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Is there an alternative way to avoid another eurozone crisis to the Five Presidents' Report?

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ABSTRACT

The EU Commission's Five Presidents' Report proposes new rules for the eurozone covering fiscal policy, banking and financial markets designed to avert another eurozone crisis. This paper examines the causes of the current eurozone crisis and discusses whether the Report's proposals are likely to succeed. It is argued that the main causes of the crisis were EMU and the failure of financial markets to price risk correctly. It is claimed that the Report may not solve these problems. Having already lost their monetary policy instrument, the Report's fiscal proposals would remove countries' fiscal policy instrument too and deprive countries of the means of economic stabilisation. The proposals would also transfer to an undemocratic and unaccountable Commission important national competences.
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1. Introduction

The introduction of European Monetary Union in 1999 was intended as a fundamental and permanent change to the economic and political systems of member countries. It was designed to promote economic growth, price stability, full employment and political integration. So far it has achieved none of these. To the contrary, it has made them all worse; it has resulted in major policy conflicts between member countries, fiscal crises, unsustainable sovereign debt, large current account imbalances, unstable and near insolvent banks, a volatile financial system and the ECB adopting highly controversial monetary policies outside their original remit which border on fiscal policy. The Five Presidents' Report – "Completing Europe's Economic and Monetary Union" (2015) –which was prepared by the President of the European Commission, in close cooperation with the President of the Euro Summit, the President of the Eurogroup, the President of the European Central Bank, and the President of the European Parliament, contains a set of proposals aimed at remedying all of this and, in the process, making the single currency sustainable. It suggests giving up even more national independence and introducing a Fiscal Union supervised by unelected EU officials, a Banking Union and a Capital Markets Union.

This paper considers to what extent monetary policy and the financial markets have contributed to the eurozone crisis, the lessens that may be learned from this and whether there might be a market solution that could obviate the need for further intrusive legislation that erodes national independence. This entails examining the effects of a common monetary policy on real borrowing rates in the eurozone, both prior to the crisis and afterwards, and the role played by financial markets in abetting

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the mispricing of risk. In the light of this discussion we ask whether the European Commission's Five Presidents' Report and its proposals for Fiscal, Banking and Capital Markets Unions provide a viable solution to the problems of the eurozone.

To summarise the argument of this paper, the single currency with its one-size-fits-all monetary stance set interest rates prior to the eurozone crisis that were too low for high inflation countries, the main eurozone crisis countries. As a result, these countries were able to borrow at negative real interest rates and so accumulated too much private debt (Ireland, Portugal and Spain) and sovereign debt (Greece, Italy and Portugal). This caused either a banking crisis, or a fiscal crisis, or both in these countries. Subsequently but, in part mistakenly, the ECB pursued – and is still pursuing – a highly expansionary monetary policy in order to prop up the eurozone banks and to restore the rate of eurozone inflation to its pre-crisis level.

Fatally, financial markets failed to identify the crisis or the risks that were building up prior to the crisis and continued to lend to the crisis countries at interest rates appropriate for Germany, a low-risk country. Only after the crisis did borrowing rates reflect the true risk of lending to the crisis countries which, of course, only made the risk of default in these countries greater and the crisis deeper. Despite this mispricing of risk, the ECB through its aggressively expansionary monetary policy (it is even contemplating setting negative *nominal* rates) is driving borrowing rates to levels that are even lower than before the crisis, thereby offsetting any pricing discipline provided by financial markets. The intriguing question is whether, by pricing risk correctly, future crises might be avoided without the need for the sort of procrustian proposals contained in the Five Presidents' Report.

2. Origins of the eurozone crisis

The principal aim of the euro was to facilitate the development of a single market in goods and services by removing foreign exchange transactions costs through sharing a single currency. The problem, which was foreseen by many economists, was that the eurozone was not an optimal currency area having, for example, different fiscal stances, capital markets, labour laws and rates of inflation. This was downplayed in official circles as it was widely assumed that eurozone economies would rapidly converge, thereby creating an optimal currency area. For countries facing high interest rates an even more persuasive argument was the expectation that in future they would be able to borrow at much lower rates, such as those of Germany. This expectation was due to Article 105 of the Maastricht Treaty which requires the ECB to maintain a weighted average eurozone inflation rate not greater than 2 %, where the weights reflect the size of the members' economies. The success of the ECB in achieving this target meant that Germany, being a large country with low inflation, would exert a strong influence on rates.

As a result, many countries found that their borrowing costs were much lower and so they borrowed heavily. Fig. 1 shows that following the start of EMU, and until the crisis in 2008, the nominal cost of borrowing was the same for all of the crisis eurozone countries as for Germany (NB Greece joined in 2002.). Prior to EMU, rates were different, but they rapidly converged once EMU began. After the start of the eurozone crisis rates diverged again.

Fig. 2 shows the real rates of interest of these countries. Although in 1998, prior to the euro, real interest rates were positive for each of these countries, during the period 2001–2007 real rates for the crisis countries fell some way below those of Germany. At different times during this period Ireland, Portugal and Spain had negative real rates.

Prior to the crisis the divergence of real interest rates was not seen as a problem as economic growth in all of these countries was strong. Fig. 3 shows the growth of real GDP in eurozone countries over the period 1998–2014. For the period 1999–2007, the GDP of Ireland grew by 57%, Greece and Spain grew by 35%, while Germany only grew by 20%. After the crisis all countries except Germany stopped growing; the collapse of output in Greece has been dramatic, if not catastrophic.

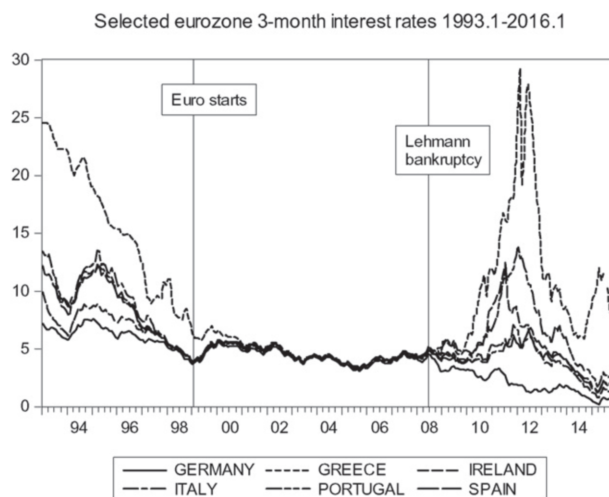

Fig. 1.

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