The euro-isation of Europe

By Guillaume Sacriste, Paris 1-Sorbonne and Antoine Vauchez, CNRS and Paris 1-Sorbonne

In the latest article in *La Revue de l’OFCE (no. 165, 2019), accessible here in French*, the authors analyze the emergence of a new European government, that of the euro, built to a great extent on the margins of the EU’s existing framework. In noting this, the article takes stock of a process of the transformation of Europe (the European Union and Member States), which we call here the “Euro-isation of Europe”, in three dimensions: 1) the creation at its core of a powerful pole of Treasuries, central banks and national and European financial bureaucracies; 2) the consolidation of a European system of surveillance of the economic policies of the Member States; 3) the gradual re-hierarchisation of the political priorities and public policies of the European Union and the Member States around the priority given to financial stability, balanced budgets and structural reforms. The article thus makes it possible to redefine the nature of the “constraints” that the management of the single currency is imposing on the economies of the Member States, constraints that are less legal than socio-political, less external and overarching than pervasive and diffuse, and ultimately closely linked to the key position now occupied by the transnational network of financial bureaucracies in defining European issues and policies.

Towards a better governance in the EU?

By Catherine Mathieu and Henri Sterdyniak

The 10th EUROFRAME Conference on economic policy issues in the European Union was held on 24 May 2013 in Warsaw on the topic, "Towards a better governance in the EU?" Revised versions of twelve of the papers presented at the Conference are included in issue 132 of the "Debates and Policies" collection of the *Revue de l'OFCE* entitled "Towards a better governance in the EU?". The papers are organized around four themes: fiscal governance, analysis of fiscal policy, bank governance, and macroeconomic issues.

The global financial crisis of 2007 and the sovereign debt crisis in the euro area that begin in 2009 have highlighted shortcomings in EU governance. The intense debate that has been going on among economists over how to analyze these shortcomings and proposals for improved governance also marked the EUROFRAME Conference.

How can the Economic and Monetary Union be strengthened between countries that are still fundamentally different? How can we get out of the financial and economic crisis, the sovereign debt crisis, fiscal austerity and depression? Is it possible to develop a governance of the euro area that ensures the strength of the single currency, that avoids widening the disparities between Member States, and that gives the Members the flexibility needed, while forbidding non-cooperative policies, whether that means the excessive pursuit of competitiveness and trade surpluses or the irresponsible swelling of their public or foreign debt?

The articles in this issue provide readers with various viewpoints on possible pathways that Europe could take:

– Some authors think that we should stick to the original Treaty, abolish solidarity mechanisms, prohibit the Central Bank from buying the debt of member countries, and make it compulsory for them to find financing on the financial markets, which, stung by the Greek experience, will now be more vigilant and impose risk premiums on countries they consider lax. But is this compatible with the single currency? Are the markets really competent in macroeconomic matters? And will the euro zone members accept being reduced to the rank of countries without monetary sovereignty, whose public debt is considered risky and who do not control their interest rates?

– Other authors believe that we should gradually move towards a federal Europe, where the European authorities would be responsible for the fiscal policy of each MemberState; this would need to be accompanied by a democratization of EU institutions, perhaps including even some form of political union. But can there be centralized management of countries in different economic circumstances with different economic and social structures, and which thus need differentiated strategies? Isn't the euro zone just too heterogeneous for this? Would every country agree to submit its social and economic choices to European trade-offs?

– Other authors believe that such heterogeneous countries cannot share a single currency; that the Northern countries will refuse to give an unconditional guarantee of public debt, even though this is a prerequisite for maintaining the euro zone's unity; that Europe is incapable of organizing a common but differentiated strategy; and that the differentials accumulated in terms of competitiveness require large exchange rate adjustments in Europe. Exchange rates need to be allowed to reflect the Members' different situations, *i.e.* sharp exchange rate falls in the Southern countries, and sharp rises in the Northern countries, by returning to the

European Monetary System, or even to flexible exchange rates. Each country would then have to face up to its responsibilities: the Northern countries will have to boost domestic demand, while the Southern ones will have to use their gains in competitiveness to rebuild their export sectors. But no country is demanding this leap into the unknown – the financial consequences could be terrible.

– Finally, some authors, including ourselves, believe that public debts should once again be risk-free assets, guaranteed by the ECB, as part of a process of genuine coordination of economic policy by the Member States, while explicitly targeting full employment and the coordinated reduction of imbalances in the zone. But isn't such coordination a myth? Is a country going to agree to change its economic policy objectives to help the situation of its partners? Don't the European countries today mistrust each other too much to agree to guarantee the public debt of their partners?

These are the questions addressed in this issue, which, as the European elections draw near, we hope will make a useful contribution to the debate on EU governance.

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[1] EUROFRAME is a network of European economic institutes, which includes: the DIW and IFW (Germany), WIFO (Austria), ETLA (Finland), OFCE (France), ESRI (Ireland), PROMETEIA (Italy), CPB (Netherlands), CASE (Poland) and NIESR (United Kingdom).

[2] This issue is published in English.

From Trichet to Draghi: Results and prospects

By [Christophe Blot]()and [Eric Heyer]()

During eight years as head of the ECB, we have seen two Jean-Claude Trichets (JCT): one dogmatic, the other pragmatic. What will be the face of his successor, Mario Draghi of Italy, as he takes office during the unprecedented crisis facing the euro zone?

Over the first five years, the pre-crisis period, we had **JCT the dogmatist:** a very experienced central banker, he scrupulously stuck to his mandate, namely to keep inflation close to 2%. In light of this single criterion, considered essential by the Germans, JCT's record was good, as average inflation in the euro zone during the period was 2.1%. However, several criticisms can be leveled at his post-crisis activity: the first is that in trying to give flesh to the single currency and make it credible, JCT decided to make it "strong" – which is different from "stable". No arrangements were made to control the exchange rate, and he was pleased to see the euro rise from $1.10 in 2003 to almost $1.50 in late 2007, an appreciation of 37%. The dogma of the strong euro, of competitive disinflation, has certainly helped to contain inflation, but at the expense of Europe's competitiveness and growth. A less strict interpretation of price stability would have led the ECB to pay more attention to the euro's exchange rate, which would in turn have promoted more vigorous growth and employment in the euro zone. Between 2003 and 2007, average annual growth in the euro zone was 0.6 percentage point lower than in the US and the UK (2.1% against 2.7%), and the unemployment rate was more than 3 points higher (8.4% in the euro zone against 5.1% in the US and UK), with comparable performances on inflation. The second criticism has to do with JCT's strict interpretation of the fight against inflation, which led him into a serious miscalculation: in the summer of 2008, just weeks before the collapse of Lehman Brothers, while the US economy was already in recession and fears were growing for Europe, the ECB decided to raise interest rates out of fear of renewed inflationary pressures fueled by the rising prices of energy and food raw materials. However, worrying about inflationary pressures at a time when the global economy was about to sink into the greatest crisis since the 1930s was not very perceptive.

For the past three years, a period of crisis, we've had the **JCT the pragmatist**: in the absence of a system of European governance, JCT has been a pillar of Europe's response to the crisis, as he engaged as equals with heads of state and made significant efforts to rescue the financial system. In this regard, and in contrast to the previous four years, he has taken some liberties with the mandate and statutes of the ECB by implementing unconventional measures, especially at the time of the sovereign debt crisis. But by raising rates since the beginning of the year, against a background of mass unemployment and substantial under-utilization of the euro zone's production capacity, JCT the pragmatist has committed the same error of interpretation as JCT the dogmatist did three years earlier: as the rise in inflation was not associated with the risk of an overheating European economy, but rather had its origin in the rising prices of food and energy raw materials, the rate increases have not had any impact on inflation but, on the other hand, they have contributed a bit to further weakening European growth.

In fact, the ECB quickly revised its diagnosis, leaving the door open to a rapid cut in interest rates. It is also likely that Jean-Claude Trichet would have acted faster had he not been at the end of his term. In doing what he did, JCT avoided locking his successor into a specific scenario, and thus left him a range of options in his first steps at the head of the ECB. Mario Draghi quickly ended any suspense about his intentions by announcing a quarter point cut in interest rates at his first meeting on 3 November. While he was careful to point out that the ECB does not make any commitments to future decisions, the macroeconomic and financial situation points towards at least one further rate cut.

Yet if the question of interest rate policy is a central element of monetary policy and thus of Mario Draghi's mandate, the challenges facing him go far beyond this issue. In the context of the euro zone crisis, the eyes of the world are focused on the ECB's program of securities purchases, which raises the question of the ECB's role in European governance. This question actually involves a number of critical and interdependent matters: the role of lender of last resort, coordination between fiscal policy and monetary policy, and the ECB's role with respect to financial stability.

The current crisis illustrates the difficulties inherent in the functioning of a monetary union that lacks a fiscal union, since in actuality this means that a member of the union is taking on debt in a currency that it does not control. Even though in normal times monetary policy operations in the United States lead the Fed to hold government securities – mostly short-term – the crisis has prompted the US central bank to expand its purchases of securities and to change the structure of its balance sheet by buying government bonds on secondary markets. The Bank of England has taken similar action by purchasing nearly 200 billion pounds of government bonds[1]. As for the Bank of Japan, it has amplified the unconventional measures that were already in place to fight the deflation that has plagued the archipelago since the late 1990s. In taking these actions, the central banks have put downward pressure on long-term interest rates, and they have ensured the liquidity of these markets by acting implicitly as lenders of last resort. While the ECB has also gotten involved in this area by buying more than 170 billion euros of government securities (Italian, Greek, Portuguese and Irish), the magnitude of its asset purchase program (2.1% of the total public debt of the euro zone countries) is still below the level implemented by the Federal Reserve and the Bank of England, which respectively own more than 10.5% and 16% of the public debt issued by their governments. Moreover, the ECB took care to specify that the program was temporary, had a limited budget and was designed to restore the effectiveness of monetary policy. In a recent comment, Paul de Grauwe compared the ECB's strategy to that of an army chief going off to war who declares that he would never use his full military potential and he would bring all the troops home as soon as possible, that is to say, without ensuring that final victory had been won. A strategy like this is doomed to failure. Only an open-ended commitment could stop the contagion affecting the euro zone countries plagued by budget problems. And only one central bank can offer such a guarantee, through the creation of money. Yet up to now Europe's countries have rejected this path, including at the summit of October 25, while at his first press conference Mario Draghi has only reiterated the strategy of the ECB, even adding that he did not believe that a lender of last resort is the solution to the crisis in the euro zone. As the size of the remaining EFSF is insufficient to halt the contagion, it is likely that the role of the ECB will once again take center stage. It is to be hoped that Mario Draghi and the members of the Board of Governors will be more pragmatic on this next occasion. It is urgent to recognize the ECB's role as lender of last resort by making the financial stability of the euro zone an explicit objective of monetary policy.

Moreover, beyond the role of lender of last resort, the coordination of economic policy more generally also needs to be revised. The articulation of the policy mix is indeed a central element of performance in terms of growth. In the US, the complementarity between monetary and fiscal policy is now obvious, as by putting pressure on long rates, the Federal Reserve implemented a policy to ensure the sustainability of fiscal policy at the same time that it is promoting the impact on growth. The main criticism of this policy argues that this undermines the independence of the Central Bank. However, there is no evidence today to say that the Fed has abandoned the conduct of monetary policy in favor of the government. The question does not even arise, since the US central bank is pursuing the same objectives as the US government: growth, employment, price stability and financial stability [2]. These objectives are interdependent, and the euro zone will find its way to growth again only once all the authorities are rowing in the same direction.

While these issues are not all the exclusive responsibility of Mario Draghi – a reform of the Treaty could strengthen and legitimize his decisions – his position will nevertheless be decisive. The crisis in the euro zone calls for urgent decisions and will quickly reveal the ambitions and the capabilities of its new president.

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[1] The BoE has, however, just announced that its program to buy securities will be gradually expanded to 275 billion pounds sterling.

[2] See "The Fed, the ECB and the dual mandate".