

# The Fragility of the Eurozone's Institutions

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## 1 Introduction

The introduction of the euro in 1999 is without any doubt one of the great achievements in the European integration process. In one bold stroke national monetary sovereignty was abolished and transferred to a new European institution, the European Central Bank (2009) that from then on became the guardian of the new currency. The skeptics, and it must be admitted most of us economists were skeptic, were proven wrong.

Despite this success, the Eurosystem remains a fragile construction. Problems of governance of the Eurosystem exist and should be resolved so as to ensure its long-term survival. In this paper we discuss some of these governance issues (For more extensive surveys of these issues see Baldwin and Wyplosz (2006), Bruegel (2008) and European Commission (2008)). The first one deals with the objectives of the ECB and its singular focus on inflation. We discuss this in Section 2. Next we discuss the governance issues that arise from the absence of a political union (Sections 3 to 5). We will argue that political union is essential for the long-term survival of the eurozone.

## 2 Excessive focus on inflation?

The ECB has been giving a mandate to maintain price stability. There can be little doubt that it was very successful in keeping inflation low. From 1999 to 2008 the

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average inflation rate in the eurozone was 2.2% not much above the target of 2% the ECB had set itself as an objective. The Treaty, however, does not mandate the ECB to only care about inflation. It also mandates the ECB to be concerned about other objectives in particular economic and financial stability, provided these objectives do not interfere with price stability. With the onslaught of the banking crisis one can ask the question of whether the ECB could and should have done more to avert this crisis. In addition, the question arises of how the governance of the Eurosystem can be improved to avoid a recurrence of such a crisis.

Much has been written about the causes of the financial crisis. An essential development that made a banking crisis possible was the progressive deregulation of the banking systems in the US and in Europe starting in the 1980s. This allowed commercial banks to take on all the activities investment banks had been taking, e.g. the underwriting and the holding of securities; the development of new and risky assets like derivatives and complex structured credit products. Thus banks were allowed to take on all risky activities that the Great Depression had thought us could lead to problems.

Deregulation and financial innovation promised to bring great welfare improvements: better risk spreading; lower costs of credit, benefitting firms that would invest more and benefitting millions of consumers who would have access to cheap mortgages. Who could resist to the temptation of allowing these market forces to function freely without interference of governments?

The trouble is that it did not work that way. Nobody has written a better book on the capacity of financial markets to generate bubbles and crashes than Kindleberger in his masterful “Manias, panics and crashes”.<sup>1</sup> Kindleberger showed how the history of capitalism is littered with episodes during which asset markets are caught by a speculative fever that pushes prices to levels unrelated to fundamental economic variables (see also Shiller (2000)).

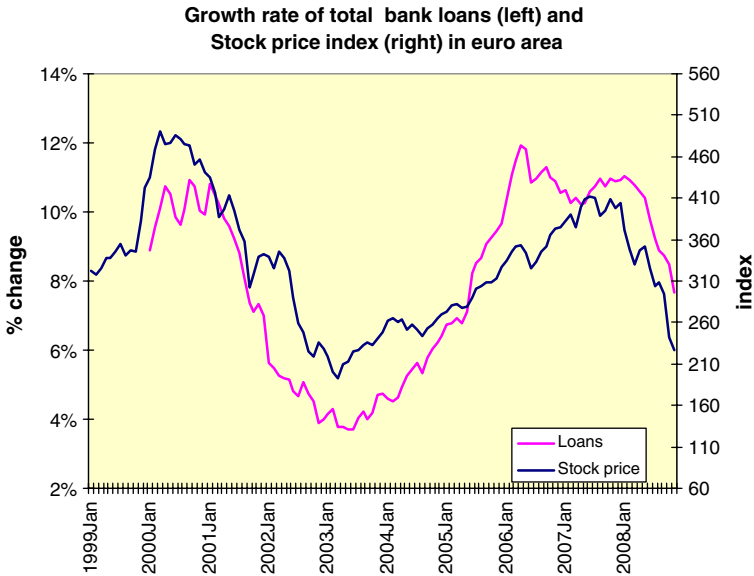
The fact that financial markets are continuously gripped by speculative fevers leading to bubbles and crashes would not have been a major problem had banks been prevented from involving themselves in financial markets. However, the deregulation of the banking sector that started in the 1980s fully exposed the banks to the endemic occurrence of bubbles and crashes in asset markets. Because banks were allowed to hold the full panoply of financial assets, their balance sheets became extremely sensitive to bubbles and crashes that gripped these assets. Banks’ balance sheets became the mirror images of the bubbles and crashes occurring in the financial markets.

This is shown in a spectacular way in Fig. 1. It illustrates how since the start of the decade the growth of bank loans in the eurozone closely mimics bubbles and crashes that occurred in the eurozone stock markets. The high correlation of bank credit and asset prices is a feature that is present in most bubbles and crashes in history. The two variables feed on each other. A bubble tends to loosen up bank credit automatically because it increases the collateral value of assets used in the loan process. And the increase in bank credit in turn intensifies the asset bubble.

It would be grossly unfair to put the responsibility of these developments to the ECB or the Eurosystem. The deregulation of the European banking system and the emergence of the universal banks which extended their investment reach to the whole

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<sup>1</sup> See Kindleberger (2005).



Source: European Central Bank  
 Note: The stock price index is the Euro Stoxx-50

**Fig. 1** Growth rate of total bank loans (left) and Stock price index (right) in Euro area

financial market, antedates the start of the Eurozone. Nevertheless, there were some failings in the governance of the Eurosystem that made the large scale propagation of the credit crisis to Europe possible, and that led to its near-collapse. These failings are to be found in two areas. First, by focusing almost exclusively on price stability, the ECB put too little emphasis on trying to clamp down on the emerging bubbles and the explosion of bank credit. Yet there can be no doubt that a central bank has the tools to keep bank credit in check. The ECB, however, failed to do so.

Second, there was a major failure of bank supervision within the Eurozone. Clearly as supervision has explicitly *not* been entrusted to the ECB, the ECB cannot be made responsible for this. The responsibility for bank supervisions remained entrusted to national regulators and national banks. Thus, it can be said that there was a failure of the monetary authorities as a whole in the eurosystem.

What can be done to avoid a recurrence of such a crisis?

A number of institutional changes will be necessary. The first one is that a significant component of the supervision within the Eurosystem should be centralized at the Eurosystem level. One possibility would be to subject “systemic banks” to European supervision, either by the ECB or a new European supervisor. It just does not make sense anymore to maintain supervision an exclusively national responsibility while monetary policy is fully centralized at the European level.

Second the responsibility of the ECB in maintaining financial stability should be strengthened. This could take the form of giving the ECB the responsibility of keeping the growth rate of bank credit under control. Mandating the ECB to take on another objective also requires that instruments should be available. The ECB has one such instrument, but has failed to use it up to now. This is the minimum reserve

requirement. The ECB could actively use this instrument to control the growth rate of bank credit. Thus, when bank credit increases too fast (like during the period 2004–2007) the ECB should raise the minimum reserve requirements so as to penalize excessive growth in bank credit.

### 3 Asymmetric shocks and divergencies in the Eurozone

One of the surprises of the functioning of the Eurozone has been the extent to which the competitive positions of the Eurozone countries have diverged. We show the real effective exchange rates in the Eurozone (based on unit labour costs) since 1998 in Fig. 2. The striking fact is the extent to which the relative unit labour costs have tended to diverge. As a result of these trends, some countries (Portugal, Netherlands, Spain and Italy) have lost a significant amount of price and wage competitiveness. Others, like Germany and Austria have gained a significant amount of price and wage competitiveness.<sup>2</sup>

There can be no doubt that part of these divergent developments in prices and wages are the result of divergent national wage policies. Since 1999, Germany has followed a tight policy of wage moderation. We show some evidence in Fig. 3. This presents the yearly nominal wage increases in Germany and in the rest of the Eurozone (excluding Germany). We observe the strong decline of nominal wage increases in Germany. The rest of the Eurozone maintained more or less constant wage increases around 3% per year. Thus, each year Germany tended to improve its competitive position vis a vis the rest of the Eurozone. The contrast between Germany on the one hand, and the UK and the US on the other, is even stronger. The latter allowed their wages to increase by 4 or 5% per year.

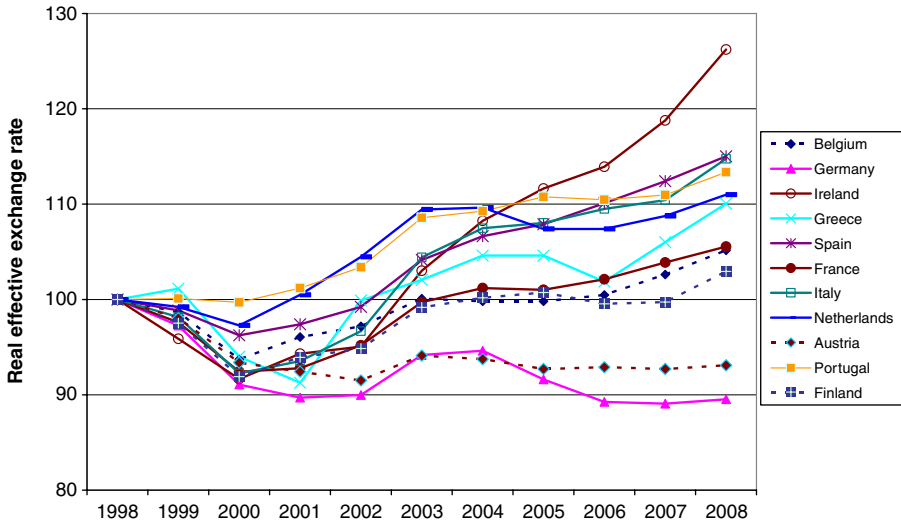
This German policy of wage moderation has not been without consequences for the other Eurozone countries which have seen their competitive positions deteriorate thanks to these German wage policies. Thus the latter have worked as “beggar-thy-neighbor” policies forcing other countries in turn to also institute drastic policies of wage moderation.<sup>3</sup> In this sense one can conclude that there has been a coordination failure in the eurozone. There can be no doubt that this had led to a major asymmetric shock that will have to be corrected.

The correction mechanism is likely to be painful. Other countries will be forced to intensify their policies of wage moderation, inducing the former again to restrict wage increases. All this is adding to deflationary tendencies characterized by low growth in consumption and investment and by increasing unemployment.

The divergent movements of competitive positions within the Eurozone are not only the result of German wage policies but also of the different speeds in the structural reform process in the member countries. The process of structural reforms (labour market reforms, liberalization of output markets) has remained a strictly national affair. Some countries, e.g. the Netherlands and Spain have gone some way

<sup>2</sup> It could be argued that these trends may also be the result of different initial levels of per capita income so that they reflect a catch-up process (Balassa-Samuelson effect). Since the real effective exchange rates shown here are based on unit labour costs they take into account differences in productivity growth.

<sup>3</sup> For a similar analysis in the context of the EMS, see Blanchard and Fitoussi (1992). For a theoretical analysis see Blanchard and Giavazzi (2003)



Source: European Commission

Fig. 2 Intra-euro area real effective exchange rates (based on ULC)

in deregulating employment protection systems, while other countries, e.g. France and Italy have a long way to go. These divergent movements have much to do with differences in national political systems. They generate a potential for divergent movements in employment and output (asymmetric shocks) within the Eurozone which will necessitate adjustments in the future. As these are likely to be painful. They are bound to lead to tensions in a monetary union.



Source: European Commission, Statistical Annex to the European Economy

Fig. 3 Nominal yearly wage increases in Germany and the rest of the eurozone

#### 4 On the need for further political integration

Large areas of economic policies remain in the hand of national governments creating asymmetric shocks that undermine the sustainability of the monetary union. In particular, the use of uncoordinated national wage policies leads to divergent trends in the competitive positions of the member countries of the eurozone. This in turn leads to a vicious circle in which each country tries to recover its competitive position by wage cuts, leading to deflationary spiral. Not only wage policies have remained in the hands of national governments, the whole of social policies together with the structural reform processes are national affairs. These create a potential of structural divergences between member states leading to diverging trends in output and employment.

These problems call for further steps towards political union (see also Von Hagen (1996) on this issue). Without a political union the Eurozone is at risk. The previous analysis allows us to describe how such a political union should look like.

A first element of such a political union is a certain degree of budgetary union, giving some discretionary power to spend and to tax to a European executive, backed by a full democratic accountability of those who are given the authority to spend and to tax. This will allow setting up an insurance system against asymmetric shocks in the Eurozone. This can take many forms, and several proposals have already been made (see e.g. Méhitz and Vori (1993), Von Hagen and Hammond (1995)). The transfer of budgetary power does not have to be spectacular as was shown by the previous authors. Nevertheless, it will require a European budget that increases significantly relative to its present level of about 1% of GDP.

Second, an increased institutionalized coordination of a number of economic policy instruments that have macroeconomic consequences will be necessary. We have mentioned social policies (including structural reform policies) and wage formation. The need to coordinate does not imply that these areas should be fully centralized. Rather it means that spillover effects of decisions in these areas into the monetary union should be internalized. Thus, decisions like cutting the working week in France which have obvious implications for the Eurozone as a whole should be a matter of common concern, and should not be allowed to be decided by individual countries without consultation with other countries. Similarly, national wage policies will have to be coordinated in order to avoid asymmetric developments in competitive positions of the member countries.

Third, accountability of the European institutions that today take major decisions at the macroeconomic level will have to be improved significantly. This includes the ECB, an institution that singularly has managed to escape any serious degree of accountability. Improving accountability of the ECB also implies that the definition of the objectives of monetary policy should not be left to the sole judgment of the ECB, as it is today. The definition of the objectives of the central bank belongs to the political sphere. It is not just a technical problem that the ECB alone decides about. It also follows that the independence of the ECB should be restricted to instrument independence, much in the same way as this is done today in major countries in the world, such as the UK, the US and other industrialized countries. This means that once the objectives have been defined by accountable politicians, the central bank should be left free to pursue a policy that leads to these objectives.

## **5 The institutional weakness of the present Eurozone governance: the stability pact**

The present institutional design of the Eurozone exhibit other weaknesses, in particular at the level of fiscal policies.

The Stability and Growth Pact (SGP) was supposed to provide the cornerstone of the governance of fiscal policies in the Eurozone. The SGP was seen as the necessary fiscal framework providing long run sustainability of national fiscal policies. The SGP, however, is built on a weak institutional foundation. The reason is the following. As argued earlier, spending and taxation are still very much the responsibility of national governments and parliaments. That is also the level at which democratic legitimacy is vested. As a result, these spending and taxation decisions are backed by an elaborate process that is deeply embedded in national democratic institutions.

The SGP now imposes top down an extensive control and sanctioning system on the net effect (budget deficit) of this democratic decision making process by institutions that are perceived to lack the same democratic legitimacy. Lawyers will undoubtedly object that the SGP is the result of a Treaty that has been ratified by the same democratic institutions, the national parliaments, so that it has the same legitimacy as the national parliaments. This is undoubtedly true from a legal point of view. It is not from a political point of view.

When the Commission starts an excessive deficit procedure which aims at forcing national governments to cut spending and/or increase taxes, it bears no political responsibility for these decisions. In fact, the national governments do. When these follow up on the Commission's procedure and cut spending and raise taxes they are the ones who will be judged by their national electorates, and who face the threat of being punished by the voters at home. In contrast, the European Commission at no time faces the prospect of being voted away. Thus from a political point of view, the European Commission, which initiates the control and sanctioning procedure of the SGP, lacks democratic legitimacy, because there is no mechanism to make the Commission accountable before an electorate for its actions.

This lack of accountability of the Commission makes the SGP unsustainable. Each time a conflict arises between the Commission and the national governments, the former is bound to loose. This is also what has happened in November 2003 when France and Germany disregarded the SGP. It is in the process of happening as a result of the financial crisis that will make it impossible and undesirable for many eurozone governments to abide by its rules, even the watered down ones since 2005. Thus, it can be concluded that the SGP is a fragile institutional construction that is unlikely to lead to its objective.

This problem will continue to exist as long as the nation-states maintain their sovereignty over spending and taxation, and as long as those who decide about spending and taxation are made accountable for decisions before a national electorate.

## **6 Conclusion**

In this paper we have analyzed some of the governance problems existing within the Eurosystem. We have focused on two broad problems. The first one arises from the singular focus attached by the ECB on inflation. The eruption of the financial crisis

teaches us an important lesson. Central banks have a broader responsibility than keeping consumer prices stable. This broader responsibility includes the maintenance of financial stability. The idea that financial stability will be achieved by just targeting inflation has been proven to be wrong. Central banks, including the ECB, must do more. First, they should intervene to prevent bubbles in financial markets from emerging. The best way they can do this is by keeping the growth rate of bank credit under control. Bubbles emerge mostly when they are allowed to emerge because of excessive bank credit. A central bank should and can keep bank credit under control. Second, the supervision of the banking sector within the Eurozone will have to be revamped. A significant part of the supervision of banks should be centralized at the Eurosystem level. It just does not make sense to have a fully centralized monetary policy and a fully decentralized system of bank regulation and supervision.

The second governance problem arises from the fact that monetary policy in the Eurosystem has been fully centralized while most of the other instruments of economic policies (including banks supervision) have remained in the hands of the member countries. We have argued in this paper that the long run success of the Eurozone depends on the continuing process of political unification. Such a political unification is needed to reduce the scope for the emergence of asymmetric shocks and to embed the Eurozone in a wider system of strong political ties that are needed to take care of the inevitable divergent economic movements within the Eurozone. In addition, such a political union is necessary to deal with the flaws in the governance of the Eurozone. The major flaw is that while national politicians continue to bear the full political responsibility for unfavourable trends in unemployment, key instruments to deal with this problem have been taken away from them and have been transferred to European institutions that bear no political responsibility for their decisions.

The recent no votes concerning the European constitution signal that there is a strong “integration fatigue” in the European Union today, making it unlikely that significant progress in political unification can be made. This will continue to make the Eurozone a fragile regime. In the long run, however, there can be little doubt: without further steps towards political union the Eurozone has little chance of survival.

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