Disaster Avoidance

How analytical, executive, and democratic deficits threaten the existence of the eurozone.

By William R. White

This article reflects upon the importance of the three eurozone policy "deficits" identified by Nicolas Véron of Bruegel. He refers to them as the analytical deficit, the executive deficit, and the democratic deficit. Implicitly, he raises again three long-standing sets of questions pertaining to the pursuit of good public policies. What should be done (the analytical deficit); what could be done (the executive deficit); and what will be done (the democratic deficit)? Broadly put, the answer to the first question is in the realm of economics, the second in the realm of law and regulation, and the third in the realm of politics. Failure at any individual level could threaten the future of the eurozone as a whole.

A first consideration is whether is whether these deficits have contributed materially to the current economic problems in Europe. It is argued here that they have. A second consideration is whether these deficits can be filled adequately enough and quickly enough to ensure continued progress towards the initial vision and an intact eurozone. This is a much more difficult question, not least because the judgement of "adequacy" will be made by fickle financial markets. It is argued here that member governments

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need to take significantly stronger measures than they have. Relying heavily on the European Central Bank to preserve the integrity of the eurozone could prove a fatal error.

THE "SHOULD" PROBLEM

At the level of economic theory, what "should" eurozone policymakers do to best support the integrity of the eurozone? An unfortunate starting point is that many policymakers in the eurozone, particularly in the core countries, seem to have false beliefs about how the eurozone economy actually works. These false beliefs have contributed materially to the eurozone's continuing problems.

To begin with, false beliefs contributed to the onset of the crisis. That is to say, measures expected to ensure crisis prevention failed totally. Moreover, false beliefs also contributed to bad crisis management, not least through giving undue emphasis to the problem of "moral hazard." Similarly, excessive fears about contagion and financial instability have contributed materially to the failure to bring about crisis resolution. That is, neither the overleveraging of lenders in core eurozone countries nor the over-indebtedness of borrowers in peripheral countries has been adequately dealt with. Thus, the eurozone remains highly vulnerable to further shocks, whether internal or external.

Perhaps the most important false belief in the eurozone was one shared with many other policymakers outside Europe; namely, that the achievement of price (CPI) stability effectively ruled out the possibility of other macroeconomic problems. The starting presumption was that "really bad things" could not happen, which we now know is not true.

Against this comforting analytical backdrop, it was also all too easy to believe that growing current account imbalances within the eurozone were of no great importance. Unfortunately, while it was true that exchange rate risk had disappeared, at least as long as the eurozone hung together, counterparty risk had not disappeared. The materialization of this risk, a "sudden stop" of the capital flows required to finance debtor countries, then led to the crisis and even a heightened possibility of the collapse of the exchange rate regime itself.

Moreover, since the crisis began, the ancillary factors that encouraged capital outflows from deficit countries have actually become stronger. The problem of the bank-sovereign nexus, the concern of creditor banks about their own solvency, the concern of regulators about the same issue, and the concern of depositors in peripheral country banks about the safety of their assets (in euros) have all worsened since the crisis broke. Arguably, official policies in the post-crisis period have contributed materially to these concerns in a variety of ways.

The failure to recognize that the eurozone had to deal with a balance of payments crisis meant that another explanation had to be found. The narrative chosen was that the peripheral countries had unsound fiscal positions, although this was evidently not true in the case of Spain and Ireland and not obvious in the case of Italy. Given the false diagnosis, it was not surprising that the false solution of fiscal austerity was prescribed everywhere. Indeed, far from recommending symmetrical easing in creditor countries, as would have seemed obvious given balance of payments problems, the creditor countries themselves embarked on programs of fiscal restraint even more severe than was demanded by existing legislation.

The basic misdiagnosis of the problem also led to another false conclusion; namely, that sovereign debt burdens were sustainable. Therefore, they did not have to be eased through restructuring much less the reduction of principle. The basic idea was that fiscal restraint would eventually restore sustainability. Unfortunately, the reduction of GDP due to fiscal restraint was so great that the debt ratios of the peripheral countries actually increased very substantially rather than decreasing. This was even the case in Greece where private sector creditors did in fact take a major haircut. Similarly, while domestic deflation in peripheral countries was welcomed as a factor improving their "competitiveness," the effect of deflation on increasing the real burden of debt service was essentially ignored.

Avoiding a truly bad outcome has become the eurozone's biggest challenge.

All of these policy errors were also supported by the prevailing moral view, in the creditor countries, that debtors had only themselves to blame for their problems. Thus, they alone had to adjust to reality.

This is a curious position since, whenever a loan is made, there is both a lender and a borrower and both might have been acting imprudently. Had this been recognized much earlier, private banks in core countries might have been prevented from reducing their exposure to peripheral countries in the aftermath of the crisis. In turn, this would have prevented the public sector from simultaneously increasing its exposure in the form of higher TARGET2 surpluses held by the central banks of the core countries. Holding the lenders more accountable might also have led to the earlier recognition of losses and the need for the banks themselves to be either recapitalized or closed. The failure to do this has had important economic and political implications.

From an economic perspective, failing to "bail-in" the creditor banks left them in a state of uncertainty about their own survival that has inhibited lending, particularly to peripheral countries and to small- and medium-sized enterprises. This is particularly unfortunate since Europe is more reliant on SMEs for growth and jobs than is the United States or the United Kingdom. Moreover, given relatively underdeveloped financial markets, compared to the same two states, SMEs in the eurozone rely much more on bank lending.

From a political perspective, absolving the lenders meant that potential losses could only be avoided through debtor adjustment or through taxpayers in creditor countries accepting losses. If the latter is ruled out politically, then austerity in peripheral countries has had to be much more stringent than would otherwise have been the case. Worse, by absolving the lenders, a sharply adversarial approach has been fostered between the citizens of debtor and creditor countries. This is the very opposite of the cross-border trust that will be needed to make the difficult, longer-run reforms required to ensure the viability of the eurozone over time. Finally, letting the lenders off the hook offended the sense of justice and fair play of ordinary citizens. It has thus contributed to the political polarization and distrust of elites that is being seen in Europe and across the world.

A final false belief is closely related to the first one noted above. Too much reliance is being put on the European Central Bank to solve the problems within the eurozone. It is not just that increasingly easy monetary policies ("whatever it takes") might not achieve the goal desired—strong, shared, and sustainable growth within an intact eurozone—but that such policies might actually have unintended consequences that threaten desired outcomes. The overhang of debt, especially sovereign debt, is worsening almost everywhere. Productivity growth is slowing as easy money truncates the Schumpeterian process of "creative destruction." Bank term and credit margins are shrinking, threatening profits and prospects for recapitalization, and negative rates pose still more dangers of the same kind. Insurance companies and pension funds feel their solvency will be threatened over time, and are tempted to buy risky assets (such as commercial property) whose prices already seem vulnerably high.

Perhaps the most serious side effect of this reliance on the ECB is that governments, both singly and severally, feel there is less urgency about making the major institutional reforms that would seem necessary if the eurozone is to survive and prosper. The ECB's successive actions have succeeded each time in generating a positive market response in the form of lower interest rate differentials between core and peripheral countries. However, on each occasion, governments have reacted by slowing down the pace of institutional reform. Should market confidence once again be lost, the ECB's pledge to do "whatever it takes" could easily be challenged by the conditionality surrounding the initial pledge, by legal challenges, and by political opposition from Germany in particular. Recognizing that narrow sovereign spreads were actually the proximate cause of the eurozone crisis should also help challenge the belief that the current narrow spreads, influenced by the ECB, indicate that the eurozone's problems have been permanently solved. This is not the case.

Many policymakers in the eurozone seem to have false beliefs about how the eurozone economy actually works.

Challenging false beliefs is always a difficult task. Thomas Kuhn, Daniel Kahneman, and many others have written extensively on this. Yet this is a challenge to which Europeans must rise. As Keynes put it in the closing lines of the *General Theory,* "The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood." Overcoming the analytical deficit in the eurozone will take a particularly great effort, not least because the general public seems increasingly to accept the comforting but false belief of policymakers that the ECB alone can cure all of the economic problems of the eurozone.

Supposing these false economic beliefs could be overturned, what should be done? A number of policies can be suggested to address both demand side and supply side issues, a combination of Keynesian and Hayekian insights.

First, more fiscal stimulus (or at least less austerity) is needed in the core countries, as well as in the peripheral ones. Faster wage growth in core countries would also be helpful in restoring both household demand and the relative competitiveness of peripheral countries. Second, more public investment is needed, especially in infrastructure, and measures to support more private investment as well.

Third, stronger measures to restructure and forgive debts are required, both sovereign and private. As a corollary, accept that some banks will need to be either recapitalized or closed. Fourth, accept the need for structural reforms. While the need is most glaring in some of the peripheral countries, existing impediments to investment in the services sectors of the core countries are great and need to be removed. This would not only raise productivity and living standards in the core countries. It would also help blunt the mercantilist pressures that have contributed to current account imbalances, both within the eurozone and globally.

THE "COULD" PROBLEM

What institutional changes are required in order that the policies that "should" be followed are actually capable of being adopted? The view of policymakers at the moment seems to have converged on the idea of "more Europe." To firmly support monetary union, the eurozone needs banking union, fiscal union, and political union. Recognizing that Europe is still far from being a single market, economic union is also generally recommended. While these proposals might seem straightforward, as always, the devil is in the details.

First, there are different views about the desired end point. Is the European Union, with the eurozone imbedded within it, to be a super state or a federation of nation states? The French seem to prefer the former, with a common Treasury, a bigger central budget, and a greater capacity for burden sharing. In contrast, the Germans seem to want the latter, but with tougher rules to guide national policies. Since the preferences of each of these countries basically reflects an extension of their own national institutional structures, changing these visions will not be easy.

Second, there remain striking differences of view as to the relative importance of these various unions and the order in which they should be pursued. Some see political union as coming only at the end of the process, and perhaps not even necessary in the end. In contrast, then-German Chancellor Helmut Kohl, on the eve of the Maastricht Treaty, said that without parallel moves to political union, monetary union would remain a "castle in the air." More prosaically, consider the establishment of banking union. Many suggest that, with the banking crisis unresolved, the process should have begun with joint resolution procedures and a euro-based deposit insurance scheme. In practice, it has begun with joint supervision in the hands of the ECB. Even this has recently been challenged by those who see a conflict between the ECB's role in the pursuit of price stability (negative interest rates to spur demand) and in the pursuit of financial stability (negative interest rates that cut bank profits).

Finally, there are still more practical issues. Once eurozone legislation or regulation is agreed, it must be enforced. The eurozone's record on this is not good. Consider, for example, the fiscal provisions of the Maastricht Treaty.

Too much reliance is being put on the European Central Bank.

The core countries of France and Germany were the first to break the rules, inadvertently encouraging the peripheral countries to follow their example. Since then, there have been almost continuous rulings from Brussels that overruns on both deficits and debts can be tolerated. Moreover, these rulings have been such as to suggest there is one set of rules for big countries and another for smaller ones. Again, this does not help to build trust. Finally, enforcement is not encouraged when politicians make late-night agreements and then routinely renounce them in their national media almost the morning after.

Proceeding towards "more Europe," to provide more solid institutional foundations for monetary union, thus faces many obstacles. However, perhaps the greatest difficulty will be in getting ordinary citizens to share in the view of the policymakers that "more Europe" is indeed the solution.

THE "WOULD" PROBLEM

Even supposing the "should" and "could" problems can be overcome, in democratic societies the ordinary citizens must also be broadly supportive of what policymakers suggest. The "would" problem comes down to the complementary need for the "will to act," even supposing you know what to do and you have the powers to do it. However, the will to act on the part of politicians can be compromised by popular hostility to what is being proposed. One senses such popular hostility today. The question is, why?

Going back in history, the creation of the eurozone was not done in a very transparent way. The Delors Commission, for example, was largely made up of technocrats (central bankers) whose mandate was to solve technical problems concerning implementation rather than assessing the desirability of doing so. As well, the popular press, in both Germany and France at the time, were apparently encouraged by their respective governments to avoid a discussion of such fundamental issues.

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As a result, the invitation to "more Europe" today is often met by the retort that the general population never asked for "Europe" in the first place. This is unfortunate, but it is not possible to change history.

While the general population for a long time simply went along with measures to strengthen the eurozone, there is increasingly a sense that a turning point has been reached. Populist parties are increasing their influence in virtually every country in the eurozone. Moreover, the possibility that Greece might leave the eurozone, while currently subdued, has by no means been totally removed. While the basic nature of a deal is clear (Greek structural reforms for the forgiveness of debt principal), the deal has by no means yet been consummated. In this regard, the popular aversion in Germany to writing off more Greek debt is a serious political complication. Potentially even more important is the possibility that the United Kingdom might leave the economic union, should the Brexit forces win the planned referendum. While the United Kingdom is not a member of the eurozone, such a popular rejection of the European Union would raise many questions about the desirability of international agreements involving the loss of national sovereignty.

But why a turning point now in public support? The answer seems to be a series of bad accidents. The global crisis which began in 2007 has raised suspicions of policymakers almost everywhere. A polarization of political views to the left and the right is more a repudiation of the role of "elites" than an ideological splintering. At heart, the process of globalization that the elites have championed is increasingly viewed as harmful to the interests of ordinary people. Within Europe, the migrant crisis has further challenged the competence of policymakers, has raised suspicions about the adequacy of European institutional structures, and is seen as a fundamental threat to the national social fabric in many countries.

It will be difficult to restore popular trust in the competence of the European elites. Moreover, people must be convinced that policy prescriptions concerning the European Union and the eurozone are truly directed to the best interests of the whole community and are not essentially self-serving. While difficult, these tasks are not impossible. The first, most important, and likely most difficult step will be to get the immigration problem quickly under control. A second step would be to take overt actions to reduce the political influence of various industrial lobbying groups, not least the financial sector. A third step would be to review both the tax system and various forms of governance to ensure that they are "fair." Fairness provides the foundation for trust, which in turn is the bedrock of cooperation on which the future of Europe and the eurozone depends.

The eurozone remains highly vulnerable to further shocks.

BIGGEST CHALLENGE

In his recent and latest book on Europe, David Marsh concludes: "We should prepare for neither resounding success nor catastrophic failure, but instead for a further drawn-out phase of standoff, slowdown, and stalemate." In effect, Marsh argues that "fear of the unknown" will be sufficient to stymie all radical political solutions.

In contrast, it is suggested here that the various shortcomings in the eurozone—the analytical, executive, and democratic deficits—are of sufficient importance that they could lead to an endogenous breakdown of the system. This would have profound implications for the economic, social, and political spheres in Europe.

Recognizing the multiplicity of these deficits implies that the eurozone might easily be classified as a complex adaptive system. There are many such systems in both nature and society and the characteristics of these systems have been well researched and are broadly similar across disciplines. Moreover, and fortunately, these characteristics point us in the direction of some potential policy lessons.

The first of these characteristics is that complex adaptive systems break down regularly. The lesson to be drawn is that we should be prepared (*ex ante*) to cope with such eventualities. Accordingly, steps should be taken to ensure that countries can, under certain conditions, leave the eurozone temporarily and then return. Nor should this automatically mean leaving the European Union as is now the case.

In complex adaptive systems, breakdowns are often preceded by growing evidence of systematic malfunctioning. Lesson two is that these malfunctions should be identified and dealt with. Today that implies making serious efforts to deal quickly with the three deficits discussed above. The idea that there is plenty of time, time bought by the ECB, is increasingly a dangerous delusion.

Finally, multidisciplinary studies of systems of this type indicate that the precise timing of a crisis, and the prior identification of the likely trigger, is essentially impossible. Economic and political resources directed to such objectives have essentially been wasted. These resources would be better used in addressing the fundamental shortcomings that contribute to the system's inherent instability. Avoiding a truly bad outcome has become the eurozone's biggest challenge. ◆