Closer fiscal integration is unavoidable if the Eurozone is to survive

29/02/2016

The fundamental flaws of the European Monetary Union can only be overcome by a drastic change in macroeconomic policies, according to recent research carried out by **Enrico Marelli** *and* **Marcello Signorelli**. *They argue that in the long run, radical reforms at the Eurozone level are needed if the monetary union is to survive, although it is still admissible to allow non-Eurozone countries to follow a weaker form of integration. They also suggest that in order to provide financial substance to the 'Europe 2020' plans, a common budget should be created within the Eurozone.*

The failure of the Eurozone to implement real convergence has been one of its critical flaws from the outset, as we argue in a recent paper. The fundamental weakness in the creation of the monetary union was the emphasis that was placed on so-called "nominal convergence" criteria, to the neglect of "real convergence" that, it was assumed, would be an inevitable outcome of the monetary integration process. This analysis is corroborated by our econometric investigations into the long-run convergence processes within the Eurozone. We find that convergence in per-capita income has been more evident in the enlarged EU, which includes the new member states of Central and Eastern Europe that are "catching-up", rather than in the Eurozone. In any case, the adoption of the euro did not play any significant role in the process of real economic convergence.

Furthermore, as many other writers have observed, the requirements for a well-functioning monetary union, as set out in the theory of the "Optimum currency area" (similarity of production and specialisation, labour mobility, public insurance in the case of asymmetric shocks), are not satisfied in the Eurozone; in some cases, they have even deteriorated after the recent crises. The greatest failure in the construction of the Eurozone has been the lack of any central fiscal capacity based on a sizeable central budget, which at present represents only 1 per cent of the EU's GDP. This not only undermines the possibility to have adequate instruments that favour real convergence, but also excludes the use of effective crisis-management tools in case of large economic shocks.

Recent macroeconomic trends in the Eurozone can be described as a "double crisis": the financial crisis (2007-08) and the consequent Great Recession (2008-09), then the "sovereign debt" crisis (since 2010-11). The latter crisis and the inadequate and delayed policy response by the Eurozone authorities led to a second recession in 2012-13, which in some peripheral countries stretched out to 2014. Even the current recovery is in most cases feeble, and there is a high risk of continuing stagnation with persistently high unemployment. In particular, the level of youth unemployment is remarkably high in many peripheral countries of Europe and the risk of a "lost generation" has become a real possibility.

In our paper, we argue that the adopted austerity measures were the wrong policy response. They were initially imposed on the "assisted" countries using the EU's rescue funds (the European Financial Stability Facility – EFSF; the European Stability Mechanism – ESM) under the supervision of the "troika", subsequently extended to all Eurozone countries through stricter rules on public budgets (Growth and Stability Pact, Fiscal Compact, "six-pack" and "two-pack"). From a theoretical point of view, such austerity policies were adopted on the basis of mistaken assumptions about the size of fiscal multipliers, which in the real world were far larger than had been assumed. The consequence has been that the austerity programme has been too harsh, too long and too pervasive (spreading to many countries). This mistaken policy caused a fall of output that, in addition to deflation or almost zero inflation, has kept the debt/GDP ratio at permanently high levels. In this sense, austerity has been self-defeating.

While monetary policy in the Eurozone can currently be considered suitable, in reality adequate measures were adopted too late. The key interest rate was reduced to almost zero in Autumn 2014 (six years later than the Fed) and, more important, "quantitative easing" (QE) was introduced at the beginning of 2015 (much later than by other major central banks). A crucial step was taken by President Draghi in the autumn of 2012 (after his crucial summer "whatever it takes" speech) with the introduction of the Outright Monetary Transaction (OMT) plan, that has been so important in reducing interest rates on sovereign debt, especially the spreads of peripheral countries over German bonds.

Seat of the European Central Bank. Credits: Epizentrum / Wikimedia Commons

Hence, this plan has really been decisive to "save the euro", but not to improve the credit conditions in the Eurozone. This is why, also in consideration of the deflationary conditions (with an inflation rate close to zero, much below the 2 per cent target) QE was launched in 2015, and now the European Central Bank (ECB) is ready to strengthen and prolong it. However, despite having achieved a minimal "banking union", the credit markets in the Eurozone are far from working in an efficient manner and there is still segmentation along national lines.

The policy implications are clear. In the long run, radical reforms at the Eurozone level are needed if the monetary union is to survive. The asymmetry between a centralised monetary policy and decentralized fiscal policies (even though constrained by EU rules) is the major design failure of the EMU. In the future, a common budget should be created at the Eurozone level. This is needed to face asymmetric shocks and to provide financial substance to the "Europe 2020" plans, with a greater role for structural funds, greater investment and infrastructure networks, and more spending on R&D and the development of human capital. All these are urgently required to ensure "real convergence". In a nutshell, more integration is necessary, though it is perfectly acceptable to leave the option for countries not adopting the euro to maintain a weaker form of integration. From this point of view, the recent document by the "Five Presidents" (June 2015) also seems too hesitant.

In any case, in the short run, a drastic change in macroeconomic policies is required to put an end to the present stagnation. The survival of the euro desperately requires that Eurozone policies should be rapidly and strongly re-oriented towards the objective of economic growth, while fiscal discipline should be assessed with a medium to long term horizon. Monetary policy is not enough to solve the current problems of feeble economic recovery (as recognised even by President Draghi) while the currently envisaged structural reforms can only be effective from a long-run perspective. Consequently, demand-management policies are urgently needed; for example, a spur to investment would both support aggregate demand in the short run and enhance economic growth in the long run. Unfortunately, the so-called "Juncker plan" is far too timid, and inexcusable delays have occurred in its implementation.

To sum up, it should be acknowledged that the "too little too late" approach is misguided. The risk of dismantling not only the Eurozone but the EU as a whole would be a calamitous defeat because, in a globalised world where the competitive pressure from new economic powers in all continents is every year more intense, a fragmented Europe would certainly lose out and fade into global insignificance.

Please read our comments policy before commenting.

Note: This article gives the views of the authors, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics. To read more on the topic, you can access the authors' recently published *paper in Croatian Economic Survey. Featured image credits: PAP / EPA*

Shortened URL for this post: **http://bit.ly/1QcVrMy**

About the authors

Enrico Marelli – *University of Brescia*
Enrico Marelli is Full Professor at the Department of Economics and Management, University of Brescia (Italy). Post-graduate studies at the London School of Economics and at the University of Pennsylvania. In Brescia, he has been Head of the teaching board of the degree in Economics and is now member of the Department Committee (Giunta). E-mail contact: enrico.marelli@unibs.it.

Marcello Signorelli – *University of Perugia*
Marcello Signorelli is Associate Professor (with " *abilitazione*" as Full Professor) of Economic Policy at the Department of Economics, University of Perugia (Italy), and he is also member of the Academic Senate. Post-graduate studies at Columbia University and University of Warwick. He has been president of the European Association for Comparative Economic Studies (2010-12). E-mail contact: marcello.signorelli@unipg.it

Both authors are currently finalising the following book: Marelli E. and Signorelli M. (2016), *Europe and the Euro: Integration, Crisis and Policies*, Palgrave MacMillan, London and New York, forthcoming.

-