

What kind of governance for the eurozone?

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1. Introduction

The survival of the eurozone hinges on the capacity of its leaders to improve its governance. This has become very clear since the eruption of the government debt crisis in the eurozone in 2009, which can be said to result from a failure of economic governance. In order to answer the question of how the economic governance of the eurozone should be reformed, we should first make a diagnosis of the crisis in which the eurozone has been mired since 2009.

2. Diagnosis of the crisis

A consensus seems to be emerging in Europe identifying the failure of the Stability and Growth Pact (SGP) to keep a lid on national budget deficits and debts as the root cause of the government debt crises in the eurozone. I would argue to the contrary, however, that the reason why countries got into a sovereign debt crisis – with the exception of Greece – has little to do with the poor performance of the SGP. The root cause of the debt problems in the eurozone is to be found in the unsustainable debt accumulation of the *private* sectors in many eurozone countries (see the evidence presented in Figures 1 and 2). It can be seen that household and bank debt were increasing very fast prior to the debt crisis. Surprisingly, the only sector that did not experience an increase in its debt level (as a % of GDP) was the government sector.

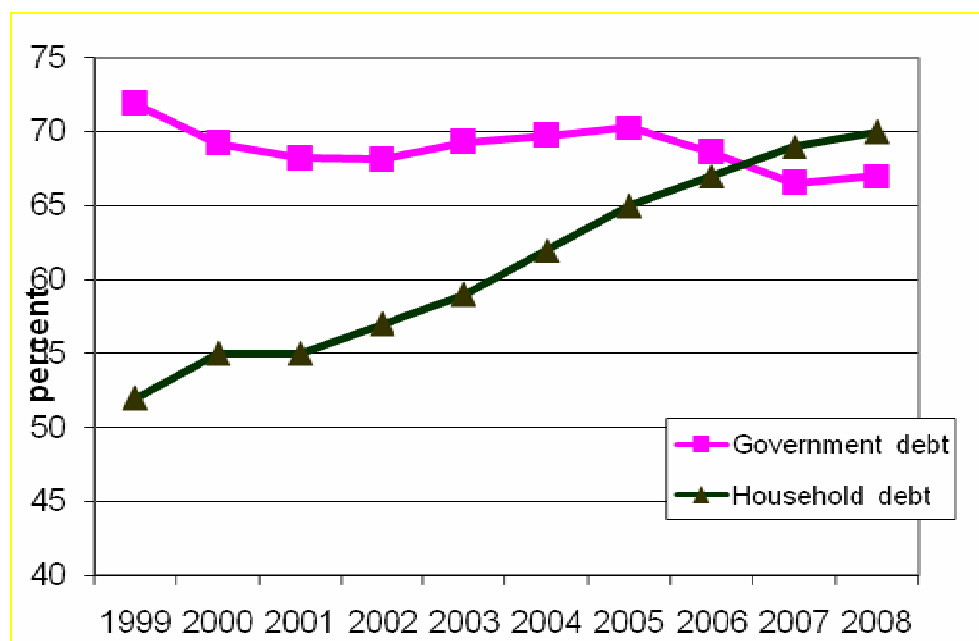
The private debt accumulation in the eurozone then triggered the well-known debt deflation dynamics (analysed by Irving Fisher, 1933) and later by Minsky (1986), forcing the governments of the eurozone countries to allow their own debt levels to increase. This was achieved through two channels: the first one consisted of governments actually taking over private

debt (mostly bank debt), and the second one operated through the automatic stabilisers set in motion by the recession-induced decline in government revenues. As a result, the government debt/GDI ratio started increasing very fast *after* the eruption of the financial crisis. In Figure 3, we show the government debt to GDP ratios before and after the crisis for the eurozone countries. The most surprising feature of figure is that except for Germany and Portugal, the government debt ratios of the other eurozone countries were all declining prior to 2008. Even more striking is to find that in two countries that have experienced severe government debt problems recently, Ireland and Spain, the government debt ratios were declining spectacularly prior to the crisis. These were also the countries where the private debt accumulation has been the strongest.

From this evidence it is clear that it is difficult to maintain that the cause of the government debt crisis in the eurozone is due to government profligacy prior to the crisis. The only country where this can be said to be true is Greece. It does not apply to the other countries, where the fundamental cause of the crisis is to be found in unsustainable private debt accumulation forcing governments to step in to help out (in some cases to save) large segments of the private sector.

Although the cause of the government debt crisis does not reside in the poor workings of the SGP, it remains true that the latter does not work well. This was shown dramatically in 2003 when France and Germany decided to waive the SGP rules unilaterally. It is therefore important to understand why the SGP does not work well before we decide to tighten its rules and to impose more sanctions, or before we try to apply its method to other areas of national economic policies.

Figure 1. Household and government liabilities in eurozone (% of GDP)



Source: European Commission, AMECO database and CEPS.

Figure 2. Bank and corporate liabilities in the eurozone (% of GDP)

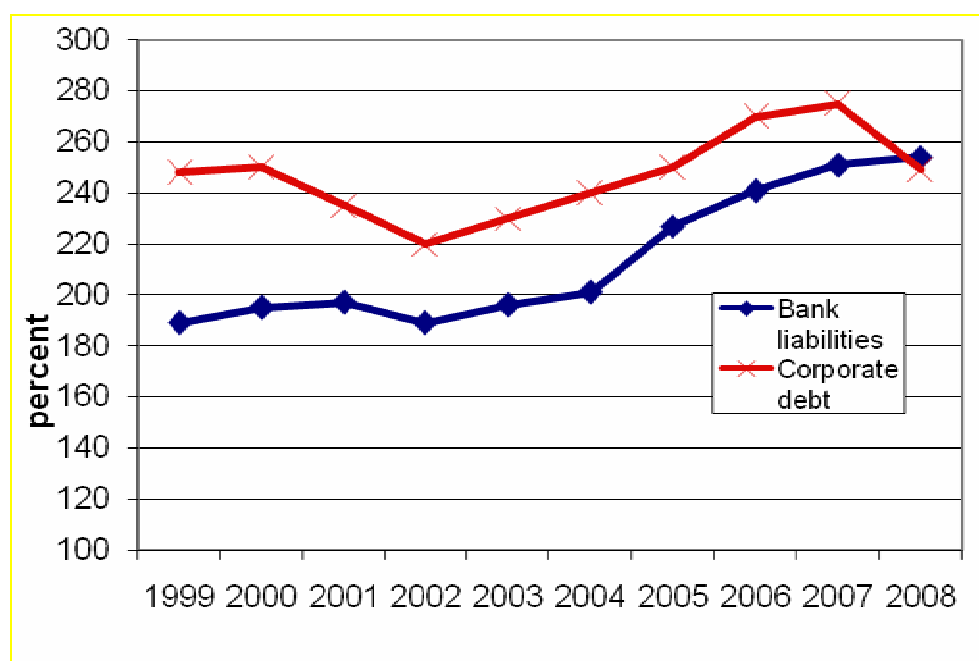
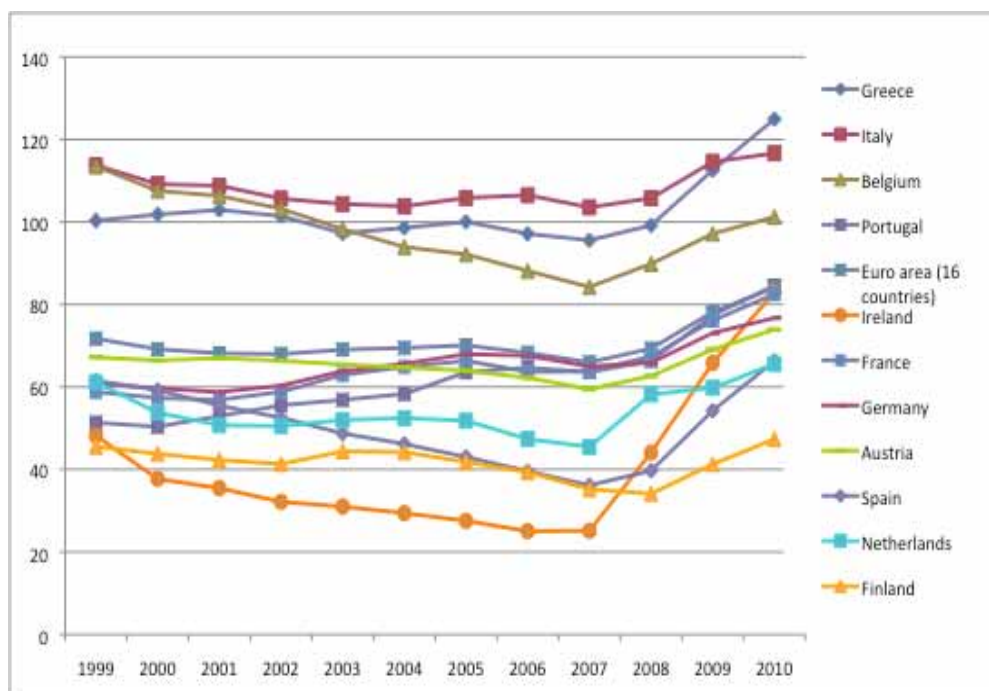


Figure 3. Government debt in the eurozone countries (% of GDP)



Source: European Commission, AMECO database.

The reason why the SGP worked poorly can be described as follows. As long as budgetary policies (spending and taxation) remain vested in the hands of national governments and parliaments, the political responsibility for the decisions about spending and taxation rests with these national governments and parliaments. The latter face the political sanctions by national electorates. Neither the European Commission nor the other members of the Council face the political sanction for the measures they impose on one member country. “No taxation without representation” belongs to the essence of democracies. The SGP has been an attempt to short-circuit this principle, by giving powers to individuals and institutions that do not face the political responsibility for their actions. Such an attempt had to fail and happily so.

The Commission has proposed to tighten the rules and to apply stiffer sanctions in the SGP. It looks increasingly likely that the Task Force on Economic Governance presided over by the President of the European Council, Herman Van Rompuy, will propose a similar tightening of the SGP rules. It is unclear how stiffer rules and sanctions will help to salvage the SGP that is deeply flawed because it disregards elementary principles of political economy.

The previous analysis leads to the following two conclusions. First, the crisis in the eurozone has mostly to do with the divergent developments in private debt. The latter have much to do with macroeconomic divergences in general. So, something must be done about these divergences. But what exactly?

Second, the method of convergence implicit in the SGP should not be the model to impose convergence in other areas of national economic policies. This method has not worked well in the budgetary field; it is unlikely to do so in other fields.

3. How to deal with macroeconomic divergences?

Here also we need the right diagnosis. Where do these macroeconomic divergences come from? I think we do not have a very good answer today. We do not understand very well how these macroeconomic divergences in the eurozone come about.

It is often said that the source of the boom-and-bust dynamics in countries like Spain, Greece and Ireland is due to the fact that these countries enjoyed a strong decline in their real interest rate thanks to their entry into the eurozone. This decline in the real interest rates then triggered a boom in consumption and a bubble in the housing markets. Fair enough, but this does not explain everything. Italy similarly enjoyed an unprecedented decline in its real interest rate when it entered the eurozone, yet it did not experience a boom and a bubble.

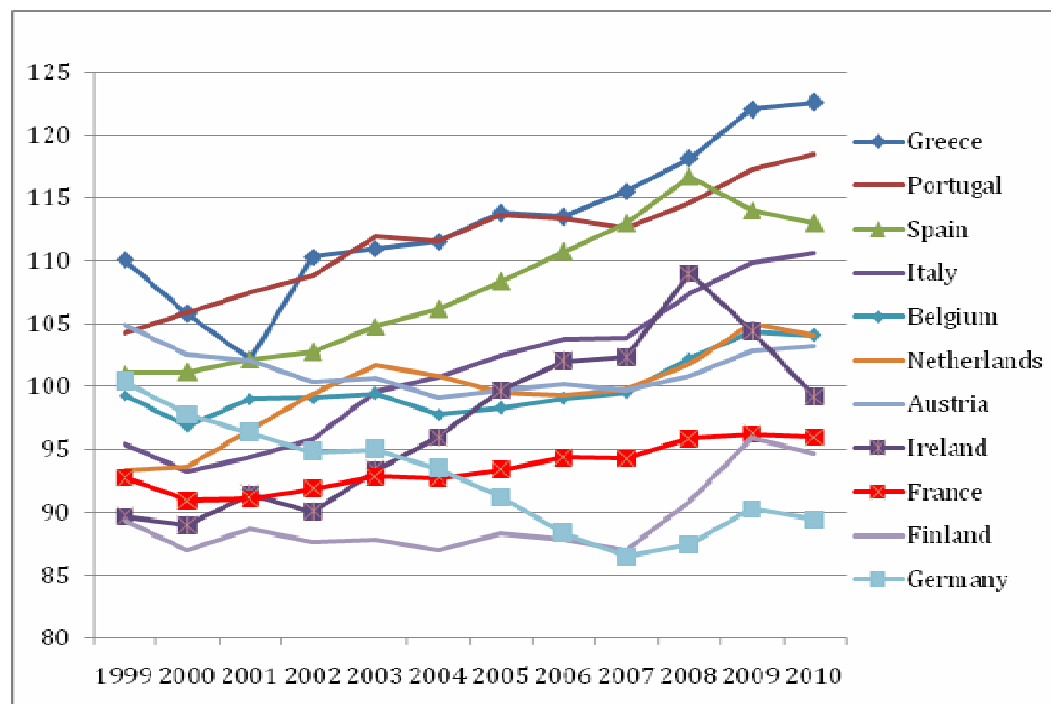
This leads me to bring in another explanatory variable: animal spirits, i.e. waves of optimism and pessimism that in a self-fulfilling way drive economic activity (see Akerlof & Shiller, 2009; Leijonhufvud, 1973 and Minsky, 1986). My hypothesis is that as far as animal spirits are concerned, the eurozone is far from being integrated. Remember just a few years ago when

'angst' prevailed in Germany while bursts of optimism exploded in Spain and Ireland. Today optimism drives the German recovery and pessimism prevails in the once-booming countries. Thus, member states of the eurozone are still very much independent nations creating their own animal spirits.

The existence of idiosyncratic animal spirits is at the core of the divergences in competitiveness observed

during the last decade. The optimism prevailing in peripheral countries led to booms in economic activities which in turn triggered wage and price increases in these countries. A few years of such booming activity was enough to push prices and wage costs out of line with the rest of the eurozone, as is shown in Figure 4, which presents the evolution of the relative unit labour costs in the eurozone since 1999.

Figure 4. Relative unit labour costs in eurozone (average 1970-2010 = 100)



Note: In this figure, the author takes the average of the relative unit labour costs over the period 1970-2010 to be a close approximation of the equilibrium values and sets this average equal to 100. The divergent movements in unit labour costs are less pronounced than when 1999 is selected. Nevertheless, there is upward divergence in Greece, Portugal, Spain and Italy and until 2008, also in Ireland.

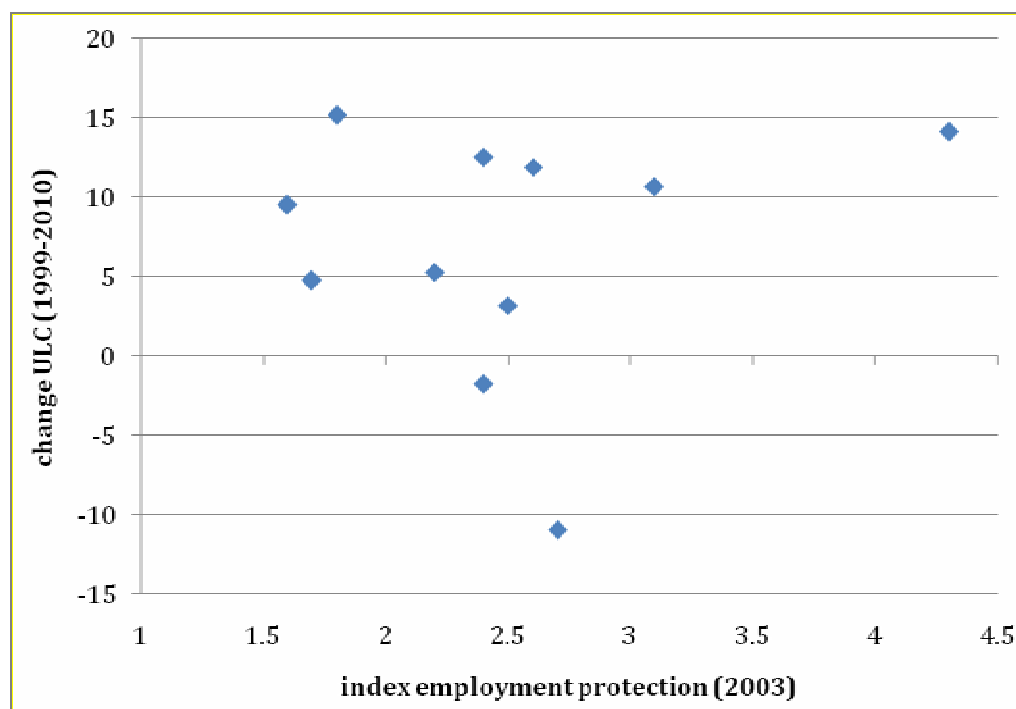
Source: European Commission, AMECO database.

There is a tendency in Europe to blame 'structural rigidities' for the divergent movements in competitiveness in the eurozone, and that thus 'structural reforms' should be instituted. While undoubtedly the European Union exhibits much rigidity, this probably has little to do with the divergent movements in competitiveness, as shown in Figure 5. This presents the OECD index of employment protection (on the horizontal axis) and relative change in unit labour costs from 1999 to 2010 (on the vertical axis). It can be seen that there is no relationship between the OECD index of rigidities in the labour markets of the eurozone countries and the changes in competitiveness since the start of the eurozone.

Structural reforms are therefore not the answer to divergences in competitiveness. The latter are better explained by divergent movements in macroeconomic conditions¹ that in turn are very much influenced by national animal spirits. It is therefore surprising to find that the European Commission considers sanctioning countries that do not introduce structural reforms to improve their competitive position. There is simply no evidence that introducing structural reforms in the labour markets will improve the competitiveness of countries.

¹ See Gros & Alcidi (2010).

Figure 5. Change in unit labour costs and employment protection



Sources: OECD for Employment Protection index and AMECO for ULC.

If booms and busts and the ensuing movements in prices and wages are the results of animal spirits that continue to have a national, not European origin, what can one do about it? Put differently, do national governments have the tools to deal with this?

They surely have some at their disposal. Budget policies for example can in principle be used as an anti-cyclical instrument. The use of these policies, however, is very much constrained, mainly because the decision-making process underlying these policies makes them less than flexible instruments.

There is another aspect that tends to reduce the capacity of national governments to deal with local booms and busts. Booms and bubbles are most often correlated with domestic credit expansion. This is shown vividly in Figure 6 on page 6 for industrial countries. It is the combination of bubbles (especially in the housing markets) and credit expansion that makes bubbles potentially lethal. This has been made very clear by the experience of Spain and Ireland.

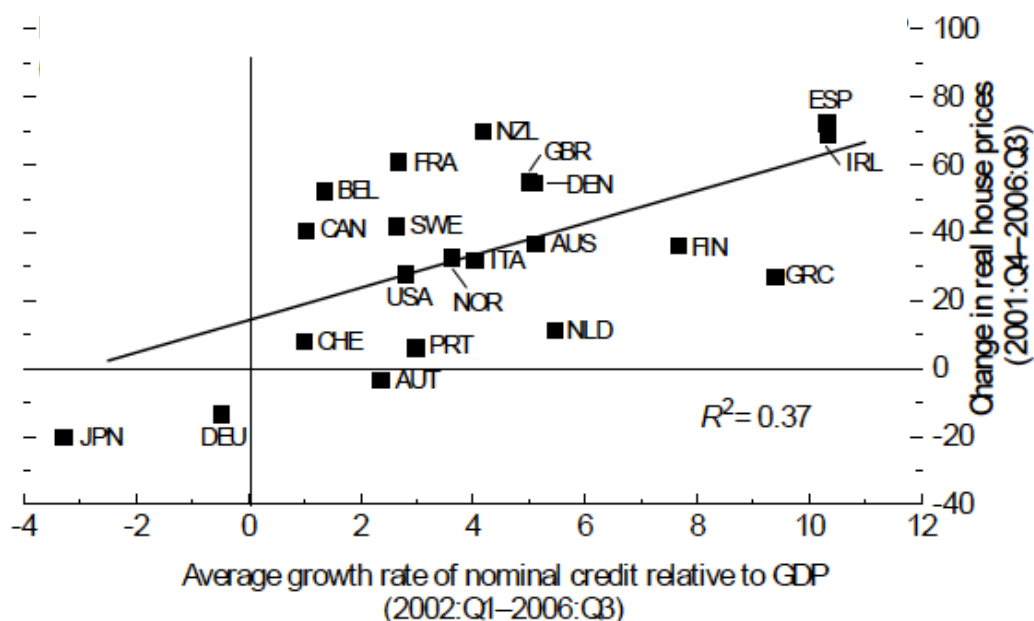
Thus, any policy aimed at stabilising local economic activity must also be able to control local credit creation. It is clear that because the member states of the eurozone have entered a monetary union they lack the instruments to deal with this. Put differently, if the movements of economic activity are driven by credit-fuelled animal spirits, the only instruments that can effectively deal with their behaviour are monetary instruments. Members of a monetary union, however, have relinquished these instruments to the European monetary authorities.

The next question then becomes: can the European monetary authorities, in particular the European Central Bank (ECB), help out national governments? We have been told that this is impossible because the ECB should only be concerned by system-wide aggregates. It cannot be made responsible for national economic conditions. The reason is that it has one objective, namely the maintenance of price stability in the eurozone as a whole, and because it has only one instrument to achieve this goal.

This I believe is too cheap an answer. The ECB is not only responsible for price stability but also for financial stability. The financial crisis that erupted in the eurozone last year clearly had its origin in a limited number of countries. It is therefore important that the ECB focuses not only on system-wide aggregates but also on what happens in individual countries. Excessive bank credit creation in a number of member countries should also appear on the radar screens of the ECB in Frankfurt and that institution should take action accordingly.

One may object that the ECB does not have the instruments to deal with excessive bank credit in parts of the eurozone. This, however, is not so. The Eurosystem has the technical ability to restrict bank credit in some countries more than in others by applying differential minimum reserve requirements, or by imposing anti-cyclical capital ratios. These can and should be used as stabilising instruments at the national level.

Figure 6. Real house prices and growth rate of nominal credit relative to GDP (percent)



Source: Kannan et al. (2009).

Another objection is that it is the responsibility of the financial supervisors to deal with excessive risk-taking by banks. When banks extend too much credit and thereby increase the risk of their balance sheets, national supervisors should intervene. This is undoubtedly so. At the same time it does not absolve the Eurosystem from its responsibility to maintain financial stability. When a credit-fuelled boom emerges in some member states, it is also the responsibility of the Eurosystem to act. The Eurosystem also has the most powerful toolkit for controlling the macroeconomic consequences of booms and busts.

The recent reforms in the supervisory landscape in the eurozone increase the scope for action by the Eurosystem. As will be recalled, the European Systemic Risk Board (ESRB) has now been created, which will be presided over, very pointedly, by the President of the ECB. Thus the creators of the ESRB have clearly understood that the ECB lies at the centre of the monitoring of emerging systemic risks in the eurozone. It would be highly paradoxical for the President of the ESRB (ECB) to sound warning signals about systemic risk and then not follow-up this warning by action to reduce the risks, leaving it to the national supervisors to act alone.

4. Conclusion

Much of the discussion about how to impose more convergence among member states of the eurozone has focused on what national governments should do to avoid divergent developments in a number of

macroeconomic variables (competitiveness, current account imbalances). Without denying that national governments bear part of the responsibility, the role of these governments has been over-emphasised. Conversely the role of the monetary authorities, in particular the ECB, has been under-emphasised.

This conclusion is based on my diagnosis of the causes of the present crisis, namely that the divergences between member states of the eurozone have been driven mainly by ‘national animal spirits’, i.e. waves of optimism and pessimism that continue to have a strong national basis in the eurozone. There are as yet no animal spirits gripping the eurozone as a whole. These national animal spirits endogenously trigger credit expansion and contraction. It is this link between credit and animal spirits that make the latter so powerful in shaping movements in output and investment. It follows that the key to the control of the national divergences in macroeconomic variables lies in the control over the movements of credit at the national level. The key institutions in the eurozone that can influence national credit movements are the monetary authorities, including the ECB.

The official EU-proposals (from the European Commission and the Task Force on Economic Governance) to deal with national divergences in the eurozone should therefore not concentrate almost exclusively on what governments of the member-states should do, but also on the responsibilities of the eurozone monetary authorities. Some hard thinking about the role of these monetary authorities will be necessary to come to grips with endemic macroeconomic divergences in the eurozone.

Finally we also stressed that the European Commission's proposals to strengthen the Stability and Growth Pact by adding more sanctions is ill conceived. The fundamental cause of the debt crisis in the eurozone is to be found in the unsustainable expansion of private debt prior to the crisis. The strong expansion of government debt levels in the eurozone started *after* the financial crisis erupted and it was necessary first to save large parts of the private sector and second to prevent a downward spiral in economic activity. The Commission's proposals suggest that future governments that intervene to save the private sector should be punished for such wickedness.

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