2. How to embed the Eurozone in a political union

Paul De Grauwe

University of Leuven and CEPR

The Eurozone lacks the mechanisms needed to ensure convergence of members' competitive positions and to resolve crises. This essay argues that the survival of the Eurozone depends on its capacity to embed itself into a political union. The latter must imply some transfer of sovereignty in macroeconomic policies and the organisation of automatic solidarity between member states.

Two fault lines marred the Eurozone's foundation from its inception but were overlooked by most. The recent debt crisis has laid them bare for all to see.

- There is no mechanism to ensure convergence of members' competitive positions, and thus to prevent major trade imbalances.

This stems from the fact that economic policies (spending and taxation, social policies, wage policies, etc.) remain firmly in the hands of the member governments and members do not coordinate such policies.

- There is no mechanism to resolve crises caused by these imbalances and divergent competitive positions.

Consequently, Eurozone crisis management is ad hoc, time-consuming, and hindered by a lack of credibility.

Lack of political union: What are the essential missing elements?

These two fault lines are intricately related to the fact that the Eurozone is not embedded in a sufficiently strong political union. The Eurozone's future depends critically on its capacity to move forward into a political union. Failure to move forward towards a political union will almost certainly condemn the Eurozone to oblivion.

But a full political union seems unrealistic for the foreseeable future, as it would imply a significant transfer of spending and taxing powers to a central EU government and parliament. Today, the EU budget represents about 1% of EU GDP and proposals to boost that by even 0.1% consistently attract vetoes from several EU members. A budgetary union, in short, is out of reach.

Is there anything less than full budgetary union that can save the Eurozone? Put differently, what is the minimum ingredient of a political union that can keep the Eurozone alive in the long run?

The answer is dictated by the Eurozone's fault lines. The political union needed is one that can repair the two fault lines.

Redressing the imbalance fault line

The necessary elements of political union must be able to:

- Prevent the massive divergences in competitive positions and trade imbalances within the Eurozone.

Importantly, with the exception of Greece, the imbalances and divergences we see today had little to do with government profligacy. They appeared in the private sector. Unsustainable consumption and real estate booms financed by private debt emerged in a number of member countries, like Ireland and Spain. These led to strong price and wage increases, undermining the competitiveness of these countries and leading to large current account deficits.

It is both ironic and instructive that these countries scrupulously adhered to the Stability and Growth Pact. Enforcing the pact may be a necessary condition for preventing future crises, but it is far from sufficient.

The domain of the Stability and Growth Pact must be broadened – it must include the monitoring of private debt developments as well as public debts.

Additional pooling of economic policy sovereignty

The European Commission has recognised this point in its latest proposals on economic governance in the Eurozone. The issue, however, is how one can make these proposals bite. One thing is certain – there will have to be a transfer of sovereignty in economic policies.

This transfer of sovereignty should not only take place in the "deficit" countries that allowed private and/or public debt levels to explode. One should not forget that "surplus" countries helped finance this debt explosion. Any scheme aiming at identifying and monitoring imbalances will have to be symmetric. It would have to ensure that both deficit and surplus countries change their policies.

From the Eurozone's perspective, there are not good imbalances and bad imbalances – just imbalances. There are, consequently, no good and bad guys when it comes to international imbalances. Institutional reforms must recognise this.

Redressing the crisis-resolution lacuna: A second-best proposal

Full-fledged monetary unions – most of which are embedded in political unions – typically involve automatic transfers across regions. Regions experiencing economic good times transfer resources to regions in economic distress.

As argued earlier, such a budgetary union remains a remote possibility for the Eurozone. That's why a second best solution must be sought.

The recent decision to create a financial stability fund within the Eurozone goes in the right direction. It should allow the Eurozone to pool resources and to act quickly in a crisis situation. It falls short of an automatic insurance mechanism, however, mainly because it is a network of bilateral loan agreements, making it possible for individual countries to pull out in the future.

Thus far, the design of the Eurozone has foregone any form of automatic insurance mechanism. The main reason was that – as with any insurance mechanism – the risk of moral hazard was viewed as too great. The specific risk here was that governments would create excessive debts and deficits in anticipation of insurance-fund bailouts. Avoiding this was the main reason why the Eurozone was created without an insurance mechanism.

While it is understandable that countries were not willing to automatically transfer resources to deficit countries, it is less clear why so many fell for the illusion that a monetary union could function smoothly without such an insurance mechanism.

The present crisis shows that even if countries never intended to provide assistance to others, events can force them to do so. The same juxtaposition of intentions and actions exists on the domestic front. Governments that never intended to bailout their banks found themselves doing exactly that when the banking crisis erupted. Thus, at some point, a monetary union forces its members to show solidarity, whether they like it or not. That's why setting up an explicit solidarity (insurance) mechanism is important.

The official doctrine in the Eurozone has been that an insurance mechanism is not necessary for a smooth functioning of the Eurozone. The Stability and Growth Pact would do the trick. The received wisdom was: "Just make sure that countries abide by the rules". If they do so, i.e. if they are always well behaved, there is no need for an automatic insurance mechanism funded by a centralised budget or European Monetary Fund. But this is like saying that if people follow the fire code regulations scrupulously, there is no need for a fire brigade. The truth is that there will always be some people who fail to follow the rules scrupulously, so a fire brigade will always be necessary.

Survival of the Eurozone

There can be little doubt that the survival of the Eurozone depends on its capacity to embed itself into a political union. The latter must imply some transfer of sovereignty in the conduct of macroeconomic policies other than monetary policies and the organisation of minimal forms of automatic solidarity between member states even when some of these have misbehaved.

About the author

Paul De Grauwe is Professor of International Economics at the University of Leuven, Belgium, having also been a visiting scholar at the IMF, the Board of Governors of the Federal Reserve, and the Bank of Japan. He is a member of the Group of Economic Policy Analysis, advising the EU Commission President Manuel Barroso, and was a member of the Belgian parliament from 1991 to

2003. His research interests are international monetary relations, monetary integration, foreign-exchange markets, and open-economy macroeconomics. His books include *The Economics of Monetary Union* (Oxford University Press), *International Money. Post-War Trends and Theories* (Oxford University Press), and *The Exchange Rate in a Behavioural Finance Framework* (Princeton University Press). He obtained his Ph.D. from the Johns Hopkins University in 1974 and *honoris causae* of the University of Sankt Gallen (Switzerland), of the University of Turku (Finland), and the University of Genoa. He is a CEPR Research Fellow.