses the deep distrust that exists between these countries.

## **10. Conclusion**

The recent decision by the ECB to act a lender of last resort is a major regime change for the Eurozone. It has significantly reduced the existential fears that slowly but inexorably were destroying the Eurozone's foundations.

The ECB's new role although necessary is not sufficient, however, to guarantee the survival of the monetary union. Signals must be given that the Eurozone is here to stay. These signals are, first a partial debt pooling that ties the hands of

the member countries of the Eurozone and shows that they are serious in their intentions to stick together.

Second, it implies that macroeconomic policies be made more symmetric. The asymmetric nature of the macroeconomic adjustments that puts most of the adjustment burden on the deficit countries has created a deflationary bias in the Eurozone. It also explains the double dip recession into which the Eurozone has been pushed at the end of 2012. More symmetric macroeconomic adjustment mechanisms are key to avoid a long and protracted deflation that will not be accepted by large parts of the Eurozone population. Indeed the greatest risk for the survival of the Eurozone today is the risk emanating from social and political upheavals in countries that are forced into a deflationary spiral. Thus while the ECB's decision to act as a lender of last resort has reduced the risk of a financial implosion, this risk has been substituted by a new risk, i.e. the risk of implosion due to uncontrollable social and political disturbances in the South of Europe.

Finally, in the long run the monetary union will have to be embedded in a significant fiscal union. This is probably the hardest part of the process to make the Eurozone sustainable in the long run, as the willingness to transfer significant spending and taxing powers to European institutions is very limited. It remains a necessary part, though. Without significant steps towards fiscal union there is no future for the euro. I have highlighted a number of small steps that can be taken now and that create a signal about the political commitment to move forward on the road to more integration. These steps have to be taken now as they act as signals of the resolve of the Eurozone countries that the union is here to stay.

However, the moves towards political unification should not come at the cost of a loss of democratic legitimacy. I have argued that this is the case with the recent introduction of the "two-pack" legislation. The latter transfers considerable power to the Commission without this power being checked by political control. The European Commission, which now obtains de facto power to force national governments to impose additional taxes or to cut spending, escapes the political accountability for these decisions. Such a model of integration should be rejected now. If not, it will lead to great conflicts in the future and a slow but steady



further erosion of the willingness of the European populations to move forward into a political union.

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