The European Monetary Union after its crisis

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1 Introduction

It is fitting to review critically the experience of the monetary union now that the crisis dust starts settling. José Luis Malo de Molina has been deeply involved in the creation and management of the Eurozone since the very beginning. Of course, the topic is very broad; doing it justice requires at least one thick book. I will therefore be highly selective and focus on what I see as three essential lessons, two of which were by no means clear at the outset, while the last one was unfortunately foreseen. The first one is that the monetary union has been, and still is, an amazing success. The second one is that the independence of the Eurosystem is not robust and has repeatedly been challenged. The third one is that the Stability and Growth Pact has not delivered and continues to be the problem, not the solution to the fiscal discipline requirement.

2 An amazing success

When the monetary union was being mooted, there was no lack of warnings that it could not and would not work. Blinded by the equation one money = one country, many observers concluded that it was a failure waiting to happen. They were right in the sense that the Maastricht Treaty was and remains unfinished business, but not for the reasons usually brought up. They were wrong in the sense that more than 300 million people from 19 countries use the euro every day without thinking about it.

The creation of the monetary union was a historical experiment of considerable complexity. Such experiments cannot be one hundred percent right, and it was not.

It was plagued by several design failures. In addition to those examined below, one can also mention the absence of what is now called a Banking Union and the lack of any crisis management mechanism. The first flaw has been addressed but remains unfinished business. The second one remains unattended.

The design flaws have led to the crisis. What is remarkable is that the monetary union has survived the crisis intact, at least for the time being. The Eurozone has proved to be very robust. Its features, and wise actions by the Eurosystem, made it possible to preserve the construction, in the face of numerous policy errors. To name a few, the intentional violation of the no-bailout rule and the attendant refusal to restructure Greek debt at the outset effectively created the crisis. Obtuse adherence to the letter of the Stability and Growth Pact has imposed untold hardship on many countries, with gradually emerging political implications.

In spite of its flaws, the Eurozone has survived a most challenging crisis. This suggests that, while the flaws were deep enough to allow for a crisis to occur after less than ten years of existence, the basic architecture was strong enough to withstand the challenge. This observation – the dog that did not bark – should not be overlooked.

3 Independence of the Eurosystem

On paper, the Eurosystem and the ECB seem to be the most independent central bank system in the world. An international treaty guarantees its independence and any treaty change would need to be ratified by all EU countries, a most unlikely possibility. Yet, fine print matters and the crisis showed that all i's had not been well dotted and that the institutional design includes weaknesses, some of which had been identified long ago.

On what basis can it be asserted that independence has been constrained? Four events, in particular, have drawn attention. First, central banks always claim ex ante that they are not lenders of last resort but, when a serious crisis arises, they cannot escape intervening one way or another. Similarly, until the crisis at least, many major central banks did not identify financial stability as one of their objectives, but they could not let a crisis grow unfettered. Undoubtedly, these questions must have been at the top of the Eurosystem's deliberations throughout the crisis. Yet, it is not until mid-2012 that the ECB has provided a backstop to national public debts, in effect taking the crisis out of its acute phase. Still, the ECB has refused to act as lender of last resort to banks, even though the Emergency Liquidity Assistance facility has been used in some cases. The impression is that the ECB feared that lending in last resort would lead to burden sharing among member states, which was staunchly opposed by some countries. This stands in contrast with the central bank's mission to focus exclusively on union wide-interests.

Second, in the weeks leading up to the Greek bailout, the ECB took a strong, public stand against any debt restructuring. There were good reasons to avoid a debt restructuring. There were legitimate fears that some Eurozone banks with large exposure to Greek debt might not be able to withstand such a shock, with potential global impact so soon after the Lehman Brothers collapse. It was also natural to be concerned about moral hazard. The fears about potential implications of a debt restructuring could not have been over-riding, however. The absence of a firewall, as it was then asserted to justify opposition to debt restructuring, only betrayed the Eurosystem's refusal to act as lender of last resort. It also left the uneasy impression that one country's interest was being sacrificed to protect the private interests of some banks, possibly at these banks' behest. If so, that would be a significant loss of independence to national and private interests.

As for the moral hazard, debt is a two-way arrangement. For each debtor that borrows unreasonably there are creditors that lend too much. It is difficult to understand how the ECB has agreed to the view that debtors should be the only ones to bear the burden of excessive borrowing and lending. Here again, national interests were at stake.

The two surprising interest rate increases in mid-2011 constitute the third event. The Eurozone as a whole was entering into a second recession, partly due to rising oil prices. In normal times, it is considered that monetary policy should focus on the risk of inflationary second round effects. But these were not normal times. All the arguments that were used to justify the bailout of Greece, Ireland and Portugal were now suggesting that avoiding a recession relapse should be a priority. The subsequent fall of the inflation rate well below the official definition of price stability confirms, with hindsight but not unpredictably, that the interest rate increases were not warranted. Why did the Eurosystem go against the trend? One explanation is an honest policy mistake. Another explanation is that one major country, Germany, was not under the threat of a recession and more worried about the inflationary impact of oil price increases. That would be a violation of the longstanding position that the Eurosystem only cares about the Eurozone as a whole, and not about any particular member country. This event leads to yet another suspicion that the Eurosystem was not acting as independently as it was expected to do.

Finally, the ECB agreed to join the Troika and therefore act as a designer and enforcer of conditions imposed on the crisis countries, not as their central bank. Normally, in IMF negotiations, the central bank sits on the other side of the table, alongside the government, and is asked to play its role in dealing with the problems that led to a request for emergency assistance. Troika membership solidified the choice not to act as lender of resort, closing down options that would have prevented the massive debt increases that will plague these countries for years to come.

It is most surprising that the independence of the ECB has been challenged, in spite of the treaty guarantee. Its own governance could provide one possible explanation. Its outsized Governing Council limits the width and breadth of deliberations. Furthermore, national governors are unlikely to be detached from their country's interest, especially at crisis time. The Executive Board is much smaller but the unwritten rules of appointments, which guarantee a seat to nationals from large countries, inevitably inject national interests into this crucial body. Since its own deliberations are kept secret, there is no proof that this is the case. Yet the experience of other federal central banks suggests that it is inevitable.

4 Fiscal discipline

Fiscal discipline is a necessary condition for the monetary union to operate smoothly. This has been clearly understood from the start and dramatically confirmed by the debt crisis. The chosen solution combined the Stability and Growth Pact and the no-bailout rule. The pact is ill designed and has failed repeatedly since 1999; the no-bailout, which is an essential component of any solution, has been summarily discarded in 2010.

The most crucial flaw of the Stability and Growth Pact is its internal contradiction: fiscal policies are national competences while the pact is centralized. The Commission and the Council of Ministers have no authority on fiscal policies. Theoretically, the contradiction has been resolved through the adoption of a punishment mechanism. Politically, however, the mechanism is unlikely to ever work, for two main reasons. First, it creates an open conflict between the EU and a government on an issue universally seen as deeply ingrained in national sovereignty. Second, because the final say is in the hands of the Council of Ministers, a highly politicized body unlikely to function properly on such a divisive issue.

The no-bailout clause, on the other hand, is a powerful instrument. It operates successfully in a number of federal countries, where it is the centerpiece of fiscal discipline. The clause works by providing proper incentives to subcentral units to enforce fiscal discipline themselves. An implication is that it must credible. Having been dismissed on the first instance it became binding, the clause has lost its credibility and is therefore unavailable. Restoring its credibility is a major challenge. Meanwhile, two steps need to be taken. First, fiscal discipline must be a sovereign obligation enforced by national legislation and institutions. The Fiscal Compact includes these essential components but it is imprecise enough to allow a number of countries to adopt weak versions. Second, the legacy debts inherited from the twin crises of the early 2010s must be somehow brought down. As long as they are very large, fiscal policies are hamstrung and the no-bailout clause is too politically difficult to be implemented.

5 Conclusions

During the last thirty years, European integration has proceeded at a brisk pace, including the monetary union. By luck or design, much of the resulting arrangements are well crafted, a testimony of the efforts of those who, like José Luis Malo de Molina, have contributed to the process. Yet, such a momentous undertaking cannot be faultless from the start. Inevitably, design deficiencies eventually emerge, and they did. Some progress has been achieved in recent years, but the effort remains incomplete.