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Recovering from Maastricht

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The euro area crisis was less a crisis of the euro than a crisis of the Maastricht doctrine. The latter was based on a triple ban: no monetization of fiscal deficits, no bail-out, no sovereign default. The euro architecture was also based on a strict division of tasks: the European Central Bank would stabilize prices in the euro area as a whole, whereas national governments would stabilize their own economies in case of idiosyncratic shocks. To make things even more dysfunctional, bank supervision remained under the competence of the member states. Although much has been done since the crisis to reform the Maastricht framework, there are still major flaws that weaken the single currency.

Keywords: *Economic and Monetary Union, economic governance, economic convergence*

JEL codes: *E42, E61, F45*

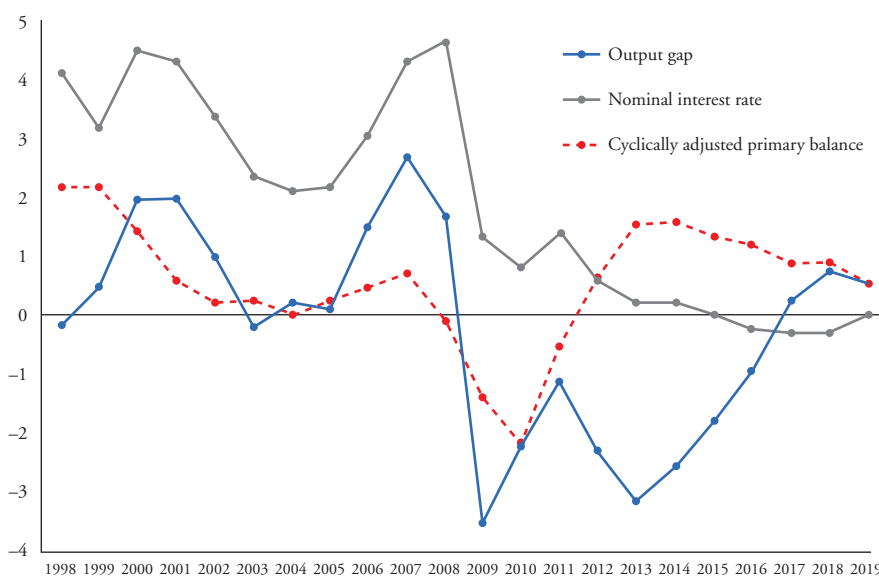
1 INTRODUCTION: SUCCESSFUL EURO, FAILED MAASTRICHT

The architecture of the euro area is inherited from the Maastricht Treaty (1992), the latter being influenced by the macroeconomic literature that was available in the early 1990s. Somewhat paradoxically, the Maastricht architecture has failed whereas the euro has to a large extent been a success.

The success of the euro can be measured along three monetary dimensions:

- First, the European Central Bank (ECB) has proved an extremely strong institution during the global financial crisis (GFC) and subsequent euro area sovereign debt crisis. Although it is possible to criticize the ECB for raising its policy rates in 2011 and starting its quantitative easing policy only in 2015, the central bank has proved extremely reactive to addressing the bank liquidity crisis and extending its toolkit while operating within its mandate.
- Second, the euro area by construction has deployed a fully coordinated monetary policy during the GFC. Without the euro, the GFC would probably have resulted in disorderly devaluations across Europe and ‘beggar-thy-neighbor’ policies. During the euro area crisis, the TARGET (Trans-European Automated Real-time Gross settlement Express Transfer) system has succeeded in keeping the access of commercial banks in peripheral countries to the liquidity in euros despite being sometimes cut from cross-border private lending. Furthermore, the ECB’s ‘whatever it takes’ has succeeded in eliminating the ‘bad’ equilibrium of high interest rates and unsustainable debts, hence it has succeeded in keeping the euro area together.

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Note: Output gap and cyclically adjusted primary balance are in percent of potential output; three-month interest rate is in percent.

Source: European Commission, AMECO.

Figure 1 The euro area aggregate policy mix, 1998–2019

- Third, as illustrated in Figure 1, monetary policy in the euro area proved counter-cyclical most of the time between 2008 and 2019, unlike aggregate fiscal policy which has often been pro-cyclical.^{1,2}

On top of these achievements, the euro has received strong support from the citizens of the member countries, as evidenced by Eurobarometer surveys: in the fall of 2019, the percentage of respondents in favor of the euro ranged from 61 percent in Italy to 87 percent in Ireland (Eurobarometer, November 2019).

These successes must however be balanced against a number of difficulties that appeared after the GFC. The latter was relatively well addressed by macroeconomic policies. However, the GFC revealed poor financial supervision in the euro area. Furthermore, the euro area was ill-prepared for the subsequent sovereign debt crisis, and its aggregate fiscal policy turned pro-cyclical during the second GDP crisis (2012–2013, see Figure 1). After these different episodes, the euro area was left with little monetary and fiscal policy

1. Here we consider monetary policy to be counter-cyclical when the three-month nominal rate and the output gap move in the same direction; we consider fiscal policy to be counter-cyclical when the cyclically adjusted budget balance and the output gap also move in the same direction. The measurement of the output gap and of the cyclically adjusted budget balance are difficult since potential output cannot be observed. However, alternative measures of the cycle (such as the unemployment rate) concur to this stylised fact.

2. The euro has also contributed to trade and financial integration among member states. However, the contribution of the euro to trade integration has been limited (Santos Silva/Tenreyo 2010). As for financial integration, it was followed by disintegration when the crisis hit, so it can hardly be considered a great economic achievement of the euro.

space to combat low inflation and possibly a new crisis, since interest rates were still close to zero or even negative whereas sovereign debts had not been reduced significantly in most member states.

These difficulties are directly related to various flaws in the Maastricht architecture which have been only partially corrected during the 2010s. This architecture relies on two pillars. The first is a strict assignment of responsibilities between the euro area level and that of the member states. The second pillar is the ‘triple ban’ of no bail-out, no debt monetization, and no debt restructuring. In the following, we explain why these two pillars are dysfunctional, before discussing the reforms that have been carried out since 2009 but still fall short of fully consolidating the monetary union.

2 STRICT POLICY ASSIGNMENT

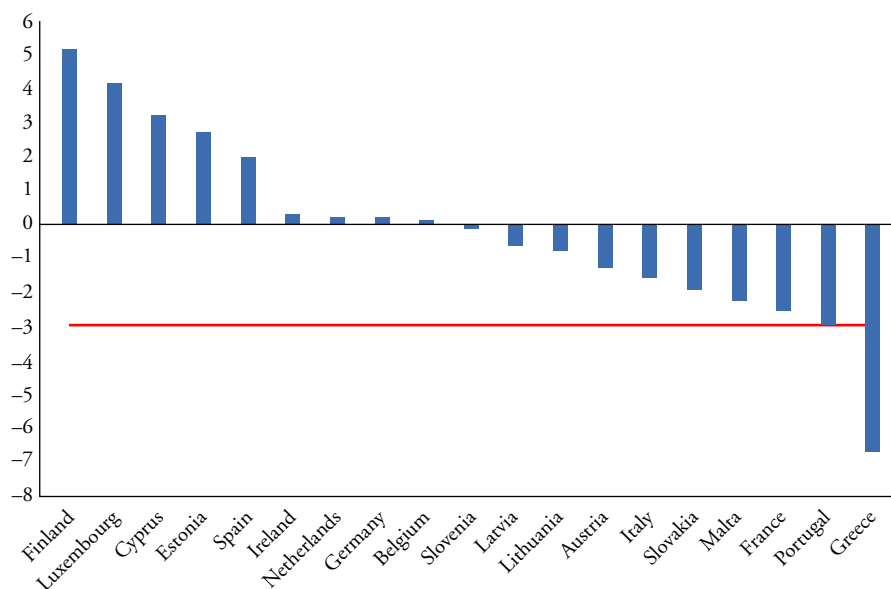
Since Jan Tinbergen (1952), economists have known that, in order to reach N objectives, economic policy should use N independent policy instruments. The Maastricht architecture reflects this rule. The single monetary policy has been assigned the objective of price stability for the euro area as a whole, hence the objective to react to symmetric shocks (see below). Meanwhile, national fiscal policies are in charge of stabilizing national output (by tightening in good times and expanding in bad times) in case of idiosyncratic shocks.

This policy assignment relies on four key assumptions:

1. With nominal rather than real wage rigidities, there is a ‘divine coincidence’ between stabilizing prices and stabilizing output (Blanchard/Galí 2007). Hence, there is no need to instruct the ECB to stabilize the euro area’s output gap nor to instruct national governments to stabilize their own price indices: price stability and output stability are very much the same thing.
2. National governments can effectively use fiscal policy to stabilize their economies. Thanks to the Stability and Growth Pact (SGP), their budgets will be close to balance in the medium term, hence there will be ample fiscal space to stabilize output.³
3. The spillovers across euro area countries are limited: fiscal stimulation or adjustment in a particular member state has negligible effects on the other member states through demand channels and also through financial channels, since all sovereign debts remain safe (hence they do not endanger the banks that hold them).
4. The scope for very large shocks is limited, as exemplified by the ‘great moderation’ of the 1990s: between 1990 and 2007, GDP growth was relatively stable in advanced economies, around 2–3 percent per year. Even the ‘dot-com’ crisis of 2001 did not cause major damage.

These different assumptions all proved incorrect after 2008:

1. The relationship between the output gap and inflation was increasingly put into question, with the apparent flattening of the Phillips curve (Blanchard et al. 2015).
 2. Peripheral countries proved unable to stabilize their economies through fiscal policy. Some of them had entered the crisis with still-large fiscal deficits. However most
3. In the early days of the euro, the rule of thumb was the following. For a large euro area country, a reduction of GDP growth by 1 percentage point (p.p.) leads to a reduction in the fiscal balance by around 0.5 percent of GDP. Starting from budget balance, automatic stabilizers can then absorb a 6 p.p. reduction in GDP growth before hitting the 3 percent limit. The absorption capacity is even greater once the fiscal multiplier is accounted for.



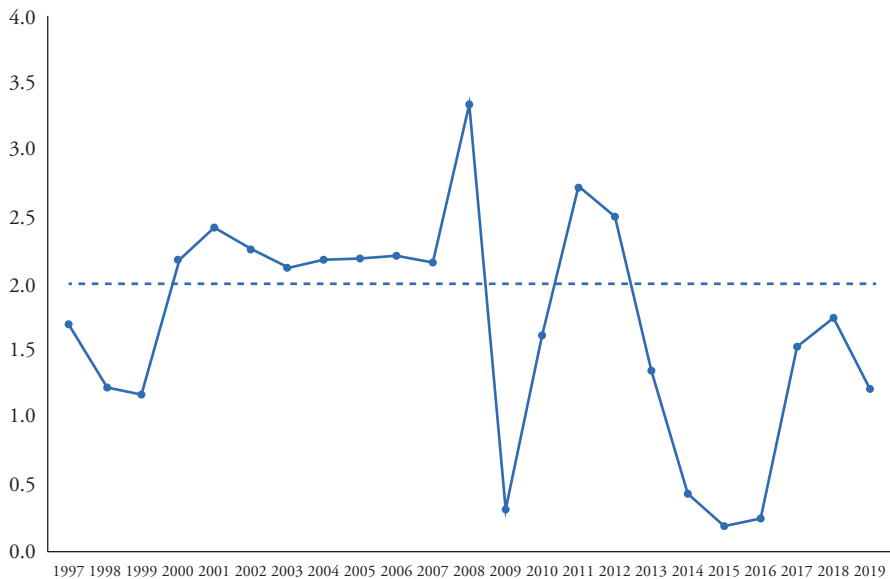
Source: European Commission, AMECO.

Figure 2 General government balance in 2007 (percentage of GDP)

- member states were safely above the 3 percent deficit threshold (Figure 2). In fact, the euro area crisis started with a ‘sudden stop’ of capital inflows that hit both public and private agents. One direct consequence was the inability of national governments to borrow in order to finance higher deficits to stabilize their economies.
3. Although, in normal times, macroeconomic spillovers are limited across member states, this proved no longer to be the case during the crisis, for two reasons. First, due to the exposure of banks across the euro area (financial spillovers). Second, because demand spillovers are larger when the interest rate is at its effective lower bound (Blanchard et al. 2016).
 4. The aggregate shock was large enough for the ECB to be unable to secure an inflation rate ‘lower but close to 2 percent’ (Figure 3). One reason is that fiscal policy turned pro-cyclical after 2010 (Figure 1). It is tempting to attribute this collective failure of fiscal policy to past profligacy: several euro area governments did not have enough fiscal space to expand their budget in order to support the economy. However, this explanation does not square with the fact that Spain and Ireland entered the GFC with fiscal surpluses (Figure 2). Furthermore, a large part of pro-cyclical fiscal adjustments came from non-crisis countries, some of which were not even constrained by the SGP.

Because aggregate fiscal policy had turned pro-cyclical, monetary policy had to do even more easing. In 2015, the ECB started its quantitative easing program, which spurred criticism for the large amounts of sovereign bonds purchases it involved.

Economists have long viewed the ‘fiscal dominance’ problem as the risk that fiscal profligacy will ultimately force the central bank to monetize the deficits (Sargent/Wallace 1981). In the middle of the economic crisis, a new version of the ‘fiscal dominance’



Source: European Commission, AMECO.

Figure 3 Headline consumer price inflation, euro area (percent per year)

problem appeared: since euro area governments were unable or unwilling to expand their budgets, the ECB was forced to substitute for them. As a complement, a form of ‘banking dominance’ emerged in relation with the ‘doom loop’ between sovereign risk and banking risk: to the extent that the commercial banks of a country were heavily exposed to the risk on their own sovereign, any risk arising on the latter would immediately be transmitted to the former. As a lender of last resort, the central bank is committed to maintaining the liquidity but not the solvency of the banking sector. However, the concentration of sovereign risks in the banks of the home country makes it difficult to separate illiquidity from insolvency, since sovereign bonds are routinely used by commercial banks to obtain liquidity at the central bank. This problem raises the risk that the central bank could be pushed to extend liquidity to an insolvent bank, or with low-quality collateral, in order to avoid the breakout of the euro area. This risk materialized in Greece in 2015 when the ECB had to regularly raise the cap on emergency liquidity assistance delivered by the central bank of Greece.

To make things even more dysfunctional, the Maastricht framework assigned to national governments the task of supervising their banking sector. As seen during the crisis, light supervision and regulatory capture produced massive externalities across Member states and made the risk of fiscal dominance more acute.

3 THE TRIPLE BAN

The Maastricht framework also relied on a triple ban: no bail-out, no monetization of fiscal deficits, no debt restructuring. The no-bail-out rule was enshrined in the Treaty as a way of protecting European taxpayers from the need to repay the debts of other member

states. The no-monetization rule was also enshrined in the Treaty as a way of protecting monetary policy from fiscal dominance. Finally, the no-debt-restructuring rule was not written anywhere, but it was implicit that no euro area sovereign debt could ever be restructured. The financial regulation was consistent with such impossibility since sovereign exposures were exempt from risk-weighting in bank capital requirements.

The sustainability of the triple ban relied on the SGP: if all member states complied with the rules, there would be no need for bail-out, monetization, or restructuring. However, several countries, including France and Germany, breached the SGP during the 2000s. More importantly, complying with the SGP did not protect a number of countries from suffering deep financial crises and ultimately sovereign debt crises.

The Europeans managed the crisis in a pragmatic, dirty way, as they accepted small amounts of the three evils: some bail-out (through lending to crisis countries at a lower rate than markets would have asked for), some temporary monetization (in Ireland), and some debt restructuring (in Greece). But then the discussion raged about sovereign debt restructuring. At one end of the discussion, the German Council of Economic Experts (Feld et al. 2016) was arguing that only a credible possibility of debt restructuring (in the event of a European Stability Mechanism program) would make the no-bail-out rule credible. In order to protect the banking sector, it would be necessary to impose risk weights on sovereign holdings and adequate capital buffers. At the other end of the spectrum, Italian economists such as Tabellini (2018) argued that making sovereign debts unsafe, even as a last-resort option, would destabilize the financial system and raise the risk of an immediate self-fulfilling crisis.⁴ In between, the 7+7 report (Bénassy-Quéré et al. 2018) argued in favor of a comprehensive framework where only a marginal flow of new debts could be restructured in last resort while the system would simultaneously be consolidated with a common fiscal capacity and a safe common asset.

4 AMENDMENTS TO THE MAASTRICHT DOCTRINE

Set up in 1992, the Maastricht doctrine has been revised several times. The most notable amendments are the following:

- Fiscal rules have been adapted over time to make them less pro-cyclical, more stringent in good times, with more emphasis on debt dynamics but also to introduce some flexibility.
- The banking union has harmonized bank regulations, centralized the supervision of the largest banks (and coordinated the surveillance of smaller banks), harmonized the process of bank resolution, and introduced a fund to accompany bank resolutions.
- The creation of the European Stability Mechanism (ESM) has offered a scheme to extend emergency loans to a country in exchange for an adjustment program which is supposed to ensure the solvency of the government receiving the loans.
- The Outright Monetary Transactions (OMTs) announced (but never used so far) by the ECB have contributed to stabilizing the euro area's economy by allowing the ECB to buy potentially unlimited amounts of sovereign bonds provided an adequate adjustment program is agreed with the ESM. In contrast to the ESM, the ECB

4. An additional argument was that whatever was done to reduce banks' sovereign exposures, the fate of commercial banks would stay closely linked to that of their home economies. In a word, the doom loop could not be eliminated.

has unlimited capacity to lend, hence the announcement was considered credible and helped to discard the ‘bad’ self-fulfilling equilibrium of high spreads with unsustainable debts.

- The Macroeconomic Imbalances Procedure (MIP) has been introduced to broaden the surveillance of the member states to private sources of imbalances, and national productivity councils have been set up to monitor productivity and competitiveness at the national level.

Although these various reforms are extremely important, they have not entirely solved the problems mentioned in the previous sections. More specifically:

- The concentration of national sovereign risk in the banks has increased rather than decreased since 2008: although, in theory, national governments can no longer bail out their banks, the ‘doom loop’ is still alive.
- SGP rules have become extremely complex and opaque.⁵ And they have performed poorly in ensuring fiscal adjustment in a non-stabilizing way. With high debt levels, and unless the ‘general escape clause’ introduced in 2011 is activated,⁶ there is a risk that governments tighten their budgets during the next crisis, whereas the ECB would not be in a position to do much easing.
- The MIP has proved largely ineffective (Esthathiou/Wolff 2019) and not always geared towards macroeconomic convergence (Bénassy-Quéré 2015; Bénassy-Quéré/Wolff 2020).

Writing in early 2020, the triple ban issue has not been solved. This keeps the euro area in a perilous situation, where a sovereign debt crisis could degenerate into a bank sovereign and/or liquidity crisis and ultimately to a breakup of the euro area.

5 THE DEFLATION BIAS

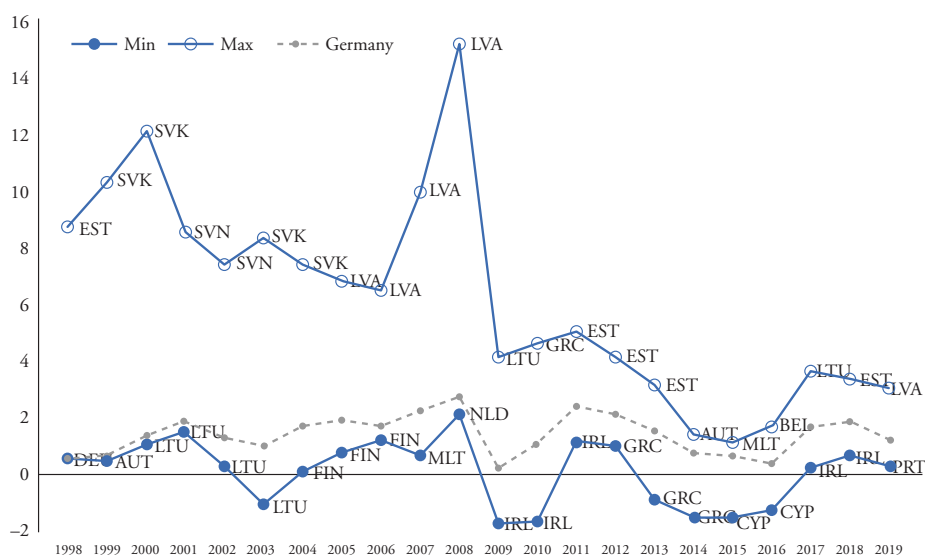
As evidenced in Figure 3, the euro area suffers from very low aggregate inflation. This has three major implications.

First, the low level of inflation reduces the space for monetary policies. When the nominal interest rate is at the effective lower bound (which is slightly negative), the only way to further reduce the real interest rate is through higher inflationary expectations. The central bank can try to raise the latter through forward guidance and possibly a revision of its communication strategy. For instance, the ECB could move to a symmetric inflation target, or to a price-level or nominal GDP target. However, the dis-anchoring of inflation makes it difficult for the central bank to stimulate the economy should the euro area be hit by a new crisis; as evidenced by the case of Japan since the early 1990s, it is not easy for the central bank to convince financial markets and the general public that inflation will recover after a period of very limited general price increase.

Second, low aggregate euro area inflation makes relative price adjustments more difficult not only within each economy, but also across the member states. Figure 4 illustrates this point by plotting the minimum and maximum inflation rates within the euro area. Since 2009, peripheral countries have posted very low, sometimes negative inflation

5. See the 108 pages of the European Commission’s ‘Vade Mecum on the Stability and Growth Pact’ (EC 2019).

6. The general escape clause was activated on 23 March 2020 to allow national governments to take all the necessary action during the COVID-19 crisis.



Source: Author's calculations based on AMECO.

Figure 4 Minimum and maximum CPI inflation rates in the euro area (percent per year)

rates. With Germany's inflation at 1.3 percent on average over 2009–2019, reducing intra-euro-area real exchange-rate misalignments is long and painful, since negative inflation can trigger self-fulfilling depression in countries with high public or private leverage.

This brings us to the third problem created by low aggregate inflation, which is its impact on leverage. Assuming that the 'triple ban' still applies in the euro area, there are only two possibilities for debtors to deleverage: (i) through higher savings, and (ii) through higher nominal income growth.

Whether public or private, higher savings means lower aggregate demand, hence lower GDP growth and inflation in the short run. The net effect on debt ratios is unclear, as exemplified by the Greek crisis. With higher inflation on average in the euro area, deleveraging would become easier in peripheral countries.

The question then is how to raise the inflation rate in the euro area when monetary policy is running out of instruments. This raises the dual question of demand-side and supply-side instruments.

On the demand side, the European Commission has repeatedly asked those countries with a current-account surplus to incentivize private corporate investment and raise public investment. These recommendations are part of the European semester and more specifically of the MIP. However they have encountered mixed reactions at the national level. Another route could be to raise aggregate demand through the 'green deal' vehicle: recapitalizing the European Investment Bank so as to raise its lending capacity, committing to higher carbon prices and adjusting financial regulations would hopefully raise the level of investment across the European Union (EU). Existing evaluations suggest an additional 1–2 percent of GDP of additional gross investment at EU level is needed to meet carbon commitments (see EU High-Level Expert Group on Sustainable Finance 2018).

On the supply side, the recommendations of the Commission have been less clear. Although national governments control minimum wages and the remuneration of

nationwide public employees, they have no direct instrument to influence private-sector wages. More fundamentally, the Commission has failed to provide guidelines and to coordinate national productivity councils in order to impulse nominal convergence between euro area member states. So far, the country-by-country approach has prevailed, carrying the risk of a ‘race to the bottom’ where each country tries to reap price competitiveness in isolation. It should be remembered here that the euro is a flexible currency. Should wages and prices decline in all euro area countries, the euro would probably appreciate against other currencies. Hence, as a whole, the euro area cannot raise its price competitiveness through lower inflation. This toxic low-inflation equilibrium needs to be eliminated through some form of coordination.

6 CONCLUSION

As we are reminded by Frieden (2016), it took several decades for the United States to achieve monetary union. By American standards, the first 20 years of the European Economic and Monetary Union appears a relatively short period and one should not be surprised to observe that the initial set-up was not perfect. The ability of the Europeans to carry out major reforms of their economic governance in just a few years is remarkable. However, governments should not be complacent. Failing to complete the reform program would leave the euro area fragile and with little firepower when the next crisis hits.

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