

Eurozone governance – squaring the trilemma

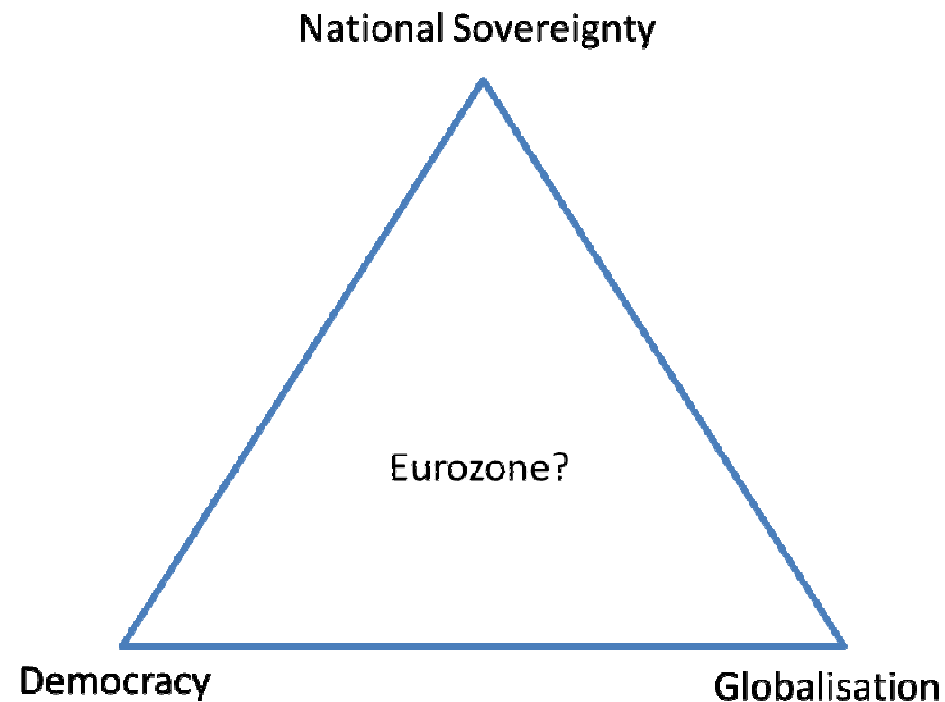
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The problem

- The economics of a monetary union requires:
 - integration, partial risk-sharing
(loss of sovereignty)
 - unpopular policy measures
(loss of democracy)
- The politics of the Eurozone
 - People want democracy and national sovereignty

The trilemma

- Rodrik coined the globalisation trilemma



The trilemma explained

- Why is that a trilemma?
 - Nation states defined by rules and institutions
 - Globalisation = harmonization, coordination
- Still, why a trilemma?
 - (Tom) Friedman: with globalisation “your economy grows, and your politics shrinks”
 - From labour standards to industrial policy

Does the trilemma apply to the EZ?

- Yes...
 - Policy integration, coordination, macro-discipline
- But...
 - Europe does have common institutions and a common democracy
 - Is full integration really necessary?

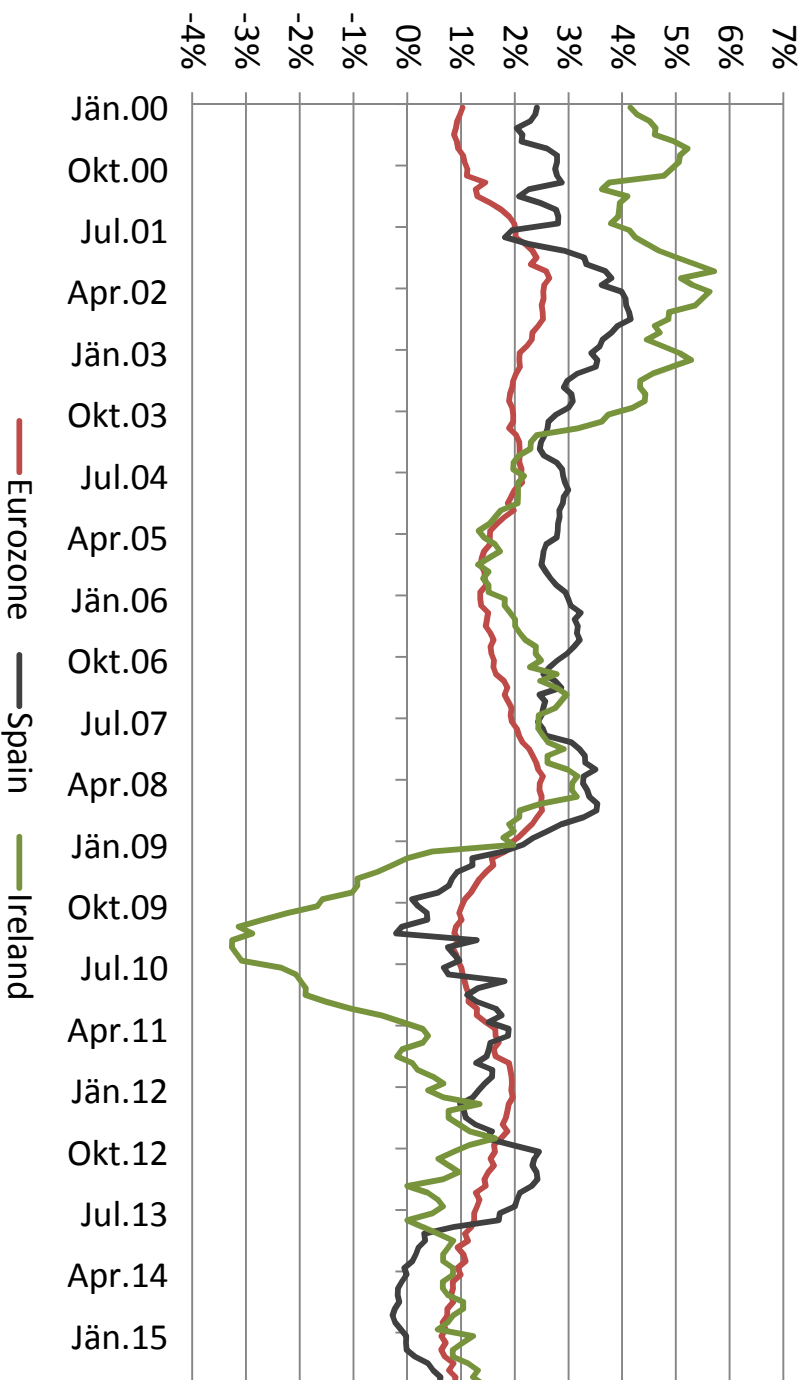
What the Eurozone needs

- Assumption: moving away from national and democratic sovereignty is politically costly
- Which areas need a common eurozone response?
- Political capital is limited!

Economics of a monetary union

- Three stabilisation tools: monetary/currency, fiscal, regulation
 - Giving up monetary autonomy ==> fiscal and regulatory measures more important
 - Very strongly counter-cyclical policies
 - Pre-crisis example: Spain

Core inflation in the Eurozone



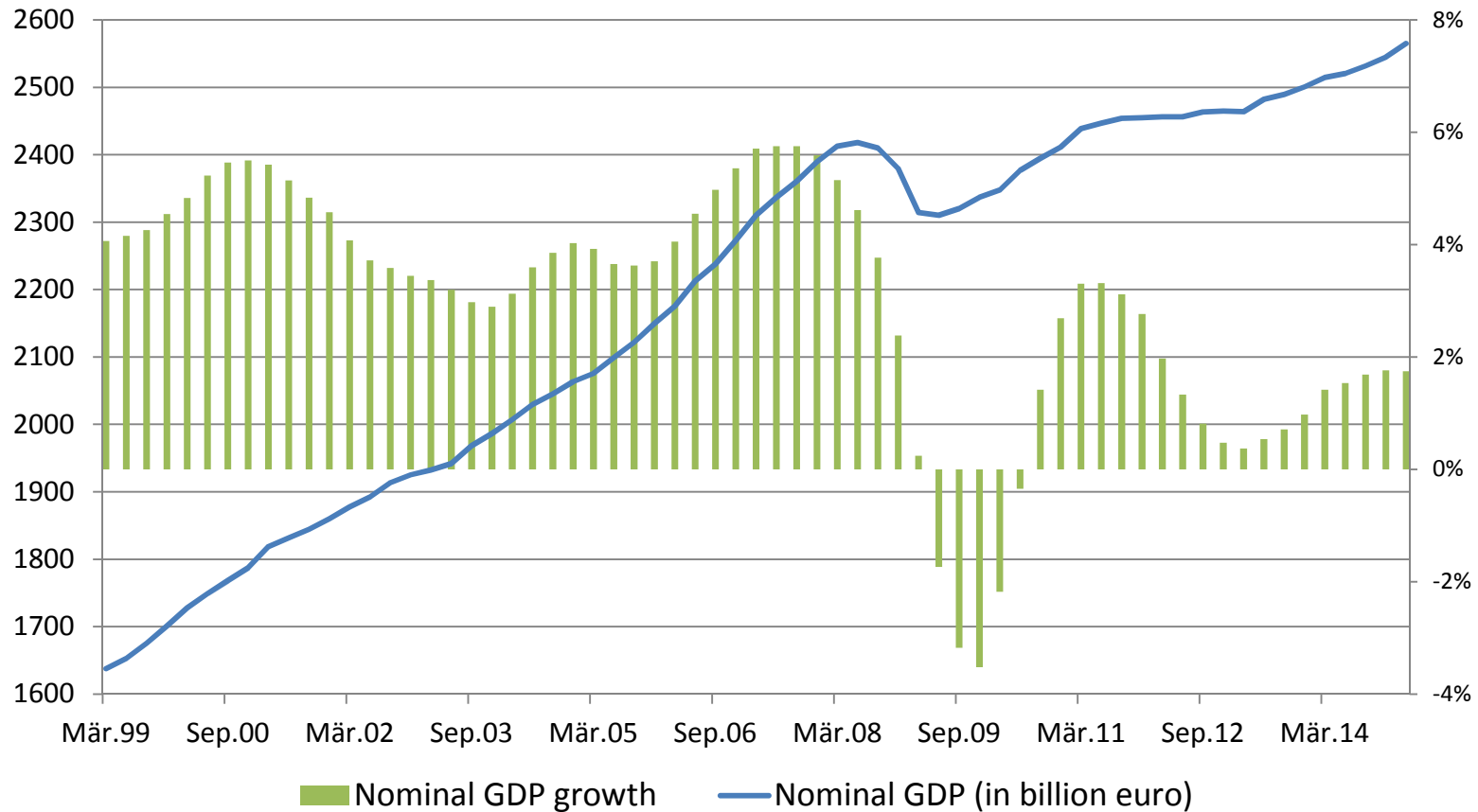
Economics of a monetary union

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 - Pre-crisis example: Spain
 - Counter-cyclical policy and democracy

Economics of a monetary union

- Monetary policy still important
 - Demand shocks amplified across regions
 - Important to keep overall demand on track
 - Monitor financial bubbles / credit to avoid crises
- How has ECB done pre- and post-crisis?

Demand in the Eurozone



Economics of a monetary union

- Labour market flexibility & migration?
 - Ambiguous effects
 - Wage flexibility leads to downward spiral (Germany)
 - Labour market flexibility: can amplify the downside, contribute to demand shortfall
 - Migration helps receiving country and migrants, but country of origin?

Economics of a monetary union

- Financial market integration
 - Capital markets: spreading shocks across countries, private risk-sharing
 - Banks: some risk-sharing, but risk of risk-amplifying
 - Sovereign-bank doom loop
- Government debt
 - Run on government bonds

A feasible Eurozone setup

- Three categories
 - Areas where integration is crucial
 - But better democratic accountability at European level
 - Areas where national policy-making should dominate but democracy can destabilise
 - Areas that should be left to national democracies

Banking and capital markets

- Private risk-sharing is essential
 - Developed cross-border capital markets a key building block
 - Capital markets union should be a priority
- Banks
 - Decoupling from sovereigns should be completed
 - Resolution European responsibility
 - Regulation: diversification, bailinable funds
 - Deposit insurance: implicit already via ELA?

Monetary policy

- Aggregate demand crucial for stability
 - ECB needs to do better
- More vigilance for financial instability
- More aggressive in case of demand shortfall
 - Different mandate to include demand or higher inflation target?
 - More tools: private risky assets? Helicopter drops?

Lender of last resort

- Important for banks
 - ECB has been reluctant, but it's critical for financial stability
 - LOLR should be at ECB level
- Important for governments
 - Huge political resistance
 - Not unconditional
 - Codify it into law?

Dissolve national central banks

- Monetary policy and banking supervision at ECB level
 - No need for national institutions
 - Regulation less politicised (national champions, banks as vehicles of national interests)
 - Monetary policy less politicised, too
- Euro exit threat lower without national central banks

Counter-cyclical policies

- National interest and eurozone interest aligned
 - ... but short-termism of politics
- Chile shows: it is possible
 - Copper-based fiscal rule
 - Almost 30% in budget surpluses 2004-08
- Lesson: strong national institutions

Counter-cyclical policies

- But don't we have fiscal rules?
 - Problem 1: current rules treat counter-cyclical policy as an afterthought
 - Problem 2: optimal setting too complex for rules
 - Problem 3: are rules binding?
(national ownership)

Counter-cyclical policies

- Fiscal policy committees (FPCs): central-bank-like independent authorities
 - Make sure policies are set counter-cyclically
 - Broad set of policies (more later)
 - Ensure debt sustainability
- Macroprudential regulation jointly with ECB
 - Macropru serves double purpose

Counter-cyclical policies

- Broad range of policies can be set counter-cyclically (but aren't):
 - Unemployment insurance (duration and amounts)
 - Tax system
 - Tax credits for investment during recessions
 - Property transaction taxes
 - Pension system (recession bonus for pensioners)
 - Public investment (cyclical transfers to local gov)

Structural policies

- Structural policies at the heart of national democracies
- ...also in common Eurozone interest
 - Does outside actor know better and should enforce?
 - Local knowledge of binding constraints
 - Sequencing of reforms
 - Is national democracy incapable of delivering (vested interests)?

Structural policies

- Democracy-enhancing multilateralism?
 - Example: rankings of countries
 - Example: common justice system standards
- Countries with different structural policies ==> little enthusiasm to help
- Balance of political arguments: let national democracies decide

Conclusion

- Political reality: national democratic sovereignty
- Economic reality: need for integration, coordination, discipline
- Squaring the trilemma: focus on
 - banks and capital markets
 - ECB demand and LOLR policies
 - Strongly counter-cyclical policies