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ARTICLE

'Nobody told me we could do this': why fiscal union is not the answer to eurozone woes

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Abstract The economic and financial crises evident since 2007 have refocused the debate as to the future structure of the European Economic and Monetary Union (EMU). This article looks at the issue from the perspective of economic history and identifies that current proposals for fiscal union are based on an over-reliance on Optimum Currency Area theory and are not realistic in the current political environment. In addition, European fiscal rules have become over-complicated, inefficient and open to widespread manipulation. In the medium term, rather than risk the lessening of political commitment to the EMU through divisive fiscal union proposals, the EU should focus on developing unique governance mechanisms that better reflect the current characteristics of the EMU. In this context, this article proposes four actions to complement existing initiatives such as the Banking Union: (1) simplified EU budgetary rules, (2) the creation of an independent European Fiscal Board to assess and enforce national compliance, (3) a commitment to retaining core national fiscal autonomy with a strict 'no bailout' rule, and (4) increased levels of investment through an expanded European

The quote in the title is attributed to veteran socialist intellectual Sidney Webb (Lord Passfield) on hearing of Britain leaving the gold standard in September 1931.

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Fund for Strategic Investments. Only following the successful completion of these measures should fiscal deepening be discussed at a political level.

Keywords European monetary union | Euro | Economic history | Germany | Monetary unions | Banking

Introduction

Nearly a decade after the beginning of the Great Recession, debates over the future structure and design of the European Economic and Monetary Union (EMU) are about to return to centre stage.[1] While the ongoing work on completing the Banking Union and revamping the European Semester process is urgently required, the plethora of new fiscal rules which have been deployed—for example the Two Pack, the Six Pack and the Fiscal Compact—have significantly increased the role of the EU in national budgetary frameworks. At the same time, the eurozone continues to be characterised by relatively low growth, high unemployment and an increasing sense of political fragmentation. The latter sentiment is driven primarily by the success of more populist and anti-EU movements in several member states.

In this context, this article addresses whether emerging proposals for a fiscal union among eurozone members are actually required for the medium-term sustainability of the EMU. Rather than applying a strictly economic assessment based on Optimum Currency Area (OCA) criteria, this article views the situation from an economic history perspective and considers whether OCA theory itself provides an accurate baseline for assessing the future needs of the eurozone.[2]

In addition, three further issues are considered. The first is the importance of independent and non-biased assessments of member states' adherence to the EU's fiscal rules. The second is a consideration of why maintaining core national fiscal autonomy (with a strict no-bailout provision) is key to developing a credible political commitment to the EMU. The third is an acknowledgement that investment can act as a driver to return growth to the European economy, thus ensuring long-term debt sustainability.

Politics and Germany, not economic theory, will determine if the EMU survives

OCA theory has come to dominate the debate about the future structure of the eurozone. The standard narratives, even before the euro was introduced, were remarkably

[1] The European Commission is due to publish a white paper on the future of the EMU in the first half of 2017.

[2] Optimum Currency Area theory (OCA) was developed by Mundell (1961) and highlighted four criteria necessary for an OCA to be achieved. These are (1) a high level of labour mobility, (2) the mobility of capital and price/wage flexibility, (3) currency risk sharing, and (4) similar business cycles.

consistent for such a subjective profession as economics: the creation of the EMU was driven by politics and the countries setting up the euro certainly did not constitute an OCA. From the 1990s onwards economists identified the problems associated with responding to asymmetric shocks in the EMU. The EMU was (and remains) a monetary union characterised by an absence of centrally coordinated fiscal policies and quantitative criteria for national debts and deficits (see e.g. Eichengreen and Wyplosz 1998). From US academic economists, a veritable library of research emerged in the late 1990s that highlighted the fact that the EU was a suboptimal currency area (e.g. Dornbusch 1997; Eichengreen and Frieden 1998). The absence of exchange rate flexibility was seen as a key impediment to future EMU stability (Feldstein 1997).

It is, therefore, hard to disagree with the assessment that many US (and indeed some European) economists' negative views of the EMU project were based on an overemphasis on OCA theory, which resulted in a 'static, ahistorical approach' and ignored the 'dynamic, political and institutional aspects of monetary integration' (Jonung and Drea 2010). OCA theory, while a useful tool in framing the development of monetary unions, has been identified as having little predictive capacity (Goodhart 1998). Events since the onset of the economic crisis in 2007 have not changed the underlying economic assessment. The notable exception to this is the increasingly dismissive tone of newly convinced Eurosceptics (e.g. Krugman 2010, 2015).

What then can economic history tell us about the future sustainability of a non-OCA euro area? Two important points are relevant. First, the EMU is unique and there is no precedent for independent countries surrendering their national currencies to form a common monetary union. Earlier historical examples, such as the creation of the US monetary system and the establishment of national monetary authorities in Germany and Italy in the nineteenth century, highlight that previously monetary union usually followed after political union had been achieved (Bordo and Jonung 1999). With this EMU, the utilisation of monetary union as a driver of eventual political union highlights the clear political basis of the current project. In this context, it is the political will of its members, not the application of economic theory, which will decide whether the euro lives or dies in the long term.

Second, history is very clear in highlighting that in functioning monetary unions, such as the Federal Reserve System (the Fed) in the US, decision-making (whether formally or through an informal bias) is dominated by those members with major economic power (Bordo and Jonung 1999). The example of the Federal Reserve Bank of New York underpinning the Federal Reserve System from its creation in 1914 to at least the mid-1930s highlights this clearly. Power within decentralised monetary unions—such as the pre-1930s Fed and the current EMU—will inevitably flow to the strongest economic components. The death of the commanding Benjamin Strong (Governor of the New York Fed) in 1928 has been identified as a partial explanation for the Fed's later disjointed response to the Great Depression (Kindleberger 1973).

For the EMU and the EU this lesson is clear. Retrofitting greater political and fiscal integration to match an already achieved monetary union will be very difficult, if not impossible, to achieve. This is particularly important in light of the current high levels of public antipathy towards the wider European integration project. The situation is compounded by existing national debt levels, relatively low economic growth and high youth unemployment in several member states. Moves towards fiscal integration could actually lead to further political dislocation at the EU level.

As primarily a political project, the survival of the EMU in the long term will require not just political commitment, but also a newfound willingness (among larger members) to develop atypical governance mechanisms. These mechanisms will be necessary to support the unique characteristics of the non-OCA euro area in the medium term. Without this willingness, the longer-term goal of transforming the EMU into an OCA is largely irrelevant and the euro will not outlast the possible lessening of political commitment in the future.

Please, please, please: no more fiscal rules!

The constraints now placed upon the budgetary plans of member states have developed into a veritable cottage industry. However, it is not clear if such an intrusive approach is actually working (O'Rourke and Taylor 2013). European fiscal rules have become overcomplicated, inefficient and open to widespread manipulation (Mody 2013).

National histories play an important role in fiscal preferences. The composition of national taxation systems and state expenditure patterns are reflective of the national consciousness (Eichengreen and Wyplosz 2016). The levels of personal taxation evident in Belgium or Germany would never be politically acceptable in Ireland. Conversely, the low level of public pension provision evident in Ireland would not be acceptable in countries such as Italy and France. History matters in the design of economic priorities. The fiscal governance of the EMU has become a poor mirror of the German 'centralised-federal' approach, notwithstanding its debatable operational performance within Germany itself (Wyplosz 2013).

Rather than attempting to achieve minimal fiscal union at great political cost, a cost which could weaken overall political commitment to the EMU (Matthes and Iara 2016), the EU should re-evaluate the actual constraints under which countries operate in the EMU. Realistically, the divergent opinions of member states will result in any fiscal union proposals lacking the required level of centralisation or transferability to be truly effective. The general vision for a 'euro area stabilisation fund' is short on positive rationale, but long on what it will not become (European Commission 2015). Such a negative, lowest common denominator bias will be reflected in discussions with member states in the years ahead.

In this context, the reality is that eurozone members are confronted by an increasingly complex set of fiscal rules, the inconsistent implementation of such rules by the European Commission and ongoing moves towards more fiscal integration. In a low growth economy, the eurozone's fiscal rules (and their patchy implementation) are increasingly seen by member states as barriers to growth and employment creation.

Rather than seeking to push forward with further fiscal union proposals, the EU should prioritise the creation of an independent body (i.e. a European Fiscal Board comprised of independent economists and administrators) which would evaluate member states' compliance with a simplified set of EU budgetary rules and make final binding decisions. This approach would remedy the increasingly politically driven findings of the European Commission, ensure transparency and allow greater public understanding of the entire budgetary process. The European Commission and Council in 2016 may still deem it acceptable to exempt France from existing rules 'because it is France', but such an approach reduces the credibility of the EMU and increases the perception that larger member states are treated differently (Guarascio 2016). One of the lessons from the monetary development of the US is that perceptions of central institutions matter a great deal and that credibility is difficult to achieve, but easily lost (Frieden 2016).

The current roadmap for the EMU provides for the creation of a European Fiscal Board in the period up to June 2017 (European Commission 2015). However, this body will be purely advisory in nature and while its advice will feed into decisions taken by the Commission, it will not be responsible for the decisions made. In this guise, such a fiscal board could actually further reduce the credibility of the EMU, with the Commission likely to ignore its advice in the face of political realities. It will therefore become another powerless EU body in an increasingly congested fiscal policy arena.

Rather than seeking the further centralisation of fiscal policy, the EU should commit to maintaining core national fiscal autonomy within the context of simplified EU budgetary rules. For members of a non-OCA with a centralised monetary authority, the ability to stabilise national economies through fiscal tools becomes even more important (Eichengreen and Wyplosz 2016). Such fiscal autonomy should also include the ability of member states to set their own personal and corporate tax rates, as tax competition can drive economic growth at an intra-EU level.

Concerns regarding the potential for national fiscal policies to destabilise the EMU can be alleviated in three ways. First, the establishment of the European Fiscal Board, set out above, will provide independent assessment/enforcement of simplified budgetary rules, thus increasing market credibility. Second, the continued (and much needed) evolution of the Banking Union will further lessen the link between banks and domestic sovereign bonds. Finally, the introduction of a no-bailout rule of the type evident in the US for over 150 years will further enshrine the credibility of this system, while also having a national-level fiscal stabilisation function.

There were many crises along the road to achieving a functioning monetary and fiscal union in the US. However, the creation of a credible no-bailout rule and allowing state (national) fiscal independence are necessary conditions for an eventual fiscal union to function properly in the long term (Bordo et al. 2013).

The EMU as a barbarous relic?

Brussels is awash with debates on what kind of fiscal stabilisation measures are required for the EMU to survive. A common unemployment insurance scheme is particularly in vogue (e.g. Benassy-Quere et al. 2016). However, in the short term the most pressing requirement is to refocus on the ability of the eurozone to create growth and jobs in Europe. Unfortunately, events since 2008 have seen the eurozone become synonymous with stagnation and fiscal constraints.

The internal devaluation processes undertaken by countries such as Ireland, Portugal and Greece highlight the dangers of imposing self-defeating (and often very poorly targeted) fiscal consolidation measures on economies already experiencing large asymmetric shocks. The example of Ireland shows that it is the return of economic growth that acts a key driver in ensuring long-term debt sustainability. Ireland's general government debt as a percentage of GDP declined from 119.5% in 2013 to around 90% by 2015, or less than 80% if statistical anomalies are taken into account (Ireland, National Treasury Management Agency 2016). In addition to fiscal credibility within the EMU framework, external credibility regarding Ireland's ability to grow strongly in the future is a key determinant of current growth levels. The lack of expansionary fiscal measures elsewhere in the euro area magnified the economic contraction in states such as Ireland, Portugal and Greece (Pisani-Ferry et al. 2013).

The example of Britain's experience in a reconstituted Gold Standard between 1925 and 1931 clearly highlights the difficulties of pursuing internal devaluation in the context of a fixed exchange rate regime. These difficulties are magnified when there is no corresponding increase in investment (or inflation) in other members. Britain's rejoining of the Gold Standard at its pre-war exchange rate of \$4.86 resulted in dramatic deflationary effects on income and employment (Collins 1988). The relentless grind of the austere situation in Britain in the 1925–1931 period, including large-scale public unrest, bears many resemblances to that experienced in Greece over the past decade.

However, it is the experience of Britain on leaving the Gold Standard in 1931 that should be of most interest to EU decision-makers. Freed from the burden of a fixed exchange rate and high interest rates, Britain grew steadily in the 1930s, notwithstanding the worldwide economic contraction caused by the Great Depression. Spearheaded by Montagu Norman and the Bank of England, a policy of 'cheap money' was complemented by refinancing existing debts and a strong banking system with large capital reserves. The parallels (or lack of) with the current position of EMU members are obvious.

Rather than seeking to build politically divisive fiscal union proposals at a time of increasing Euroscepticism across Europe (and the ongoing Brexit saga), the EU should focus on tackling the chronic investment shortfall that currently exists, including in member states in strong fiscal positions. Germany is a good example of a member state that should be investing more, particularly with regard to transport infrastructure (Drea 2016). The application of the EU's budgetary rules should not be mistaken for a prohibition on investment. Rather, the European Fund for Strategic Investments (EFSI) should become the primary tool with which EU members enhance their capacity to create jobs within a pan-European context. Rather than acting purely as a stabilisation tool as proposed by the European Commission, the EFSI should be developed as the EU's primary (and permanent) investment vehicle, acting as a conduit for EU governments to access private sector funds for investment purposes. The EFSI should complement, not replace, national investment strategies and be based on a rigorous economic assessment of all proposed projects.

Similarly, the wider socio-economic lessons from the ongoing internal devaluation process in Greece, and other states, should not be ignored. Here again, history points to a core commonality: austerity policies that are perceived to be undertaken as a matter of principle, and not as a tool to restart economic growth, are self-defeating (in terms of improving economic performance) and often result in political fragmentation and the weakening of traditional political parties. Greece, Portugal and Spain offer clear examples of this increasing political division. In Ireland, there has been a marked shift away from the political centre towards independent, non-aligned politicians.

On this point the experience of Germany in the early 1930s is relevant. The impact of the Great Depression was exacerbated by the restrictive economic policies favoured by Chancellors Bruning and Von Papen up to 1932. These economic policies were complemented by an unwillingness to devalue the Reichmark, even after the devaluation of sterling in 1931. This combination was partially responsible for rising unemployment, increased social unrest and ultimately the accession of the National Socialists to power in 1933. It is an irony of history that the expansionary fiscal and monetary programmes implemented by Hitler in 1933 were in fact largely developed by the preceding conservative government of General Schleicher (Tooze 2006).

Conclusions

The economic and financial crises have fundamentally changed the political dynamic underpinning the EMU and the euro. Although significant institutional reforms have already been adopted, or are in the process of being formulated, it is clear that the existing architecture of the EMU must be further developed if the euro is to remain sustainable in the long run. European fiscal rules have become over-complicated, inefficient and open to widespread manipulation.

However, this article identifies that the debates surrounding fiscal union suffer from two fundamental weaknesses. The first is an over-reliance on a static and ahistorical OCA theory as a framework for future development. This over-reliance has resulted in a disproportionate focus on the fiscal union issue. The second is the limited understanding of existing political realities within the eurozone and a failure to comprehend how events since 2008 have altered many member states' perceptions regarding the future of the EMU.

In the medium term, rather than risk the lessening of political commitment to the EMU through divisive fiscal union proposals, the EU should focus on developing atypical governance mechanisms that better reflect the unique characteristics of a non-OCA EMU. Therefore, the goal should be to allow member states to return to growth within a common currency area characterised by a single monetary policy. The EU needs to allow member states the necessary autonomy to respond to large asymmetric shocks while at the same time ensuring the credibility of simplified EU budgetary rules.

In this context, this article proposes four actions to complement existing initiatives such as the Banking Union: (1) simplified EU budgetary rules, (2) the creation of an independent European Fiscal Board to assess and enforce national compliance, (3) a commitment to retaining core national fiscal autonomy with a strict 'no bailout' rule, and (4) increased levels of investment through an expanded EFSI. Only following the successful completion of these measures should fiscal deepening be discussed at a political level.

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