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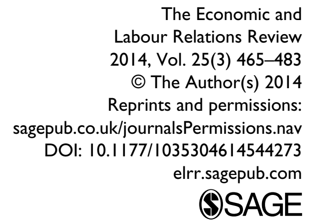


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# Reformation or exodus: Assessing the future of the Euro

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**Abstract**

Eurozone economies were the most adversely affected by the Global Financial Crisis, with forecast macroeconomic outcomes still highly uncertain. This article argues first that the Eurozone policy framework can be viewed as neo-liberalism overlaid with policy constraints associated with a mis-specified Optimum Currency Area. We are critical of this framework since it is incompatible with the policy sovereignty that is experienced, if not utilised, by sovereign economies such as the USA, UK and Australia. Second, recent and proposed policy reforms which generally lie within the constraints of the Eurozone framework are examined. We conclude that these policies are piecemeal and fail to restore policy sovereignty, which ultimately requires that member countries exit the Eurozone. Key issues associated with such an exit are briefly discussed.

**JEL Codes:** E24, E61, F33, H11

**Keywords**

European Monetary Union, fiscal and monetary policy, Global Financial Crisis, sovereignty

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## Introduction

The European Monetary Union (EMU) emerged from an initiative by the European Commission in 1969. It had its genesis in (1) the goal of preventing another European war; (2) the appeal of both post-war European integration and the creation of an economic entity to rival the USA; (3) the need to remove exchange rate volatility typically experienced by small economies; and (4) the promotion of intra-Eurozone trade with no exchange rate uncertainty.

Negotiations over the EMU formation were shaped by the neo-classical counterrevolution (1970s) and the subsequent Washington Consensus.[1] The latter was a development model devised by the International Monetary Fund (IMF), World Bank and US Treasury. As articulated by Williamson (1990), the model was in essence based on (1) the limitation of macroeconomic policy to inflation control and 'sound' public finance; (2) an increased emphasis on the operation of market mechanisms, through the implementation of privatisation, deregulation and other structural reforms; and (3) full global integration, namely trade openness and unconstrained financial flows (Fitoussi and Saraceno, 2013: 483).[2] Fitoussi and Saraceno (2013) describe the formation of the EMU as reflecting the Berlin–Washington (BW) Consensus, in recognition of the key role of the Franco–German relationship. The French were prepared to accept German reunification. In turn, the Germans were prepared to accept the policy constraints of the European framework if its institutions were replicated and underpinned by its anti-inflation bias.

The neo-liberal framework outlined by Williamson (1990) was overlaid by EMU institutional constraints detailed in the Maastricht (1992) and Lisbon (2009) Treaties. In particular, the notion of 'sound' public finance was formalised by imposing fiscal (deficit and debt) rules outlined in the Stability and Growth Pact (SGP), so that discretionary countercyclical fiscal policy was discouraged with the threat of financial penalties for breaches of fiscal requirements (i.e. the Excessive Deficit Procedure). A one-size-fits-all monetary policy based on inflation targeting was introduced. In short, the BW Consensus represents an extreme form of institutionalised neo-liberalism.

The Global Financial Crisis (GFC) had a devastating impact on many EMU member countries and resulted in growing private and public sector indebtedness, the collapse of economic activity, high levels of unemployment, particularly for youth, and, at the time of writing, the threat of deflation, with little likelihood of improvement in macroeconomic outcomes in the foreseeable future. Thus, the design of the EMU has been subject to intense scrutiny.

Modern Monetary Theory (MMT), which embraces the principles of chartalism[3] and functional finance, makes the fundamental distinction between a sovereign and non-sovereign economy. The former issues a fiat (non-convertible) currency which floats on foreign exchange markets. In a sovereign economy, the consolidated government sector (Treasury and Central Bank), a currency issuer, can never become insolvent vis-a-vis its national currency denominated obligations (Watts and Sharpe, 2013). This reflects the capacity of the central bank to act as lender of last resort.

On the other hand, members of the Eurozone have abandoned full fiscal–monetary policy sovereignty:

1. The nations surrendered their own currency and immediately started using a foreign currency which meant they became financially constrained in their spending decisions and faced solvency risk. They could no longer issue risk-free public debt.

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2. These nations surrendered their own central banking capacity and with it the capacity to act as a lender of last resort to their own banking system (and government for that matter – linked to 1).

3. They abandoned their own currency parity in favour of a single exchange rate (which logically follows 1 and 2) and so any current account imbalances had to be resolved via very harsh internal devaluation – the evidence of which is clear. (Mitchell, 2013)

The central premises of this article are, first, that the global imposition of neo-liberalism both informed the design of the EMU and was a major contributory factor to the onset of the GFC. Second, policy sovereignty is essential to the effective conduct of fiscal and monetary policy.

Using policy sovereignty as a benchmark, we argue that the recent and proposed policy reforms in the Eurozone have been piecemeal and would, at best, provide a marginal amelioration of their macroeconomic outcomes. We recognise, however, that the modest policy proposals have been guided by what is feasible within the political and economic constraints of the EMU. Nevertheless, the only sustainable solution to the macroeconomic woes of Eurozone members involves exiting the EMU to re-establish their full policy sovereignty. Key issues associated with exiting the EMU are briefly discussed before concluding comments complete the article.

## *Critique of the BW Consensus policy framework*

The deficiencies of the neo-liberal policy framework can be seen in sharpest relief by an analysis of both the causes of the GFC and subsequent policy responses by EMU members.

From a post-Keynesian perspective, the GFC had its origins in the global imposition of a neo-liberal policy regime from the mid-1970s onwards, which had four main characteristics. The first was an assault on organised labour; the second was a regulatory stance predicated on the removal of the 'dead hand' of government from the operation of the market. The third was a rejection of Keynesian policy interventions based on the management of effective demand, which had sustained full employment in the post-war period, and the fourth characteristic was a dramatic shift of income and wealth to the top 5% of the population.[4] In this context, effective demand was maintained by a problematic combination of wealth effects, based on asset-price inflation, and an unprecedented expansion of household debt. The growth in the size and influence of the financial sector, most clearly manifested in the extension of derivative trading and processes of securitisation, merely compounded the macroeconomic effects of fiscal conservatism, real wage repression and the increasing precariousness of work, by corroding underwriting mechanisms (Wray, 2009).[5]

Mitchell (2012a) argues that the EMU framework was inconsistent with the necessary conditions for an Optimum Currency Area (OCA) (see Feldstein, 2011; Mundell, 1961). These conditions include a high degree of labour mobility, which includes the absence of cultural barriers, such as different languages, and the transferability of rights such as superannuation. Economies must be open with capital mobility and price and wage flexibility. The framework must incorporate a central fiscal authority which can transfer resources from better performing to poorly performing countries, typically through tax redistribution. Finally, the business cycles of member countries must be synchronised,

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which would overcome the limitations of the one-size-fits-all monetary policy.[6] This final condition rules out the presence of asymmetric shocks (Toporowski, 2013).

Under an OCA, monetary policy becomes an alternative for wage changes as the policy instrument for impacting the overall level of employment, largely through its influence on the degree of international competitiveness. Mundell's analysis ignores the 20th-century evolution of the monetary and financial system, where capital flows dominate over trade flows as a driver of exchange rate fluctuations, opening the door to uncertainty and instability of expectations, speculation, and asset price revaluation effects. Fisher's debt deflation mechanism arising from declines in wages and prices should be viewed as one expression of this volatility (Toporowski, 2013).

When the GFC was impacting on national economies in 2008, via higher unemployment, the IMF advised that monetary policy should be loosened, but it has had very limited macroeconomic effects, despite official rates in the Eurozone, UK, USA and Australia being at record lows (Sharpe and Watts, 2012). Furthermore, there is no conclusive evidence that unconventional monetary policy (quantitative easing and its variants) was markedly successful in stimulating the real economy in the USA, UK and Japan (Sharpe and Watts, 2013). In fact, the UK has experienced its slowest recovery with respect to per capita income in its recent history (IMF, 2013a). Within the Eurozone, the centralisation of monetary policy condoned housing bubbles in Spain and Ireland prior to the GFC.

Notwithstanding the major real shock which confronted both sovereign and non-sovereign economies following the GFC, there was a broad consensus that only short-term fiscal stimulus measures were appropriate. It was asserted in the Organisation for Economic Co-operation and Development's (OECD) *Economic Outlook* that, following a deep recession, the rise in unemployment would be partially translated into higher structural unemployment and lower potential output via hysteresis effects (OECD, 2009: 230). These 'hysteresis effects are asymmetric in the sense that they tend to raise the NAIRU[7] when unemployment rises, but do not lower the NAIRU when unemployment falls'. This claim supports the view that fiscal stimulus should only be short-term, with unemployment more effectively addressed by further structural reform (OECD, 2009). On the basis of these beliefs, in 2011, stimulus measures had been wound back in most countries at the behest of the OECD and the IMF (Sharpe and Watts, 2012).

The Eurozone economies were confronted with the imperative for pro-cyclical fiscal policy, owing to the constraints of the SGP and the related absence of the central bank role of lender of last resort, which meant that all deficits had to be funded by borrowing. Member countries, operating as currency users, rather than issuers, were thus exposed to the sentiments of international investors. Furthermore, given the three consequences of Eurozone membership noted in the 'Introduction' section, the Eurozone could have reduced the consequences of the negative aggregate demand shock if its central bank had behaved as a federal fiscal authority (Mitchell, 2013).

Both the IMF and the OECD enthusiastically advocated front-loading austerity measures on the basis that fiscal multipliers were low, thus reducing both the benefits of ongoing stimulus and the costs of austerity measures. In the face of mounting empirical evidence to the contrary (with the IMF, in particular, making major concessions about the magnitude of fiscal multipliers), these organisations began to adopt a more cautious

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approach, although the medium-term objective of fiscal restraint remained (Sharpe and Watts, 2012).

Through the use of national accounting identities, advocates of MMT have shown that sustained budget surpluses are inconsistent with sustained full employment unless large persistent current account surpluses are achieved, which clearly cannot constitute a universal policy. The inability to achieve high levels of economic activity also implies that reliance on monetary policy has also failed (see below).

In general, peripheral Eurozone economies did not have large fiscal deficits prior to the crisis, but did have current account deficits. In the presence of significant private debt and ongoing fiscal austerity measures, there is little prospect for sustained increases in private sector and net public sector spending to offset the current account deficits (see IMF, 2013a). In particular, private investment has been subdued, reducing the likelihood of a sustained increase in the international competitiveness of peripheral economies either through improved quality or growth in productivity. Consequently, structural reform has been forced on uncompetitive Eurozone countries in the form of wage and price cuts. A race to the bottom via ongoing wage and price cuts across the Eurozone is a distinct possibility with the prospect of debt deflation adding to the economic pain experienced by households since the advent of the GFC (Toporowski, 2013: 580).

The current account surplus in the core countries (such as Germany) has not declined, however, largely owing to sluggish domestic demand. A recent IMF (2013b) outlook report asserts that 'stronger domestic demand in surplus countries is critical to support stronger demand in the euro area as a whole and help sustain a rebound in exports from deficit economies' (p. 45, Box 1.3). Even though the volume of intra-Eurozone trade has increased under the EMU, the contribution of net exports to total expenditure in the member countries is necessarily a zero-sum game.

Finally, since the OECD (1994) *Jobs Study*, there have been many critical empirical studies of its supply side reform agenda (see Watts, 2010 for a summary). While the OECD (2006) made concessions about the effectiveness of some supply side reforms and now recognises two successful policy models – neo-liberal and Nordic – it continues to encourage the adoption of the former rather than the latter (Watt, 2006). The BW Consensus implies a hands-off role for government, whereas structural reforms can interfere with 'relationships and customs that are rooted in society' (Fitoussi and Saraceno, 2013: 486).

## Policy reform in the Eurozone

### *Introduction*

We now canvas a non-exhaustive set of recent and proposed policy reforms which generally lie within the constraints of the Eurozone policy framework. It has been proven difficult to design a consensus solution to the ongoing crisis due to the divergence of views regarding its origins. For example, Mazier and Petit (2013) maintain that '[t]he present crisis arises from structural disequilibria linked to the heterogeneity of member countries and permanently asymmetric patterns of development' (p. 521; see also Simonazzi et al., 2013: 653). The inference then is that a monetary union is a viable arrangement if

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countries are homogeneous and will remain so. On the other hand, Auerback (2012) argues that the fundamental policy contradiction is the presence of a monetary union without a fiscal union, when stimulatory monetary and fiscal policies need to be framed in a recession.

## *European Central Bank policy*

The European Central Bank (ECB) reduced its main refinancing operation rate to a historic low of 0.15% in June 2014.[8] Prior to this, the European Parliament (2013: 8) recognised that monetary policy transmission channels to the real economy were severely impaired, given the persistence of low growth and high joblessness, and questioned the efficacy of further rate cuts in light of the potentially adverse impacts. First, very low interest rates, for a prolonged period, can harm private savings and pension plans. Second, prolonged low interest rates may encourage 'aggressive risk taking, the build-up of financial imbalances, distortions in financial market pricing and incentives to delay necessary balance sheet repair and reforms'.

Consequently, the ECB has adopted unconventional measures since the advent of the GFC. Long-term refinancing operations in December 2011 and February 2012 generated over €1 trillion of funds to European banks as low interest loans with a term of 3 years. Also, Emergency Liquidity Assistance lines provided by national central banks amounted to €206 billion at the end of 2012. The European Stability Mechanism (ESM), which replaced the European Financial Stability Facility, raises funds on capital markets and will finance new bailouts up to a modest €500 billion.

The ECB conducted large-scale government debt purchases in the secondary market in June 2012, which was not contrary to Maastricht Treaty rules (Auerback, 2012). The Outright Monetary Transactions (OMT) programme was announced in September 2012 and replaced the Securities Market Programme. Under OMT, the ECB committed to make unlimited government debt purchases on the secondary market for those Eurozone countries subject to bailout agreements with the Troika. Austerity measures negotiated by these countries, however, continued. To placate the Bundesbank, (albeit unsuccessfully), the liquidity effects of OMT were fully 'sterilised' to convey the impression that public debt was not being monetised, which was considered inflationary. The programme was successful, with 10-year bond rates for Ireland, Greece and Portugal, all declining from late 2012. These outcomes confirm the absence of solvency issues for a central bank with its own sovereign currency.

While the ECB's policies appeared to stabilise liquidity conditions within the banking system and contributed to lower bond market spreads, credit growth stayed low. Small and medium-sized enterprises (SMEs) remain particularly vulnerable, which is problematic since SMEs represent about 98% of all Eurozone firms, generate about 60% of value added, employ 72% of the labour force and have much higher gross job creation (and destruction) rates than large enterprises (European Parliament, 2013).

Credit tightening has had an asymmetric impact on firms with SMEs viewed as a higher default risk by banks and unable to switch to other sources of finance. The ECB should consider a programme geared to enhancing credit access by SMEs along the lines of the Bank of England's (BoE) 'funding for lending scheme' (European Parliament, 2013: 8). European Parliament (2013) acknowledges that poor business sector growth in

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the Eurozone primarily reflects demand side, rather than supply side constraints over investment sentiment, but continues to argue that 'a low-inflation environment is the best contribution *monetary policy* can make towards creating favourable conditions for economic growth, job creation, social cohesion and financial stability' (p. 5, emphasis added). Yet it would seem that fiscal stimulus and direct job creation is the best contribution that *macroeconomic policy* can make to the admirable objectives listed above. But, given significant institutional and ideological barriers, policy sovereignty must first be restored (see below).

## *Banking union*

The close links between governments and banks in the Eurozone deepened with the onset of recession. Deteriorating fiscal balances and increased credit risk 'in turn puts pressure on balance sheets of banks that hold government bonds but also depend on the same government for possible recapitalisation' (Beck, 2013). Banks in the peripheral countries remain the major holders of their domestic government bonds.

This interdependence between banks and governments exposed fragility in the Eurozone architecture which was neglected in the Maastricht Treaty (1992). Reforms to the EU supervisory framework, including micro- and macro-prudential pillars, targeted 'a stable, reliable and robust single market for financial services' (Enderlein et al., 2012: 44). However, the new agencies have limited powers, and national authorities remain responsible for most decisions. Beck (2013) argues that the only viable option is 'a Eurozone wide deposit insurance scheme with public back-stop funding by ESM and a regulatory and supervisory framework'.

The establishment of the Single Supervisory Mechanism (SSM) is a key step towards a banking union in Europe and severing the ties between banks and government. The SSM aims 'to ensure the safety and soundness of the European banking system and to increase financial integration and stability in Europe' (ECB, 2013). The ECB will assess the asset quality of European banks, as the institution prepares to assume its full supervisory role under the SSM in November 2014. The SSM will also be combined with (preventive and corrective) frameworks for deposit insurance (Deposit Guarantee Directive) and the resolution of credit institutions (Bank Recovery and Resolution Directive). The former overcomes the problem with national deposit insurance schemes which are designed for idiosyncratic bank failures, not systemic crises when major public funding is needed. While the SSM entails supervision at the supranational level, there is no indication that resolution will occur at this level.

The European Parliament (2013) argues that the establishment of the SSM will 'contribute to restoring confidence in the banking sector and to reviving interbank lending and cross-border credit flows', but offers two key recommendations (p. 9). First, the development of small and medium-sized local banks should be encouraged, which would strengthen the diversity and improve the resilience of the banking system. Second, a full separation of deposit and investment banks should be considered to strengthen the stability of the banking system, and avoid too-big-to-fail institutions and associated risk taking.

The current crisis has to be solved before banking union is in place. Beck et al. (2012) argue that this should be achieved via the establishment of an asset

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management company or European Recapitalization Agency, which would sort out fragile banks across Europe and perhaps take an equity stake in restructured banks to benefit from possible upsides. This would help disentangle the government and bank links, and might make for a more expedient and less politicised resolution process than if undertaken at the national level.

## *Eurobonds*

The issue of Eurobonds or Stability Bonds would be a further step towards a fiscal/political union. European Commission (2011) canvasses the alleged benefits of jointly issued Stability Bonds, namely to (1) alleviate market pressure during debt crises and reinforce financial stability in the Eurozone; (2) benefit high-yield members from the creditworthiness of traditionally low-yield members; (3) generate a large pool of liquid assets to improve the effectiveness of Eurozone monetary policy and offer a solid benchmark for pricing other assets; and (4) strengthen the Euro as a reserve currency.

Eurobond proposals vary according to the degree of substitution of national issuance and the nature of the guarantee. The best-known proposal is the blue/red scheme devised by Delpla and Von Weizsacker (2010) in which jointly backed, low-yield blue Eurobonds would be issued for up to 60% of members' gross domestic product (GDP), whereas red bonds, which attract a risk premium, would be issued beyond this reference value. The higher yields should discourage their issuance (see also De Grauwe and Moesen, 2009). Enderlein et al. (2012) recommend establishing a European Debt Agency to jointly guarantee EMU member debt.

There are some key practical and legal problems associated with jointly guaranteed debt. First, Stability Bonds may conflict with Article 125 ('no bailout' provision) of the Lisbon Treaty. Second, a 'free-rider' or moral hazard problem may arise as members exploit the reduced risk (and lower yields) attached to jointly guaranteed debt and issue too much. Strict conditionality attached to joint debt issuance would be required to address the latter risk. However, if OMT is maintained, which keeps borrowing costs down and stabilises confidence, Eurobond proposals which require increasingly strict conditions and higher costs attached to issuance to mitigate the moral hazard problem are not dissimilar from national debt issuance which already carries strict conditions.

In essence, while Eurobonds would help to finance structural imbalances, they do not resolve them on a permanent basis. In sovereign economies, net government spending does not need to be financed *ex ante* through a bond issue, and government is not captive to market pressure or so-called bond vigilantes (see Sharpe, 2013). In Eurozone economies, while Treaty changes are possible, moral hazard associated with Eurobonds has generated strong resistance among members, particularly Germany. Consequently, Eurobond proposals were abandoned in July 2012.

## *Trade reform*

Simonazzi et al. (2013) explore the major trade imbalance between Germany and the peripheral Eurozone economies which they attribute to the reorganisation of the German economic system, based on internal demand repression through stagnant real wages, and

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the eastward reorientation of German trade. The competitiveness of the peripheral economies is often compared to that of Germany, which is potentially misleading, since Germany's exports are complex products and quite diversified (Felipe and Kumar, 2011). Slow growth in the Eurozone has meant that the peripheral economies have been unable to achieve sufficient diversification and specialisation of their productive structures to boost their exports either within or outside the Eurozone. IMF (2013b) findings reveal that external demand from outside the Eurozone has been a key driver of export performance, particularly in Germany, Spain and Portugal. Consequently, the Euro area in aggregate now has a current account surplus.

While internal devaluations have contributed to reduced current account deficits among the periphery, the primary cause has been repressed domestic demand, due to wage cuts and increased unemployment, which has led to a collapse in import spending. Furthermore, an internal devaluation exacerbates the burdens of servicing private debt and further dampens any hope of a recovery in private demand, in addition to the psychological and legal issues associated with nominal wage cuts.

Greece and Ireland, in particular, have experienced significant falls in unit labour costs 'on the back of both productivity gains (as labour shedding generally exceeded the decline in output) and wage declines' (IMF, 2013b: 46). Yet, the link between declining unit labour costs (the wage share) and increased output is unclear. For wage-led economies including Germany, France, Italy, UK, USA, Japan, (and for the Eurozone as a whole), a decline in the wage share leads, by definition, to a decline in growth, whereas, for profit-led economies such as in Canada, Australia, Argentina, Mexico, China, India and South Africa, growth increases (Onaran and Galanis, 2012). Nevertheless, a simultaneous decline in the wage share in all countries leads to a decline in global growth, which explains why the transition to neo-liberalism, after the stagflation episode of the early to mid-1970s, proved so detrimental to economic growth.

The IMF (2013b) has warned however that 'current account deficits could widen again significantly when cyclical conditions, including unemployment, improve, unless competitiveness improves further' (p. 48). A reduction in current account deficits can be achieved by further wage cuts and continued fiscal austerity, which further dampens private demand, and raises unemployment, but is not a sensible policy to achieve sustained output growth.

Mazier and Petit (2013) appear to partially endorse this interpretation, arguing somewhat ironically, by reference to Greece, Portugal and Spain, that '[t]he strategy of internal devaluation, combined with budgetary austerity, has a strong negative impact in terms of growth and employment and is only efficient in the long term, especially when it is implemented in large countries' (p. 518). They suggest that a multi-speed Eurozone could be accommodated through the introduction of member-based currencies for internal trade with fixed parities against the external Euro. They also recognise the need for regulation to address free capital mobility (Mazier and Petit, 2013).

This is an interesting but infeasible option, since it undermines the objective of the common currency, particularly if internal parities also change over time. Second, it reduces the imperative for structural reform of those member countries that exhibit external imbalance, which would be unacceptable to Germany. Third, reliance on trade reform alone is insufficient to achieve policy sovereignty. Fourth, the introduction of new

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currencies, irrespective of whether they are linked to the Euro or result from exiting Eurozone, raises major transitional issues associated with the currency denomination of external debt, which is acknowledged by Mazier and Petit (2013).

In summary, reliance on large current account surpluses to attain high levels of economic activity is not a universal policy model. While the heterogeneity of the member countries is a major factor in the disparate economic outcomes during the GFC, it is not the root cause of the Eurozone's problems. Addressing the trade imbalances does nothing to ameliorate the constraints on the conduct of fiscal and monetary policy among Eurozone economies.

## *Fiscal federalism*

A major criticism of the EMU is that the central monetary authority was not complemented with a federal fiscal authority. Transition towards deeper fiscal integration (e.g. a fiscal union) typically involves (1) a common set of fiscal rules; (2) mechanisms for crisis intervention; (3) fiscal equalisation and transfer mechanisms between countries; and (4) a common budget (Vetter, 2013: 3). Conditions (1) and (2) are largely conducted at the supranational level via Stability and Growth Pact requirements, reinforced by the Fiscal Compact, and recent steps towards a banking union via the Single Supervisory Mechanism, and ESM which is intended for (temporary) crisis management. Transition towards a *genuine* economic and monetary union is currently stalled because conditions (3) and (4) have not been met.

Integral to the theory of Optimum Currency Areas (OCA) is the presence of fiscal transfer arrangements that attempt to overcome the loss of a flexible exchange rate as an automatic stabiliser (Mundell, 1961). The MacDougall report, a feasibility study of the EMU, had recommended an inbuilt fiscal transfer system to counter asymmetric shocks among member economies (see European Commission, 1977). Similarly, Delors et al. (1989) advocated a union-wide federal fiscal adjustment mechanism, but also binding limits on national budget deficits. The Maastricht Treaty (1992), however, only considered fiscal rules vis-a-vis government deficit and debt targets.

Consequently, there is no central fiscal authority charged with income redistribution and stabilisation policies in response to asymmetric shocks, which highlights the flawed architecture of the EMU, even in the context of orthodox OCA theory. Policymakers are now tasked with creating EMU fiscal capacity in the absence of political union. This may involve the establishment of a Euro area budget to allow for risk sharing. Allard et al. (2013) maintains that a Euro area budget would require a further loss of national fiscal sovereignty. European Council (2012) warns that fiscal compliance mechanisms must be upheld which highlight the Council's concerns about moral hazard.

Enderlein et al. (2012: 31) suggest creating an automatic cyclical adjustment insurance fund. Eurozone members would contribute to the fund during good years, 'when the cyclical growth component is significantly larger than in the euro area average'. In turn, members could access the funds if, for example, their 'growth rate [is] more than 2 percentage points lower than the euro area average'. The fund would facilitate the difficult path towards an internal devaluation through real-wage adjustments, and mitigate pressure on national unemployment transfer schemes, thus easing fiscal balances during

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severe downturns. Enderlein et al. (2012) stress that the fund does not constitute a permanent transfer scheme and there must be strict rules for its operation. While the idea is beset by measurement issues (e.g. defining potential output and the type of economic shock), the fund's capacity to deal with a systemic crisis, when *all* members are seeking funds, may be problematic. Furthermore, it facilitates rather than eliminates the *need* for internal devaluations.

Vetter (2013) discusses a common unemployment insurance scheme in which pooled funds would be available to assist with short-term unemployment benefits. Long-term unemployment benefits, however, would still remain the domain of national unemployment insurance mechanisms. Members with low unemployment (e.g. Austria, Luxembourg and The Netherlands) would persistently fund economies with high unemployment. Furthermore, the resulting partial harmonisation of benefits from the scheme would present political and economic challenges to members with both generous and low benefits.

Likewise, Mazier and Petit (2013) advocate a permanent stabilisation fund which would authorise transfers to countries according to their unemployment performance, but the scheme fails to address the ongoing structural problems. Mazier and Petit (2013) also consider investment programmes in education, research, infrastructure for sustainable development and suburban revitalisation, which could be financed partly by Eurobonds and through credits from the European Investment Bank (EIB) and refinanced by the ECB. Yet, as noted above, recourse to Eurobonds is not viable.

Auerback (2012) argues that the ECB should create and distribute trillions of Euros annually to national governments on a per capita basis to ultimately bring their debt ratios down to 60% (the SGP reference value). The per capita criterion attempts to overcome moral hazard since it is 'neither a targeted bailout nor a reward for bad behaviour' of those countries that have been allegedly profligate with respect to fiscal policy. This distribution would adjust debt ratios downwards, enabling additional national government spending and restoring the normal functioning of credit markets for national debt. Since Auerback's (2012) proposal is merely an asset swap, by substituting national bonds with reserves in the banking system, it will not increase bank lending and is not inflationary.[9]

Legal issues are relevant when considering the above proposals (Allard et al., 2013: 24). For example, options to veto national budgets if deemed to conflict with common fiscal rules would require Treaty changes and changes to national legislation and constitutions. Secondary legislation could be used to introduce a fiscal insurance mechanism (Articles 122, 136, and 352 of the Treaty on the Functioning of the European Union (TFEU, 2012 [1958])), and a Euro area budget could be established as part of the larger EU budget. However, a common unemployment insurance scheme would require Treaty changes to adequately identify national and Euro area responsibilities.

Fiscal federalism is designed to reinstate fiscal policy as a countercyclical device. This was absent from the original Eurozone architecture, but is an essential stabilisation mechanism. Deeper fiscal integration raises some major issues. First, proposals which require the ECB to act as a quasi-fiscal authority would conflict with Treaty rules. Second, the overriding concerns with deeper fiscal integration pertain to issues of moral

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hazard, and democratic legitimacy and accountability, which require strengthened governance and enforcement provisions regarding fiscal outcomes and reinforce members' loss of policy sovereignty. While the Euro may have been motivated by politics, the social, political and economic disparities among its members mean that forcing a fiscal/political union as an afterthought is sure to ignite tensions. Allard et al. (2013) suggest that a Euro area budget is unlikely to garner constituent support.

## Restoring policy sovereignty

While well intentioned, the aforementioned policy proposals will, at best, have a very modest impact on economic activity in the Eurozone. In essence, these measures will not restore policy sovereignty which we argue is a necessary but not sufficient condition to promote economic and social recovery in Europe. Restoring policy sovereignty inevitably involves exiting the EMU and reinstating a fiat (non-convertible) currency, a flexible exchange rate regime and monetary independence. We now briefly examine the economic issues associated with exiting the Eurozone. The discussion is prefaced by the observation that this strategy is beset by legal complexities.

Until the Lisbon Treaty (2009), neither the founding treaty nor successive amending treaties made provision for the withdrawal of a Member State from the EU (or EMU). Article 50 of the Lisbon Treaty (2009), however, embodies a unilateral right of withdrawal from the EU since (1) 'Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements'; (2) withdrawal is not conditional on the outcome of a Member's withdrawal agreement with the European Council provided that 2 years had elapsed since notification to the European Council on its decision to withdraw; and (3) 'the right to withdraw is not connected with the adoption of a constitutional change that a Member State cannot accept, but introduced without such restrictions …' (Athanassiou, 2009: 24). However, the notification of the intention to withdraw does not have to be made public.

One can only speculate as to the motivation for the (late) addition of an exit clause. Athanassiou (2009) suggests that '[t]he reasoning may well have been that if Member States have an institutionalised right to withdraw from the EU, they are unlikely to object so strongly to surrendering more of their sovereignty to its institutions' (p. 25, footnote 76).

The exit clause is particularly vague, and perhaps intentionally so. Specifically, it does not preclude multiple withdrawals or include a special provision for withdrawal of EU members participating in the EMU. One interpretation for the latter is that the drafters would then need to specify the procedure and consequences of withdrawal, which is a task beset by complexities. Unlike EU membership, EMU participation is a legal obligation for all Member States, and so, withdrawing from the EMU would be in breach of this obligation unless the Member also withdrew from the EU (Athanassiou, 2009: 28).

A related issue is expulsion from the EU or EMU. At present, there is no treaty provision for expelling a Member State although the European Council can temporarily suspend some of a Member State's rights. One technical problem associated with *a right of expulsion* clause from the EU or EMU is that it would require a Treaty amendment for

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which the unanimous consent of *all* Member States is required according to Article 48 of the Treaty on European Union (TEU, 2012 [1992]). Athanassiou (2009: 36) concludes that persuading a Member to withdraw would be an easier option.

Establishing that a withdrawal from the EU, and by extension the EMU, is legally permissible, the first practical step in the exit strategy would be to restore currency sovereignty by imposing a currency law and defining the conversion rates between the new currency and the Euro. To facilitate this process, the official exit should occur over the weekend when banks (and financial markets) are closed to prevent bank runs and allow new (physical) currency to be stocked (Variant Perception, 2012). New physical currency or stamps for existing currency should be ordered (in secret) ahead of the public announcement of withdrawal. Legislation should be enacted to force domestic residents to exchange existing Euro currency for the new currency or have existing Euros stamped. National border monitoring should be strengthened to mitigate the risk of fleeing Euros.

Other financial obligations such as bonds, loans and derivatives (e.g. currency, interest rate) would also need to be redenominated. If such obligations are issued under *local law*, redenomination to the national currency is largely unproblematic. Variant Perception (2012) maintains that almost all sovereign borrowing in Europe is conducted under *local law*. For example, approximately 94% of Greek government bonds are issued under Greek law. If the obligation is governed by *foreign law* and there is no currency clause explicitly tying payment to the law of the exiting country, it may be up to the courts to determine the implicit nexus of contract (Nordvig and Firoozye, 2012). To facilitate debt restructuring, the treaty establishing the ESM provides for mandatory inclusion of a standardised *Collective Action Clause* for all Eurozone government bonds issued after 1 January 2013.

The new national currency should be coupled with a flexible exchange rate regime. Real devaluations, harsh price and wage cuts, geared to improved competitiveness would become redundant as the nominal exchange rate would be able to make the necessary adjustment (Mitchell, 2012b). For overvalued economies, such as Greece, this would likely result in a swift depreciation of the new currency against other major currencies.

The net effect of currency depreciation, however, is unclear. Positive effects may arise from improved external competiveness if translated into output gains, which would largely be dependent on import and export price elasticities, the size of the export sector and degree of inflation pass-though. Negative effects from currency depreciation would arise due to balance sheet effects related to foreign-currency-denominated liabilities which also attract a relatively high interest rate currently. Equally, Euro-denominated assets such as bank deposits would be redenominated in the new currency. Greece, for example, could exploit its newfound currency sovereignty by compensating entities exposed to foreign-currency-denominated liabilities.[10] However, equity issues would need to be carefully considered, since any compensation of wage earners is likely to be limited to tax cuts (see below).

Domestic capital controls could be implemented to help stem capital flight due to fear of currency depreciation, even though such capital movements are already well underway in some Eurozone economies, particularly Greece. Nordvig and Firoozye (2012) note that market participants are moving to establish a (non-deliverable) foreign exchange forward market which can be used to hedge against redenomination risks and exposure to new national currencies.

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Any attempt by unions to restore the Euro value of their wages would promote high inflation arising from both demand pull, due to capacity constraints arising from the enforced recession, and cost push. Also, as noted, to the extent that production is not vertically integrated, the benefits of currency depreciation would be already reduced, without compounding the problem of competitiveness by raising domestic wages. An incomes policy would be useful to combat the risks of inflation pass-through igniting a wage-price spiral.

Restoring full policy sovereignty means that fiscal policy is no longer constrained by SGP/Fiscal Compact requirements. Well-targeted (spatially sensitive) government spending should take place, particularly in areas with traditionally higher fiscal multipliers, such as infrastructure. Income tax cuts combined with a temporary cut in consumption-based taxes would promote domestic consumption and act as the quid pro quo for wage restraint.

Abandoning the Euro and establishing a flexible exchange rate also allows national monetary policy to be restored, a move which should immediately be geared to fostering liquidity and financial stability in domestic financial markets. National central banks should coordinate and implement central bank liquidity (currency) swap lines, and national deposit insurance schemes should be strengthened to facilitate these objectives. It may also be necessary to broaden acceptable collateral for the conduct of central bank repurchase (Repo) operations. Practical and legal issues associated with refunding the central bank's capital contribution to the ECB and also the reimbursing of foreign reserve assets transferred to the Euro system would also need to be considered in due course.

A Job Guarantee should be implemented to underpin domestic demand and foster the restoration of household balance sheets. Implementing a Job Guarantee involves setting the minimum/liveable wage as nominal anchor and introducing an automatic price stability mechanism (see Mitchell, 1998 and Juniper et al., 2014 for an outline of the Job Guarantee and a response to its critics). Government expenditure on a Job Guarantee would not confront capacity constraints which could inhibit private sector spending following the enforced period of recession.

By exploiting the options of a Government with policy sovereignty, the above strategies would address the criticism that 'there exists no "optimal" exchange rate that would satisfy both the needs of trade *and* the maintenance of stable balance sheets' (Toporowski, 2013: 582).

## Concluding comments

> The drive for the Euro has been motivated by politics not economics. [The Euro] would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues. Political unity can pave the way for monetary unity. Monetary unity imposed under unfavorable conditions will prove a barrier to the achievement of political unity. (Friedman, 1997)

The imposition of the BW Consensus policy framework on members of the Eurozone has meant that these countries have foregone their policy sovereignty with calamitous consequences for governments' capacity to conduct independent macroeconomic policy. The political and economic constraints of the Eurozone mean that policy sovereignty

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cannot be restored within the monetary union, notwithstanding the array of recent and proposed policy reforms. The only viable solution involves exiting the EMU to re-establish full policy sovereignty. Only then can fiscal and monetary policy be geared to promoting an economic and social revival in Europe. However, major distributional issues would need to be addressed in the transition.

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## Notes

1. Werner (1970) offered the blueprints to an Economic and Monetary Union (EMU) among the European Economic Community. However, the proposal lost momentum in the early 1970s as the supply shocks enveloped the global economy. Debate was re-invigorated at the 1988 *Hannover Summit* which was followed by a clear and practical guide to the EMU formation set out by Delors et al. (1989).
2. The McCracken Report (McCracken et al., 1977) and the Organisation for Economic Co-operation and Development's (OECD) (1994) influential *Jobs Study* also helped to shape the neo-liberal vision.
3. For an analytical overview of chartalist concepts see Wray (2014). The term is attributed to Knapp (1985 [1924/1973]), whose *State Theory of Money*, translated into English in 1924, opposed the 'metalist' view of money as an means of exchange valued in terms of its substance, seeing it instead as a state-backed unit of account, a 'creature of law', pre-dating markets, deriving its value from its acceptance in settling debt at state pay offices. For Keynes (1976 [1930]), 'Chartalism begins when the State designates the objective standard which shall correspond to the money-of-account' (p. 11). The money supply, however, is not fixed by the state, but determined endogenously through economic activity. The state puts money into circulation through fiscal policy and removes it through taxation. The rest is accumulated as bank reserves, which are drained through monetary management in support of monetary policy. Minsky (1986: 230–231, cited in Wray, 2014: 19–20) also emphasised the endogeneity of money, defining loans as deferred payments and describing economic activity as being based on a pyramidal network of bank liabilities, convertible on demand into the central bank liabilities used for interbank clearing. Minsky saw taxes as ultimately determining the value of government-issued money: government debt is a major bank asset, and people work so they can pay taxes, using bank deposits to do so, with the result that banks draw down their reserves of central bank money. Ingham (2013) argues that money is a social relation based on impersonal trust: it 'constitutes the means of *final* payment throughout the *entire* space defined by the money of account' (Wray, 2014: 26). Citing Amato and Fantacci (2012: 236), Ingham claims that there is 'no liquidity without a lender of last resort, no lender of last resort without an irredeemable consolidated debt, and no irredeemable debt without an immortal state' (Ingham, 2013: 23).

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4. This shift of income was predicated on a new economic alliance between shareholders and management justified by the ‘turn to shareholder value’.
5. We will largely ignore matters of prudential control and regulation of financial markets, which have featured in recent debates over post-Basel III arrangements, the Volcker rule and recommendations made in *The Liikanen Report* tabled in October, 2012.
6. The admission of Slovenia (2007), Cyprus and Malta (2008), Slovakia (2009) and Estonia (2011), has further undermined this condition.
7. The non-accelerating inflation rate of unemployment (NAIRU) represents the unemployment rate believed to be needed to achieve a stable inflation rate.
8. The decision of the European Central Bank (ECB) to reduce its main refinancing rate in June 2014 from 0.25% to 0.15% was accompanied by the deposit rate on excess reserves also being reduced by 0.10% (from 0% to −0.10%) to maintain the so-called interest rate corridor within the interbank money market. The tax on excess reserves represents a misguided attempt to avoid deflation in the Eurozone by the alleged promotion of bank lending and/or purchases of foreign-currency-denominated assets to depreciate the Euro.
9. This is well documented in the Modern Monetary Theory (MMT) literature and by Constancio (2011).
10. An alternative is to facilitate the refinancing of Euro-denominated debt, by offering government-backed low interest loans, denominated in the new currency.

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