After the Eurozone Crisis

CAUSES, CONSEQUENCES, AND LESSONS FOR EUROPEAN AND US POLICYMAKERS

DALIBOR ROHAC AND LARS CHRISTENSEN
JULY 2017
Executive Summary

With positive growth rates projected for 2017 and 2018, the eurozone’s economic crisis appears to be over, at least for now. However, the damage lingers, and so do the factors that contributed to its severity across a number of the eurozone’s economies.

The most important among those is a one-size-fits-all monetary policy, guided by an extreme aversion to inflation. A comparative record of growth and fiscal consolidations in Europe illustrates that economies with flexible exchange rates coped far better with the challenges of the Great Recession than those inside the eurozone or with currencies pegged to the euro. Ultimately, the recovery in the eurozone was associated with a monetary easing in the form of a substantial program of asset purchases undertaken by the European Central Bank (ECB) in the later stages of the crisis.

The deflationary pressures attributable to the ECB’s behavior in the early years of the Great Recession likely contributed to the rise of authoritarian populist politics in Europe. While the populist wave is receding, its impact on European politics has been all too real—including the heightened risk of unraveling the EU and paralyzing Europe in the face of the increasingly aggressive Russia.

Going forward, a different monetary regime that acknowledges the importance of a stable growth in nominal spending—possibly with an explicit target level for nominal spending—is necessary for the ECB to mitigate damage from future economic shocks.

Besides monetary policy, inadequate fiscal governance continues to plague the eurozone. Current European discussions seem to be headed toward open-ended pooling of national-level debt. Instead, they ought to follow the experience of US federalism and its emphasis on a clear distinction between the fiscal authority of states and the fiscal authority of the federal government. That would involve a one-off federalization of some or all eurozone debt and giving new fiscal authority to EU institutions, while strengthening the fiscal autonomy of member states, including a no-bailout policy for future defaults by member states.
After the Eurozone Crisis: Causes, Consequences, and Lessons for European and US Policymakers

DALIBOR ROHAC AND LARS CHRISTENSEN

Shortly after the inauguration of President Donald Trump, Peter Navarro, director of the newly created US National Trade Council, accused Germany of “currency manipulation.” The euro, he argued, was “grossly undervalued,” making German companies overly competitive, particularly in their exports to the United States, destroying American jobs in the process. Most economists do not agree with Navarro’s characterization. After all, the exchange rate between the US dollar and the euro is determined by market forces, not by the fiat of the European Central Bank (ECB)—much less, the German government.

Nevertheless, to Navarro’s credit, there was a grain of truth to his claim. The eurozone’s rigid monetary system is tying together 19 diverse economies in a currency union. During the global economic crisis (the “Great Recession”) that spread from the United States in 2008, this monetary arrangement imposed large economic and social costs on the eurozone’s Mediterranean periphery. As in Argentina in 2001 and Germany in 1931, the combination of fixed exchange rates—or a common currency in the eurozone’s case—and a lack of domestic leadership on structural and fiscal reforms has led to a deep economic contraction and rendered European politics increasingly poisonous.

Since the experience of the 1930s, a large body of economic literature has explored how financial shocks, such as the US subprime mortgage crisis, can affect the real economy. A classic treatise by Milton Friedman and Anna Schwartz blamed the depth and severity of the Great Depression on the Federal Reserve’s failure to counteract the banking crisis with a monetary stimulus. Since then economists have articulated a variety of specific mechanisms describing how financial shocks, when not offset by an appropriate monetary response, result in prolonged periods of slow economic activity. For one, poor conditions for credit markets can lead to a vicious cycle in corporate capital expenditure decisions. As financial shocks drive up borrowing costs for firms, companies are incentivized to increase their markups. That, in turn, reduces real wages and household consumption. Whatever the specifics, the literature mapping the linkages between the financial sector and the real economy suggests that financial shocks ought to be confronted with more aggressive monetary easing than what is typically prescribed by the conventional monetary policy rules, such as the Taylor Rule, or by the practice of inflation targeting.

The ECB displayed an extreme aversion to inflation during the crisis. Complicating the matter further is the fact that the eurozone includes economies with different economic characteristics, making them susceptible to different economic cycles. If each of the eurozone’s economies had its own currency, it could respond to economic shocks at its own pace, resulting in changes to exchange rates. The literature on
optimum currency areas typically recommends that countries that decide to forgo that adjustment channel ought to ensure a high degree of wage flexibility, labor mobility, and effective fiscal transfers.

In the eurozone, by contrast, wages are generally rigid. Salary cuts are bad for workers’ morale and are impossible in many cases because of unionization. While workers can move from one European country to another, they face greater barriers than in other monetary unions such as the United States. Languages spoken across European countries are different, as are their cultures, labor laws, and tax systems. In the United States, people share the same language and cultural references and face only minimal administrative burdens in moving from one state to another. Survey data also reveal that migrants in Europe often perceive discrimination against them. As a result, while labor mobility in the EU has increased in recent years, it remains much lower than in the United States. Only three in 10 people who lose their jobs in the EU seek employment in another country, compared with six in 10 in the United States who seek employment in another state.

With minor exceptions—most importantly, the EU’s structural funds and agricultural subsidies—the eurozone also lacks a system of fiscal transfers to its economically depressed areas. In the United States, federal government spending—such as Social Security, Medicaid, and Medicare—is much larger than the spending of individual states. By contrast, EU spending is trivial compared with that of its member states.

Those design flaws were well-known during the euro’s creation. However, European policymakers believed that sooner or later the monetary union would be complemented by a common fiscal policy, including transfers, and by an economic convergence of member states. Neither has materialized. But even if one concludes that the creation of the euro was a mistake, there are no easy, risk-free ways to dismantle the monetary union. Unraveling the eurozone could involve a wave of sovereign defaults and a financial crisis of greater magnitude than the one prompted by the collapse of Lehman Brothers in 2008.

Yet the status quo is not sustainable, either. Following a series of European elections concluding with Germany in September 2017, one can expect intensified discussions over the unresolved questions about the future of fiscal governance in the eurozone. Such discussions, especially about pooling sovereign debt and creating a permanent eurozone-wide lender of last resort, could be fruitfully informed by the experience of American federalism, which gives the federal government a significant fiscal role without interfering with state autonomy to make decisions about taxes, spending, and debt. Such an approach, with a clear division of powers, would be more effective in reconciling the need for fiscal discipline at the national level with the necessity of providing the EU with the appropriate fiscal tools, and it would be more effective than current efforts to create an open-ended fiscal solidarity among eurozone governments by pooling debt into joint eurozone debt instruments. The risk of the current approach lies in the need for Brussels to micromanage fiscal decisions of member states, unnecessarily interfering in national politics—or, alternatively, exposing the eurozone to moral hazard problems created by the joint liability for debt of eurozone countries.

European policymakers need to remember that the ECB’s monetary policy and behavior will play a critical role in the eurozone’s future. The worst of the eurozone crisis could have been avoided if the ECB had aggressively intervened in the early stages of the crisis and counteracted the contraction in nominal spending, or nominal gross domestic product (NGDP), instead of focusing exclusively on its mandate of price stability. To avoid repeating the same mistake, the ECB ought to include NGDP in the range of metrics that inform its decisions, and the ECB could adopt an explicit NGDP target level as the main policy instrument. Targeting the level, instead of just the growth rate, is important because it would force the central bank to compensate for previous instances of undershooting or overshooting the target path, rather than letting the impact of past mistakes reverberate through the eurozone’s economy for years—as was the case during the eurozone crisis.
To be sure, better monetary policy would not solve the problem at the heart of the eurozone’s construction: It is a union of heterogeneous economies, lacking the prerequisites usually found in a well-functioning currency union. Neither is NGDP stabilization a substitute for sound structural and fiscal policies. Eurozone countries ought to make their economies more flexible and ensure that the long-term prospects of their public finances are sustainable. Whatever the final answers to those questions, the relevant reforms will be much easier to enact and have a greater chance to succeed if they occur in an environment in which the common currency offsets, rather than amplifies, economic shocks.

The Eurozone Crisis: Basic Facts

Between 2007 and 2015, Greece lost roughly a quarter of its real gross domestic product (GDP) (see Figure 1). The unemployment rate nearly quadrupled from just over 7 percent before the crisis to almost 28 in 2013, and it has since remained firmly above 20 percent. Greek youth were particularly affected, with unemployment rates among persons below 25 years of age exceeding 50 percent. Since 2008, more than 400,000 Greeks, mostly young and many highly skilled, have left the country in search of better opportunities abroad—the largest wave of emigration since 1972.

Short of plunging into an economic depression, other eurozone countries also experienced protracted periods of lackluster economic performance, with grave social consequences. One was the long-term slowdown of productivity growth across advanced industrial economies, exacerbated by the structural rigidities of Mediterranean economies. Furthermore, the eurozone faced the fallout from the financial crisis that started in 2008 in the United States. Among others, the economists Carmen Reinhart and Kenneth Rogoff observed that financial crises lead to extended and sometimes double-dip recessions and sluggish recoveries—as in the case of the eurozone.

The structural slowdown was not limited to the Mediterranean periphery. The Great Recession reverberated throughout advanced industrialized economies on both sides of the Atlantic. However, some European economies followed dramatically different trajectories than others. Figure 1 shows the changes in real output across European economies between 2007 and 2016, divided between those with independent monetary policies (“floaters” in green) and those that were in the eurozone or had their currencies pegged to the euro (“peggers” in red). Except for Norway, all the economies where real GDP was lower in 2016 than in 2007 were eurozone members or peggers throughout the period under consideration. In contrast, the top two performers—Turkey and Poland—operated their own monetary policies within a regime of flexible exchange rates.

How exactly did the financial crisis of 2008 arrive on Europe’s shores? For a long time, large banks in the EU and the United States followed similar business models. Shortly after the US banks were hit by declining profits due to subprime mortgage foreclosures, the impact was also felt across the Atlantic. Prominent early examples included the failures of Northern Rock in the UK and the German bank IKB, both exposed to US subprime mortgage securities. By early 2009, as many as 10 large Central and Eastern European banks were demanding injections of liquidity from European institutions.

In Ireland and Spain, the financial crisis led to a collapse of property markets, leaving many banks insolvent. In response, the Irish government issued a blanket guarantee on the debt issued by the six affected banks in September 2008, later complemented by the creation of the National Asset Management Agency, which took over assets from distressed banks and helped dysfunctional financial institutions wind down. In practical terms, that meant that a banking sector problem became a public finance problem for Ireland. Spain saw a drastic fall in real estate prices and a halt on new construction in 2008. The affected financial institutions were mostly the regional savings banks (“cajas”), which had provided the thrust of overall financing to real estate development. The government stepped in to provide emergency loans, as did EU institutions, turning the banking crisis into a fiscal crisis. In other countries, the impact of the crisis...
Public finances in Greece were hit directly. The Greek economy is heavily oriented toward shipping and tourism and thus sensitive to changes in global economic health. The crisis led to an immediate shortfall in government revenue and a dramatic increase in the government’s borrowing costs through 2012.

Between September 2008 and May 2009, the ECB responded to the financial shocks with a series of interest rate cuts, reducing the rate on main refinancing operations (MROs) from 3.75 percent to 1 percent. In early 2011, when the crisis was still far from over, the ECB increased this rate to 1.50 percent, reversing that decision shortly thereafter as the economic situation on the periphery continued to worsen. Since 2013, the eurozone has had low interest rates, with the MRO rate set at 0 percent since March 2016.

Yet interest rates are not reliable indicators of the stance of monetary policy, with lower rates indicating a monetary easing and higher rates indicating a tightening. Rates may fall at times when the monetary base increases, resulting in an effective easing of monetary policy. However, rates themselves are positively correlated with money velocity—making a rate reduction contractionary rather than expansionary. It is equally far from obvious that lower rates boost aggregate demand. Instead, lower rates appear to simply incentivize consumption at the expense of saving and investment. As a result, assessing the effectiveness of the ECB’s response to the crisis requires going beyond just interest rates.

First, consider the inflation rate. After the initial shock in 2008, the ECB let the eurozone slip briefly into deflation. With some exceptions, the inflation rate in the eurozone has remained firmly below the 2 percent target. Moreover, as Figure 2 shows,
monetary conditions in the eurozone subjected the Greek economy to a protracted period of deflation from 2013 to the end of 2016. The ECB's response was thus the exact opposite of the stabilization policy adopted by Iceland's central bank, which accepted a substantial spike in inflation following the króna's depreciation in 2008.

Another measure of the ECB's stance is the growth rate of broad money in the eurozone (see Figure 3). As expected during a financial panic, the growth rate fell precipitously throughout 2008–10. The ECB did not even step in to prevent money growth from falling below zero, effectively allowing the money supply to shrink at a pivotal moment of the crisis. The eurozone's periphery particularly felt the impact, resulting in a protracted NGDP contraction, as shown in Figure 4. Figure 4 also displays the changes in NGDP of Iceland (not a eurozone member), which underwent a more dramatic initial shock but rebounded quickly. In Italy, Spain, Portugal, and particularly Greece, the decline has not been reversed, shaving off almost half of Greece's NGDP between 2008 and 2016.

As the crisis intensified, it became manifest that the ECB's focus on low interest rates was inadequate in addressing the problem. The alternative instrument available was a substantial program of asset purchases, which had alleviated the impact of the crisis in the United States and the United Kingdom. While those two countries' programs of asset purchases, known as “quantitative easing,” arrived early, the ECB took until September 2012—after ECB President Mario Draghi's “whatever it takes” speech—17—to start its own large-scale program under the name of Outright Monetary Transactions (OMT). OMT was a...
subject of significant controversy in Germany, including a protracted legal challenge. Large-scale purchases of securities, including government bonds, were perceived as bailouts through the back door, which violated the ECB’s legal mandate.

Was the Problem Monetary?

Of course, the ECB’s failure to respond to the financial crisis in a timely manner is not the only factor worth considering. Many other explanations for the economic downturn on the eurozone’s periphery have been proposed. Discriminating among them empirically can be difficult.

That said, some supposed accounts of the crisis can be summarily dismissed, beginning with the national stereotyping that mushroomed in the tabloid press, suggesting that Greeks were inherently irresponsible or lazy. “Greece, but also Spain and Portugal have to understand,” the German tabloid Bild stated, “that hard work—meaning ironfisted money-saving—comes before the siesta.” Suffice it to say that Greeks work longer hours than workers in most advanced economies (more than 2,042 hours annually, compared with 1,790 in the United States and 1,457 in Denmark).

Another account of the crisis on the eurozone’s Mediterranean periphery emphasizes the bad institutions—rules of the economic game—in Greece, Italy, Spain, and other countries. Greece’s labor markets, for example, were overregulated and gave significant advantages to insiders at the expense of economic flexibility. Management of public finances was also far from stellar. The roots of those problems were political. Since the end of the military regime in 1974, PASOK and New Democracy, the two leading Greek political parties, built a system of political clientelism that

Figure 3. Eurozone Monetary Supply

distributes special favors to interest groups and organizations in exchange for political support ahead of elections. That system has proved resistant to change and has skewed policymaking away from policies that would threaten such privileges toward policies that impose costs on the general population while preserving the structures of political patronage.\footnote{21}

Mediterranean economies are unquestionably plagued by real structural and political problems, but such problems have been around for a long time and certainly predate the Great Recession. In contrast, an account of the crisis on the Mediterranean periphery needs to explain its timing—and that is not possible by relying on time-invariant causal explanations.

Even if one assumes that the financial shock only exposed the deeply rooted distortions in Greece’s economy, monetary authorities’ lack of an offsetting response to the NGDP collapse made much-needed structural and fiscal reforms harder. Recent research by economists at the International Monetary Fund (IMF) suggests that “structural reforms are best initiated in conjunction with supportive fiscal or monetary policy.”\footnote{22} That is in line with prior literature on the subject, which concludes that without support, particularly from monetary authorities, structural reforms might be contractionary or simply not feasible. Another study finds: “Absent the appropriate monetary stimulus, reforms fuel expectations of...
prolonged deflation, increase the real interest rate, and depress aggregate demand.”

The anecdotal experience of successful structural reform programs—most notably those undertaken in the first half of the 1990s by a number of Nordic countries—also indicates that such programs are facilitated by an accommodative monetary policy, which has been largely absent on the eurozone’s periphery.

In some circles the crisis is instead blamed on “austerity”—the fiscal adjustments implemented in countries such as Greece. That criticism is particularly resonant since the fiscal adjustment programs on the periphery were often not outcomes of domestic political decisions but came with rescue packages from the European Union and the International Monetary Fund. According to a plethora of Keynesian models, fiscal retrenchments are contractionary.

However, a heated debate exists around the magnitude of the effect and whether it represents a general result. Some economists are pushing against the argument by pointing to examples of well-designed fiscal adjustments, which can be expansionary by reducing the burden of public debt and liberating resources for private investment.

If one accepts the basic Keynesian reasoning, fiscal austerity does not seem to provide a satisfactory explanation for the poor economic performance in the eurozone and on its periphery. Figure 5 shows that the fiscal policy stances of two groups of countries listed in Figure 1 were similar during the crisis. Hence, over the same period, many European economies underwent fiscal adjustments of magnitudes similar to those suffered by Greece and Spain, yet their growth rates, as shown in Figure 1, were quite different.
On the opposite side of the political spectrum, especially in conservative circles in Germany, is a mirror image of the argument that blames the eurozone’s crisis on too much austerity. Due to their profligacy, the conservative argument goes, countries on the eurozone’s Mediterranean periphery had accumulated unsustainable levels of debt and eventually lost the confidence of markets in their ability to honor their debts. What followed was a mix of rescue packages and fiscal austerity, perhaps painful but inevitable—and entirely attributable to the previous governments’ lack of restraint. There was thus no “eurozone crisis” per se, simply a debt crisis of fiscally irresponsible eurozone governments.25

To be sure, countries of Southern Europe, like many other economies in the industrialized West, would benefit from better fiscal management and reforms that reconcile their spending trajectories with their long-term demographic prospects. However, it is misleading to claim that excessive deficits before the crisis were the central reason for the Great Recession’s severity in the affected countries.

Before the crisis, the state of public finances on the periphery, as captured by their debt-to-GDP ratios, was not dramatically different from other economies. In 2008, the debt-to-GDP ratio in Greece was just over 112.9 percent, high but only marginally more so than the 103.4 percent recorded in 2000. Throughout the period, Italy’s debt remained in the same territory, even declining slightly relative to its 2000 level. Portugal’s debt-to-GDP ratio steadily increased from 50.7 percent in 2000 to 71.7 percent in 2008. But in
some countries the crisis cannot be attributed at all to their fiscal situations, such as Ireland, with a very small and declining debt until 2008, and Spain, with a debt-to-GDP ratio that declined from 59.4 percent in 2000 to 40.2 percent in 2008.

As Figure 6 shows, the periphery’s fiscal problem worsened as NGDP in the eurozone collapsed. One reason is trivial accounting: NGDP acts as the denominator in the debt-to-GDP ratio, and its collapse directly inflates an economy’s debt burden. The other reason is that fiscal consolidations, like structural reforms, are most likely to succeed in accommodating monetary environments that are not under deflationary pressures. The monetary conditions, one study finds, are especially important “in the initial stages of the episode.”

Fiscal austerity is not a right-wing dogma. It is simply a matter of balancing the books in situations when the existing combination of government spending, taxation, and borrowing becomes unsustainable. As the late AEI scholar Herbert Stein was fond of saying, “If something cannot go on forever, it will stop.” Accordingly, governments on the eurozone’s periphery attempted to adjust their public finances in response to their sovereign debt crises. The fiscal adjustments undertaken by certain countries, particularly Greece, were quite dramatic in size, although one may object that Greek consolidation efforts were poorly designed and only half-heartedly implemented. Other countries, such as Latvia (a pegger), saw even more drastic austerity programs, with better outcomes.

Figure 7 shows the systematic difference of public debt burdens between the floaters on one hand and the eurozone countries and peggers on the other. The
picture is striking given that the magnitude of the sta-
bilization effort (see Figure 5) did not differ widely
across the two groups of countries.

Figures 8 and 9 emphasize the failure of the periph-
ery in bringing down debt levels, in spite of consid-
erable fiscal tightening. Greece in particular saw
dramatic cuts to public spending and tax hikes, but
they failed to stop the public debt burden from bal-
looning due to falling NGDP. The figures contrast the
periphery’s experience with that of Iceland, a coun-
try hit by a severe financial crisis following the col-
lapse of its overleveraged banking industry in 2008.
The immediate impact on the Icelandic economy was
drastic but was mitigated by the active response of the
country’s monetary authorities. Between mid-2007
and fall of 2009, the value of Icelandic króna depreci-
ated from an exchange rate close to ISK83 per euro to
more than ISK180.

As a result, unlike fiscal stabilization in the Med-
iterranean economies, the Icelandic government’s
efforts were successful, and its overall debt burden
has fallen substantially since 2011. And unlike those
economies, Iceland even saw a modest overall growth
in real GDP between 2007 and 2015—even including
the substantial hit the country took during the Great
Recession (see Figure 1).
Did the ECB Poison European Politics?

The ECB’s belated response and the economic crisis it created not only had economic consequences but also changed Europe’s politics. Similar to the radicalization of European politics in the 1930s, the economic hardship that can be attributed to misguided monetary policy is partly to blame for the wave of angry populist politics that has recently swept across the continent.

In the Great Depression, periods of low growth lasting for at least three years correlated with an increased vote share for the far right. However, the effect was strong only in countries that were on the losing side of World War I, had no preexisting tradition of democracy, or already had radical-right parties in parliament. Slow growth thus contributed to the rise in right-wing extremism in the 1930s, but only in cases in which the context was “fertile.” The link between the incidence of financial crises and support for political extremism holds across 20 advanced countries, from 1874 onward. A financial crisis tends to increase the far right’s vote share by an average of 30 percent within five years after the onset of the crisis.\textsuperscript{28} In the same vein, the financial crisis of 2008 likely exacerbated self-perceived national identities and fed into a distrust of European institutions.\textsuperscript{29}

A forthcoming study coauthored by Dalibor Rohac\textsuperscript{30} investigates the drivers of support of authoritarian populist parties in Europe, 1980–2016,
and finds that the support for right-wing—but not left-wing—authoritarian populists is tightly linked to corruption. While purely economic variables, measures of inequality, immigration, and exposure to international trade do a mostly poor job of predicting support for populist political platforms on the political right, support for left-wing authoritarian populism is associated with both slow economic growth and high unemployment rates. That result is in line with the past 10 years having seen not only a strengthening of far-right populists, largely in line with preexisting trends, but also a return of far-left populism, after decades of steady decline in support. That comeback has taken place particularly on the eurozone’s Mediterranean periphery. Instead of simply boosting support for traditional communist parties, it has led to the emergence of broader far-left coalitions. One such example is Syriza in Greece, which encompasses Maoists, Marxists, radical environmentalists, and many other left-wing platforms, all within a general narrative that pits ordinary Greeks against the self-serving “globalist” elite and its undemocratic, externally imposed austerity programs.

Several caveats need to be made regarding the link between the crisis and authoritarian populism. First, the share of votes going to far-right parties had grown progressively since their emergence as a real political force in the 1980s. Second, the rise of populist and anti-system politics has not been confined to countries most visibly affected by the crisis, such as Greece or Spain, but appears endemic throughout the Western world, including in countries that saw somewhat stronger recoveries from the Great Recession, such as the United Kingdom and the United States. Finally, although the association between political radicalization and economic crises is apparent at the country level, it is rarely visible in studies relying on individual-level survey data, in which cultural and political concerns appear to drive populist voters more than economic concerns.

There is, however, a silver lining: If economic turbulences exercise an effect on politics, it is temporary. As long as liberal democracies weather the rise of populist authoritarian forces—and in that respect, the Great Depression offers a cautionary tale of several countries that became brutal dictatorships in the process—the share of the populist vote eventually returns to its precrisis levels.

### Eurozone’s Fiscal Governance and Lessons from America’s Past

The eurozone’s crisis unfolded within a peculiar, historically unprecedented political arrangement tying the eurozone’s countries together. Unlike in an “optimum currency area,” the eurozone still lacks a joint fiscal authority with the capacity to tax and issue debt. Yet, although in principle each government was responsible for the state of its own public finances, eurozone-wide rules under the Stability and Growth Pact (SGP) imposed restrictions on the size of public deficits and debt levels. Although the creation of the monetary union at the end of the 1990s involved an explicit commitment to no bailouts, a sovereign default by a eurozone country was seen as a source of unacceptable political and financial risk. During the crisis, the ECB decided to accept Greek bonds as collateral despite their poor ratings by credit agencies. Of course, the expectations of such policies during crises invite moral hazard, encouraging governments to spend and borrow more in good economic times than they would if they were facing the full costs of their decisions.

The SGP’s ability to mitigate such behavior was limited. Without a truly federal structure, enforcement of the rules required a political consensus. As a result, key eurozone countries, including France, openly violated the criteria without any sanctions. Not only did the SGP lack any explicit provisions for sanctioning noncompliance, but just raising the issue was a political nonstarter given the weight the countries in question commanded in the eurozone.

In retrospect, admitting countries that were not qualified, especially Greece, appears to have been a critical mistake. “Accepting Greece into the euro area should not have been approved given the concrete situation at the time, which could not have been hidden from anyone who looked closer,” said former German Chancellor Helmut Kohl. Greece’s
Eurozone membership was approved based on data provided by Greece’s statistical office, which claimed the country was meeting the Maastricht criteria. Yet Eurostat, the EU’s statistical office, found major discrepancies when it reviewed Greek fiscal statistics in 2002 and 2004. The Greek government systematically underreported public expenditures and overreported its revenue. Even when European authorities discovered the discrepancies, they were not always corrected—in spite of assurances by Greek authorities. According to Kohl, it was not “easy to resist pressure from a country in such a situation.” When the discrepancies were discovered, the eurozone was doing reasonably well, and there was little to gain from ruffling feathers.

Some economists have likened the fiscal structure of the eurozone—particularly the ambiguity over future bailouts and the lack of a common fiscal capacity—to that existing in the early years of the American Republic. The grand bargain made in 1790 by Alexander Hamilton involved federalizing all state debt incurred during the Revolutionary War. Although intended to be a one-off affair, the credibility of the federal government’s commitment to a no-bailout policy was tested following the financial panic of 1837. In the early 19th century, US states had borrowed heavily to invest in infrastructure projects—typically canals connecting midwestern states to Atlantic ports—and the deflationary shock caused by the crisis of 1837 made them insolvent. Although they turned to the federal government for assistance, aid was refused. Several states—including Illinois, Maryland, and Pennsylvania—went bankrupt. Eventually, they repaid their obligations and returned to financial markets. Arguably, the precedent that episode set dissuaded future state governments from banking on the federal government’s largesse and led many to adopt balanced-budget amendments to their state constitutions.

The eurozone’s crisis exposed that the EU lacked—and still lacks—similar clarity in situations of state-level insolvency. It also set in motion gradual efforts to remedy the situation, under the constraints of existing treaties and practical European politics.

In line with the assurances made at the euro’s creation, the Treaty on the Functioning of the European Union (TFEU) explicitly states that “the Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities.” However, as the crisis pushed some Mediterranean economies, particularly Greece, close to default in early 2010, the Council of the European Union decided to create a temporary lending mechanism, the European Financial Stability Facility (EFSF), to assist eurozone governments in financial difficulties. The EFSF could issue bonds and other financial instruments, backed by guarantees from member states, to raise funds for emergency loans. In 2012, a permanent lending facility, the European Stabilization Mechanism (ESM), was created, legally embedded in a 2010 amendment to TFEU, which allowed eurozone countries to “establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole.” That move was accompanied by a tightening of the SGP under the new name of the European Fiscal Compact, complementing the original macroeconomic criteria with prescriptions regarding noncompliance, including the so-called debt brake. Participating in the compact is a precondition to receiving any ESM support. Countries that do not meet the basic criteria on the level and dynamics of public debt are obligated to follow the reform prescriptions provided by European authorities.

Like Hamilton’s grand bargain, the existing arrangements are a practical response to the risks associated with uncontrolled sovereign defaults in the eurozone. However, unlike the US example, the combination of the ESM, Fiscal Compact, and burgeoning banking union is unlikely to be a permanent structure because they still do not resolve the fundamental question of division of fiscal authority among different levels of government. After the election of President Emmanuel Macron in France and Germany’s parliamentary election in September 2017, the discussion will likely continue. For many, the premise of the conversation is that the eurozone’s future requires a eurozone-wide risk-free asset, backed by the economic strength of the eurozone as a whole.
In the American case, that served as an argument for a one-off federalization of state-level debt incurred during the Revolution. In contrast, in the eurozone’s case, some use the same argument to push for a permanent pooling of debt, likely through a repackaging of country-level bonds into a new type of European financial instrument. That would be the wrong way to go. A permanent pooling of debt—as opposed to granting autonomous power to tax and issue debt to European authorities in order to finance their own spending—will lock the eurozone into the need for highly detailed central management of national finances, which is unlikely to survive over the longer term. And without such micromanagement, it is bound to produce exactly the type of profligate behavior that German critics of the idea dread the most.

Instead, European leaders would be well-advised to consider the US federal arrangements as a model, conferring taxation and debt powers to Brussels, along with a narrow mandate to use those resources to fund fundamental Europe-wide public goods, subject to appropriate constitutional constraints. The transition could involve a one-off federalization, complete or partial, of the eurozone’s debt—with a clear provision that, going forward, national governments will not have access to an EU lender of last resort, such as the ESM. That provision’s credibility would depend critically on whether the failure of individual members could conceivably pose a systemic risk or not. The answer to that will depend on whether the eurozone’s financial institutions behave prudently and whether the macroeconomic role of the EU’s federal authority can outweigh that of individual states.

Such a federalist solution would require not only a new European treaty, but a genuine European constitution firmly embedding those principles in a wider federalist framework. The odds that such a solution will emerge in the coming years are slim, but the alternative—piecemeal, marginal changes with unintended consequences—will be bound to haunt Europe again in a future economic crisis.

Conclusion

In 2017, the eurozone’s GDP is expected to expand by 1.6 percent. Spain, Italy, Portugal, and Greece are all expected to grow, in some cases at rates exceeding 2 percent. After almost a decade, it appears that the eurozone crisis is finally over. Yet with chronically low growth rates across the Western world, Europe will take many years to recover fully from the economic damage left by the crisis.

However, sooner or later, new economic shocks will come. How the ECB responds to those shocks will determine whether Europe repeats the experience of the past decade, and there is no guarantee that the eurozone, or even the EU, can withstand another round of the drama seen over the past eight years.

The solution would not entail, as some voices in Germany fear, jeopardizing the ECB’s independence and turning its lending into a backstop for fiscally reckless European governments. Addressing the problem, however, necessitates that the ECB learn from its past mistakes by moving its primary focus from conducting monetary policy through changes in interest rates to using NGDP level as one of its targets, if not the target. The bank can directly control nominal spending by purchasing and selling securities—the ECB will thus need to overcome its current aversion, driven in part by pressures coming from Germany, to asset purchases.

To be sure, monetary policy will not miraculously solve all the challenges posed by the eurozone’s design. Completing the union’s fiscal architecture is equally important. In that regard, Europeans ought to ditch the idea of a superstate. Europe is ill-suited to be a monolithic fiscal entity, and any moves in that direction might incentivize moral hazard among the eurozone’s constituent governments and ultimately strengthen centrifugal forces. Instead, Europeans ought to embrace a federal approach that draws lines between the fiscal authority of national governments and the fiscal authority of the EU and that preserves state control over their finances while giving common European institutions the tools needed to provide essential EU-wide public goods.

Finally, a successful monetary union needs to be underpinned by solid economic policies in individual
member states, which still control the bulk of policymaking that is truly consequential for economic activity. At the margin, the European Commission can help by insisting on timely completion of the single market, yet for the foreseeable future the genuine decision-making power will rest with national governments.

The US can help too. First, it needs to carefully weigh its words. President Donald Trump and his team were not wrong in identifying Germany as the key player shaping the eurozone’s economic policies. However, a striking degree of carelessness has marked their characterization of the eurozone’s arrangement. When Navarro accused Germany of “grossly under-valuing” the euro, he should have considered the likely consequences that a stronger European currency would have on the eurozone’s periphery—and on the stability of the world’s economy. With the eurozone’s NGDP level far below its long-term trend, a stronger euro would likely derail Europe’s fragile recovery and push Europe back into crisis.

Second, the United States can help by demonstrating its commitment to Europe, including by reviving the question of a US-EU trade agreement, which would likely be a source of much-needed economic liberalization in Europe. Beyond that, the administration would be well-advised to move beyond its current transactional approach toward one that sees Europe and its economy holistically as America’s indispensable ally, friend, and trade partner.

About the Authors

Dalibor Rohac is a research fellow at the American Enterprise Institute, a visiting fellow at the Max Beloff Centre for the Study of Liberty at the University of Buckingham in the UK, and a fellow at the Institute of Economic Affairs (London). Lars Christensen is the founder and owner of Markets and Money Advisory and a senior fellow at the Adam Smith Institute.
Notes


AFTER THE EUROZONE CRISIS
DALIBOR ROHAC AND LARS CHRISTENSEN


32. Nevertheless, the health of the US recovery can be disputed, particularly because of the dismal labor market performance of large demographic groups. See Nicholas Eberstadt, *Men Without Work: America’s Invisible Crisis* (West Conshohocken, PA: Templeton Press, 2016).


34. Funke, Schularick, and Trebesch, “Going to Extremes.”

35. In November 2003, the legal proceedings against France and Germany for their excessive deficits were suspended. The 2005 reform of the pact then removed its automatic character, turning it into a matter of political decision-making. See Giandomenico Majone, *Rethinking European Integration After the Debt Crisis,* University College London, June 2012, 3, http://www.ucl.ac.uk/european-institute/analysis/2011-12/working-paper-debt-crisis. See also Paul De Grauwe, “The Politics of the Maastricht Convergence


41. Of course, over time, the credibility of the no-bailout policy weakened as government grew larger and the dividing lines between its different layers became fuzzier. In today’s America, state governments in financial difficulties are often “bailed out” in all but name, with the federal government taking on some of their obligations.


43. Ibid.


45. There are compelling reasons to federalize, at least in part, Europe’s defense spending and to create a basic social safety net to underpin free movement of workers across the EU.