ECONSTOR
Make Your Publications Visible.

A Service of
ZBW
Leibniz-Informationszentrum Wirtschaft
Leibniz Information Centre for Economics

Schmidt, Christoph M.

Article

Stabilizing the Euro: Where Do We Stand?

ifo DICE Report

Provided in Cooperation with:
Ifo Institute – Leibniz Institute for Economic Research at the University of Munich

Suggested Citation: Schmidt, Christoph M. (2018) : Stabilizing the Euro: Where Do We Stand?, ifo DICE Report, ISSN 2511-7823, ifo Institut – Leibniz-Institut für Wirtschaftsforschung an der Universität München, München, Vol. 16, Iss. 3, pp. 5-10

This Version is available at:
https://hdl.handle.net/10419/199030

Standard-Nutzungsbedingungen:

Die Dokumente auf EconStor dürfen zu eigenen wissenschaftlichen Zwecken und zum Privatgebrauch gespeichert und kopiert werden.

Sie dürfen die Dokumente nicht für öffentliche oder kommerzielle Zwecke vervielfältigen, öffentlich ausstellen, öffentlich zugänglich machen, vertreiben oder anderweitig nutzen.

Sofern die Verfasser die Dokumente unter Open-Content-Lizenzen (insbesondere CC-Lizenzen) zur Verfügung gestellt haben sollten, gelten abweichend von diesen Nutzungsbedingungen die in der dort genannten Lizenz gewährten Nutzungsrechte.

Terms of use:

Documents in EconStor may be saved and copied for your personal and scholarly purposes.

You are not to copy documents for public or commercial purposes, to exhibit the documents publicly, to make them publicly available on the internet, or to distribute or otherwise use the documents in public.

If the documents have been made available under an Open Content Licence (especially Creative Commons Licences), you may exercise further usage rights as specified in the indicated licence.

WWW.ECONSTOR.EU

Mitglied der Leibniz-Gemeinschaft

Christoph M. Schmidt

Stabilizing the Euro: Where Do We Stand?[1]

Christoph M. Schmidt
RWI and GCEE.

In its coalition agreement and in the months following its formation, the current German government provided strong indications that European issues are taking centre stage on its political agenda. In principle, this is good news for European integration. But the actual steps taken in this respect will be crucial to the success of this endeavour. Ultimately, only an incentive-compatible European architecture will constitute a sustainable engine of peace and prosperity. In my assessment, the key to ascertaining this stable architecture will be the adamant insistence on three essential principles: subsidiarity, the alignment of liability and control, and unity in diversity.

By and large, the political decisions taken over the last couple of years have been in line with these principles. Eurozone reforms have transformed its architecture mainly, albeit not exclusively, in the direction of the concept proposed by the German Council of Economic Experts (GCEE) as "Maastricht 2.0" (GCEE 2015; Feld et al. 2016a and 2016c). But more recent political rhetoric at the European level has emphasized quite different themes, as shown, for instance, by the Five Presidents' Report (Juncker et al. 2015), the subsequent White Papers and the joint Meseberg Declaration (2018) made by the German and French government. Some elements of these proposals could even jeopardize the long-term stability of the Eurozone if implemented. Instead, European policymakers should recall the three essential principles to identify the correct steps to be taken in the right order in their commendable quest for a more sustainable Eurozone.

CONCEPTUAL CONSIDERATIONS

Any approach to sorting out these intricate issues has to depart from the insight that, in many respects, the Eurozone is an arrangement without historical precedent; namely a monetary union whose individual member states retain sovereignty when it comes to fiscal and economic policy decisions and which – at the same time –operates in an historically unprecedented environment. Today, financial markets and, thus, beliefs about the sustainability of institutional arrangements, matter tremendously to the actual stability of these arrangements. This makes it difficult to decide on the best institutional arrangements for this monetary union.

Two fundamental – and in principle equally attractive – views of how to construct such a stable architecture collide. A first perspective stipulates that the monetary union needs a balancing counterpart in the realm of fiscal and economic policy, with substantial discretion for intelligent policymaking. Fuelled by a serious dose of scepticism regarding the capabilities of policy makers to display such superior conduct, a second perspective emphasizes the idea that pre-determined rules and their adamant enforcement liberate policymakers from the shackles of time inconsistency, effectively leading to better policy outcomes.

Since the lack of empirical precedent makes it almost prohibitively difficult to decide upon the relative quality of these perspectives just by recalling previous experiences with monetary unions, one is thrown back to some extent to discuss the matter on basis of key principles (Schmidt 2017). My thesis is that – perhaps inadvertently – three key principles have guided the fortification of the Eurozone institutions throughout the crisis years, and that it would be quite sensible to complete these steps towards precisely one of the two possible arrangements that promise the sustainability of the euro, namely "Maastricht 2.0". These principles are:

Subsidiarity: joint action should be limited to issues for which individual action severely lacks effectiveness, e.g. due to externalities or economies of scale. This principle respects the heterogeneity of preferences, institutions, history, etc.

Alignment of liability and control: to avoid distributional conflicts, one should adamantly avoid a mismatch between decision-making power and responsibility for the consequences of the decisions made (Feld et al. 2015).

Unity in diversity: it is no coincidence that the motto under which integrated Europe is striving for peace and prosperity actively embraces the diversity that characterises the union, in a deliberate attempt to learn from one another (Feld et al. 2016d).

While completing these steps would arguably be quite sensible, implementing measures that are incompatible with the "Maastricht 2.0" concept might even be counterproductive.

HOW THE CRISIS UNFOLDED

The crisis in the Eurozone relentlessly unveiled the two fundamental structural weaknesses of the Eurozone's original architecture:

Prevention arrangements were insufficient; banking regulation was flawed and the no-bail-out clause was not credible, and thus failed to ascertain fiscal discipline (Feld et al. 2016b).

There were no crisis mechanisms installed for the unlikely, albeit (in hindsight quite obviously) possible case of member states losing market access.

Correspondingly, the crisis triggered an intense discussion of both crisis prevention and management.

[1] I'm very grateful to Sebastian Breuer, Wolf Reuter, and Astrid Schürmann for their constructive comments.

In this process some aspects of the phenomenon were simply rediscovered: with the concept of monetary union, or European integration, the idea of forging a single market for goods, services, capital and labour, was combined with the provision of a single currency. This inevitably eliminated a dimension of macroeconomic adjustment that was previously available to member states – namely the devaluation of their own currency. In this sense, forging the Eurozone created a sort of "super-globalisation" process, with even stronger requirements regarding the flexibility of product and labour markets.

With one dimension of macroeconomic adjustment less at their disposal, member states' governments were required to ascertain that any necessary macroeconomic adjustment would be facilitated by smoothly functioning labour and product markets. It was clear from the start of the first considerations towards the formation of the monetary union that member states' governments would have to implement a broad spectrum of structural reforms aimed at boosting the growth potential of their economies as a result, and that they would have to demonstrate stern budget discipline to retain their room for manoeuvre in the case of a crisis.

In hindsight it is clear that several member states have failed to comply with these requirements sufficiently. Yet, this neglect was difficult to detect in real time, as the Eurozone members at the Southern periphery in particular experienced a credit-fuelled boom in the pre-crisis period. Had this temporary phenomenon been identified correctly as unsustainable, and had it not been mistaken by many observers as a permanent increase in the growth potential of these member states, many painful discussions could have been avoided. In reality, European policy makers discovered these underlying deficiencies of the Eurozone architecture the hard way during a severe crisis.

Over the course of the Eurozone crisis, its architecture was fortified step by step, by improving prevention measures and implementing mechanisms to deal with crises. Nevertheless, in the summer of 2012 the Eurozone was on the verge of breaking up – the GCEE at the time suggested dealing with legacy debt by installing a debt redemption pact (GCEE 2012), consisting of the inseparable combination of a debt redemption fund together with heavy obligations regarding structural reform and budget consolidation. In the GCEE's assessment, compliance with the pact would have been enforced by the then existing substantial risk premia for sovereign bonds.

This did not happen. Instead the ECB announced its OMT programme, and ECB President Draghi announced that the ECB would stabilize the Eurozone, "whatever it takes." This effectively eliminated speculation as to the premature demise of the monetary union and subdued risk premia, providing the basis for economic recovery, albeit at the expense of increasing risks to financial stability. When the crisis appeared to reignite in early 2015 – and it was feared that deflationary tendencies could take hold – the ECB implemented a second series of large-scale TLTROs and its QE programme. Basically, that's where we stand right now, when it comes to assessing the current macroeconomic outlook.

Figure 1

Real GDP Growth and Output Gap

Source: European Commission; Eurostat; Federal Statistical Office; GCEE. © ifo Institute

Figure 2

Unemployment Rates

Source: Eurostat; OECD; author's calculations. © ifo Institute

THE CURRENT STATE OF MACROECONOMIC AFFAIRS

The Eurozone has now experienced several years of economic recovery. The more recent years have witnessed strong and stable growth (Figure 1). GDP growth in the Eurozone has been exceeding potential growth since 2013. Overall, its prospects seem positive. Moreover, as growth has been exceeding its potential for a protracted period, output gaps have entered the positive realm. Finally, capacity utilisation in the Eurozone is rising and unemployment rates are declining (Figure 2).

In line with these observations, deflationary risks in the Eurozone have diminished considerably. Core inflation is stable, and it is expected to rise gradually with increasing capacity utilisation and protracted labour market recovery. At the same time, headline inflation has even risen above the ECB's target of just under 2% in June. Arguably, the ECB would be well-advised to take a symmetrical approach to monetary policy, and reduce its expansionary stance under the impression of rising inflation rates in a similar way as it reacted to their decline just a few years ago. Yet, it is still very expansionary, and risks to financial stability keep increasing. However, as monetary policy is not suitable for permanently boosting growth in laggard economies, a normalization of monetary policy is needed fairly soon.

As far as the price competitiveness of Eurozone economies is concerned, almost half of the competitiveness gains experienced by the German economy compared to other member states between the beginning of the century and the Eurozone crisis have now vanished. Unfortunately, however, not all large member states have managed to regain their price competitiveness (Figure 3). Despite these welcome adjustments, a remarkable diversity in the levels of member states' prosperity still remains (Figure 4). It is arguably up to national governments to implement the appropriate structural reforms to lift their potential growth rates and foster convergence.

Figure 3

Real Effective Exchange Rates

Vis-a-vis the euro area

Source: European Commission; author's calculations. © ifo Institute

Figure 4

GDP per Capita

Source: European Commission; author's calculations. © ifo Institute

A STABLE EUROZONE ARCHITECTURE

The economic recovery provides an important tailwind for fortifying the Eurozone's architecture. It is advisable to recall the fundamental principles any sustainable architecture would have to fulfil – subsidiarity, alignment of liability and control, and unity in diversity. Obviously, policy fields to consider are banking and financial markets, for which the decision was made to align liability and control at the level of the monetary union, and fiscal and economic policy, for which the original decision was an alignment at the national levels. Unquestionably, an arrangement whereby member states were making the decisions, and the community of member states was bearing the consequences would be unsustainable.

Figure 5

A Solid Framework for the Euro Area: Maastricht 2.0

Source: German Council of Economic Experts. © ifo Institute

Instead, two sustainable arrangements can be envisaged. The first would be to align decision-making power and liability at the level of the union. To work in practice, however, this arrangement should be pursued whenever preferences are fairly homogeneous, or when externalities are substantial (as for cross-border banking) and if, and only if, the member states display sufficient willingness to relegate their sovereignty to a supra-national level. The European banking and capital market union is a case in point. Although the process is incomplete and fraught with impediments, the development of joint approaches to banking supervision and restructuring is evidence of the willingness to delegate sovereignty in this policy field.

In reality, however, there is currently hardly any substantial willingness on the part of individual member states to relegate sovereignty in the field of fiscal or economic policy to a supra-national level. Consequently, an arrangement similar to the banking and capital market union is hardly advisable when it comes to areas like, for example, the organisation of labour markets. Unfortunately, this is often discussed nevertheless, and the potential adverse long-term implications of this misalignment are frequently disregarded.

The second sustainable arrangement would be to align decision making power and liability at the same national level(s). This arrangement would reflect the principle of subsidiarity and would also respect the European motto of unity in diversity. Yet in cases where fiscal and economic policy remain a national responsibility in monetary union, as in the GCEE's concept "Maastricht 2.0" (Figure 5), one would need to provide one of three potential safety valves for the crisis case:

Exit from the union: a member state under distress that left the union, would regain the adjustment lever of devaluating its national currency. There are very good reasons to be more than hesitant, as the process of European integration can hardly be as easily switched on and off as a country club membership.

Bail-out by other member states: while this is effectively what had to happen to retain the integrity of the Eurozone during the latest crisis, there are very good reasons to be aware of the incentive effects associated with the availability of a bail-out. A severe lack of fiscal discipline could hardly be avoided.

Restructuring of sovereign debt: if none of the first two safety valves could be installed, a member state under distress would need to have the option of restructuring its debt without leaving the monetary union. Now would be the time to phase in such an arrangement, not during the next crisis.

WHAT TO DO NEXT?

While the Maastricht criterion of a debt-to-GDP ratio of 60% was not derived from first principles, it nevertheless serves as an anchor for assessing the room available to governments to fiscally manoeuver should a crisis emerge. Unfortunately, in 12 of the 19 member states of the Eurozone this ratio is still above 60%, and way exceeds the corresponding pre-crisis levels (Figure 6). Moreover, in-depth analyses raise doubts about the sustainability of public finances in many member states (GCEE 2017). Consequently, there is a need to refocus and strictly enforce supra-national fiscal rules, which have become too complicated and overburdened with exceptions and technicalities (Eyraud et al. 2018). Furthermore, the introduction of an insolvency mechanism for sovereigns, with the possibility of debt restructuring within the union, would award more credibility to the no-bailout principle (Andritzky et al. 2018).

In view of the arguments regarding the proper alignment of liability and control, the decision to complement joint monetary policy in the Eurozone by implementing a regime of joint supervision and restructuring authorities for financial markets was commendable. This route should be pursued further, until the European Banking Union is factually completed. Yet any further integration is only advisable after further risk reduction has occurred. This requirement not only pertains to a reduction in the number of non-performing loans on the banks' balance sheets (Figure 7), it also implies the removal of regulatory privileges for sovereign debt (GCEE 2015), ascertaining a higher credibility of the resolution regime, and the separation of banking supervision from the ECB.

Instead of inventing new fiscal instruments, joint European efforts - both in the Eurozone and in the EU - should concentrate on policy fields with genuine European added value. Climate policy is a prime example of one such policy field, as the task of reducing CO2 emissions is a global challenge (Figure 8). National approaches and fragmented climate policy measures are expensive and inefficient. Instead, the EU Emissions Trading System should be strengthened by making use of a single price for CO2 for all emitters and sectors of final energy consumption in the EU (acatech et al. 2015).

Figure 6

Debt-to-GDP Ratios

Source: IMF; Mauro et al. (2005); author's calculations. © ifo Institute

Figure 7

Non-Performing Loans
% of gross loans

Source: European Banking Authority (EBA). © ifo Institute

Figure 8

CO_2-Emissions in Selected Country Groups and Countries

Source: EIA; author's calculations. © ifo Institute

REFERENCES

acatech – National Academy of Science and Engineering, German National Academy of Sciences Leopoldina, and Union of the German Academies of Sciences and Humanities, eds. (2015), *Incorporating the German Energiewende into a comprehensive European approach – New options for a common energy and climate policy,* Position Paper, Berlin.

Andritzky, J., D.I. Christofzik, L.P. Feld, and U. Scheuering (2018), "A mechanism to regulate sovereign debt restructuring in the euro area." International Finance, 1–15. https://doi.org/10.1111/infi.12142.

Eyraud, L., M.X. Debrun, A. Hodge, V.D. Lledó, and M.C.A. Pattillo (2018), "Second-Generation Fiscal Rules: Balancing Simplicity, Flexibility, and Enforceability", IMF Staff Discussion Note SDN/18/04. *International Monetary Fund,* Washington, DC.

Feld, L.P., Ch.M. Schmidt, I. Schnabel, and V. Wieland (2015), "Divergence of liability and control as the source of over-indebtedness and moral hazard in the European Monetary Union", in: R. Baldwin and F. Giavazzi, eds., *The Eurozone Crisis: A Consensus View of the Causes and a Few Possible Remedies,* Centre for Economic Policy Research, London, 187–199.

Feld, L.P., Ch.M. Schmidt, I. Schnabel, and V. Wieland (2016a), "Maastricht 2.0: Safeguarding the future of the Eurozone", in: R. Baldwin and F. Giavazzi, eds., *How to fix Europe's monetary union: Views of leading economists,* Centre for Economic Policy Research, London, 46–61.

Feld, L.P., Ch.M. Schmidt, I. Schnabel, and V. Wieland (2016b), Causes of the Eurozone Crisis: A nuanced view, https://voxeu.org/article/causes-eurozone-crisis-nuanced-view (published 22 March 2016).

Feld, L.P., Ch.M. Schmidt, I. Schnabel, and V. Wieland (2016c), Completing Maastricht 2.0 to safeguard the future of the Eurozone, https://voxeu.org/article/completing-maastricht-20-safeguard-future-eurozone (published 23 March 2016).

Feld, L.P., Ch.M. Schmidt, I. Schnabel, and V. Wieland (2016d), Unity in diversity: The way forward for Europe, https://voxeu.org/article/unity-diversity-way-forward-europe (published 22 August 2016).

GCEE – German Council of Economic Experts (2012), *After the Euro Area Summit: Time to Implement Long-term Solutions,* Special Report, Wiesbaden.

GCEE – German Council of Economic Experts (2015), *Focus on Future Viability,* Annual Report 2015/16, Chapter 1 Economic Policy: Focus on Future Viability. Wiesbaden.

GCEE – German Council of Economic Experts (2017), *Towards a Forward-Looking Economic Policy,* Annual Report 2017/18, Chapter 6: Sound fiscal policy, especially in good times. Wiesbaden.

Juncker, J.C., D. Tusk, J. Dijsselbloem, M. Draghi, and M. Schulz (2015), *Completing Europe's Economic and Monetary Union,* European Commission, Brussels.

Meseberg Declaration (2018), *Renewing Europe's promises of security and prosperity.* The Press and Information Office of the Federal Government, Berlin (press release no. 214, published 19 June 2018).

Schmidt, Ch.M. (2017), "Don't shoot the messenger: About the diversity of economic policy conclusions in the face of severe identification issues", in: T. Beck and H.-H. Kotz, eds., *Ordoliberalism: A German oddity?* CEPR Press: London, 63–75.