A plan to save the euro

Jeffry Frieden 23 May 2018

For the euro area to be stable and move forward productively, substantial improvements in its operation are required. This column, part of the VoxEU Euro Area Reform debate, argues that the proposals in the recent CEPR Policy Insight are necessary if the euro area is to avoid another catastrophic crisis and that they would go a long way towards addressing the legitimate concerns of citizens in both the core and periphery of the euro area.

Jeffry Frieden
Professor at Harvard University's Department of Government

This column is a lead commentary in the VoxEU Debate "Euro Area Reform"

The mismanagement of the euro area debt crisis has been the gravest failure in the history of European integration. Inaction, misguided action, contradictory policies, and political conflict turned a manageable debt problem into a decade of economic stagnation, social upheaval, and political protest.

The economic and social impact of this bungled crisis has contributed mightily to the rise of populist movements that challenge the euro, and European integration more generally (see Algan et al. 2017 for one among many surveys).

For the euro area to be stable and move forward productively requires substantial improvements in its operation. It is unlikely that the euro could survive another crisis like the one from which it is just (barely) emerging.

This makes it particularly important to evaluate the proposal from 14 leading French and German economists to reform the euro area in a way that they say combines risk-sharing and market discipline (Bénassy-Quéré et al. 2018). It also makes it particularly important to understand the political need for reform, and the political conditions any meaningful reform has to address in order to be successful.

There are several points worth making if we want to understand the current political economy of euro area reform.

1. Most residents of the euro area remain positive about the monetary union.

Even in the most heavily affected debtor nations, support for monetary union never fell below 50% of the population, and was typically closer to 70%. However, Europeans have little faith in the willingness or ability of existing political leaders to manage it fairly and efficiently: debtor-country citizens' confidence in the institutions of the EU dropped from over 70% before the crisis to barely 20% during it (e.g. Foster and Frieden 2017, Frieden 2016).

2. The central failure of crisis management was the inability to arrive at a reasonable distribution of the adjustment burden.

As in all debt crises, a major axis of conflict has been between debtor and creditor countries over how to distribute the pain. Creditors wanted debtors to make the sacrifices necessary for prompt and full debt service payments; debtors wanted creditors to play their part in helping reduce the political and social costs of austerity. And in this crisis, like most other debt crises, there was also a domestic axis of conflict. Citizens of debtor countries battled over who would make the most sacrifices to satisfy creditors; and within creditor countries, the dispute was over whether taxpayers, financial institutions, or others would pay whatever price there might be for a settlement. As it turned out, in this debt crisis the vast majority of the adjustment was done by the debtors, and there was no serious debt restructuring (Greece was an exception, given the clear impossibility of servicing its debt as contracted).

Citizens of the debtor nations, quite reasonably, resent bearing the lion's share of the burden of adjustment, despite the fact that lenders were at least as responsible for the accumulation of bad debts. Citizens of creditor nations, quite reasonably, having been largely misled by their governments about the true nature of the crisis, resent the use of taxpayer money for purposes never made clear to them.

And the sad fact is that much of this suffering, and much of this bitterness, was avoidable. Prompt debt restructuring, with creditor financial institutions sharing the sacrifice with debtor nations, might well have reduced the likelihood of the ten years of stagnation that ensued, of the vicious political standoffs that continue to hamper progress in the euro area, and – not incidentally – of the rise of dangerous strains of populism throughout the region.

3. The principal culprits in the mismanagement of the crisis have been national governments, not European institutions.

Certainly, the construction of the euro area left many important issues unresolved, and the euro's inadequacies deepened the impact of the crisis. However, when the crisis hit it, was not primarily the institutional inadequacies of the euro area that failed its people. It is true that the principal euro area institution, the ECB, could have played a more positive role at the outset of the crisis; but eventually, after 2012, it performed reasonably well. However, it was first and foremost the member states that came close to destroying the euro. At almost every turn, member states attempted to shift the burden of adjustment onto others, missing opportunity after opportunity for a less costly resolution of the crisis. Almost from the moment the crisis broke, the governments of the principal nation states stubbornly resisted attempts to find cooperative strategies to address the debt problem. The tragedy is that the more these conflicts delayed constructive policies, the more the costs of the crisis rose. A quicker resolution of the crisis with more burden-sharing would almost certainly have been in the interests of allmember states.

For the euro area to move forward, its member states have to overcome the existing stalemate. The gridlock hampers both the resolution of the remaining debt overhang – which continues to exert a drag on the region's recovery – and the reform of euro area institutions. This reform needs to address some of the principal gaps in the monetary union's construction; and, perhaps more important, it needs to provide assurances to the citizens of the euro area that it will be managed more responsibly in the future.

What are the principal, legitimate, concerns of the euro area's citizens? Those in the peripheral, debtor countries see the euro area as a mechanism to impose austerity on them. They believe that the creditor countries have used their massive bargaining power to force onto the borrowers virtually all of the burden of dealing with the fallout from a decade of irresponsible lending. For their part, citizens of the core, creditor nations see the euro area as a mechanism to force them to send their money to dissolute southern Europeans, to turn the euro area into a transfer union. There is some truth in both sets of beliefs; but, of course, both are misguided.

What, then, are the economic policy and political tasks faced by the member states?

Any serious reform needs to prove to citizens of the indebted, crisis-ridden periphery that the institutions of the euro area – and, most important, the other member states – will take seriously their legitimate concerns. This means ensuring that the creditor nations take on at least some of the sacrifice necessary to wind up the ongoing crisis – and that future crises will be resolved in a more timely and equitable manner.

By the same token, any serious reform needs to prove to citizens of the core, creditor nations that the institutions of the euro area – and, most important, the other member states – will undertake serious reform measures to avoid a recurrence of the current disaster. This means ensuring that the peripheral nations undertake a credible commitment not to abuse the common pool components of a monetary union in order to engage in uncontrolled and unjustified borrowing and spending.

Would the measures suggested by the current reform document accomplish these tasks? To a large extent, they would. The proposals for a meaningful mechanism to restructure troubled debts, along with a common deposit insurance scheme, would help guarantee that the risks inherent in lending among euro area members would be more equitably shared. A strengthening of the banking union, of common regulation, and of mechanisms to bail in creditors of failing banks, would all go in this direction as well.

On the other hand, sovereign concentration charges would limit opportunistic behaviour by debtor sovereigns and banks; and a more reasonable – hence credible – system of fiscal and debt oversight would limit excessive sovereign borrowing. This would complement a reform of relevant euro area institutions, first and foremost of the ESM, to play a more consequential part in monitoring the operation of the monetary union.

So the reform proposals are eminently reasonable. They are, more to the point, necessary if the euro area is to move forward without risking another catastrophic crisis. And they would go a long way towards addressing the legitimate concerns of citizens of the euro area, core and periphery. This in turn would help limit the ability of anti-European populists to point to the disastrous mismanagement of the crisis as evidence for their rejection of European integration.

Whether these reform proposals are politically feasible is another matter. Perhaps growth will soften hearts on all sides of the bargaining table. Perhaps, also, the continuing and escalating economic policy threats from the Trump administration will lead to a greater sense of solidarity among the EU's member states.

Progress in this direction is certainly to be desired. Failure to move forward with a reform of the euro area now may lead to its collapse in the future.

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