

Fixing the euro's original sins: the monetary – fiscal architecture and monetary policy conduct¹

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Abstract

The euro zone (EZ) was created in January 1999. Its weak economic performance is significantly due to the euro's neoliberal monetary architecture and the design of monetary policy. Those features undermine national political sovereignty and consign the EZ to severe economic under-performance, which in turn fosters political demands for exit from the euro. Escaping this dynamic requires restoring fiscal space to EZ countries, and also changing the design of EZ monetary policy. The paper shows how this can be done. It decomposes the challenge of reform into generic problems related to the neoliberal construction of monetary policy, and specific problems concerning the euro as a currency union. The currency union problems are further decomposed into “money – fiscal policy” architecture problems and specific monetary policy conduct problems.

1. The euro's twin original sins

The euro is afflicted by twin original sins: rupture of the money – fiscal policy link and adoption of neoliberally designed monetary policies. Those twin sins have contributed to generating dismal economic outcomes, which have fostered ugly political conditions that echo the 1930s and risk causing the euro to disintegrate.

This paper shows the euro's twin original sins can be fixed in a politically viable manner. As regards economics, the euro is a monetary phenomenon, which means that getting the monetary architecture right is the *sine qua non* for success. Other economic policy adjustments can then further strengthen the euro zone's (EZ's) economic performance, but without the right monetary architecture economic success will inevitably prove elusive.

As regards politics, the fundamental problem is the EZ consists of national political sovereigns that have been required to surrender monetary sovereignty. However, those national political sovereigns need a degree of monetary sovereignty in order to defend their public finances and pursue expansionary fiscal policy in times of economic distress. The EZ's architecture makes little provision for this, because of a combination of fears of moral hazard from country bail-outs and intellectual blindness. Fixing the EZ's monetary architecture and restoring a degree of monetary sovereignty is essential for creating the policy space needed by national governments to make the euro politically viable.

2. Diagnosing the EZ's problems

The euro was introduced in January 1999. As shown in Table 1, its macroeconomic performance was barely satisfactory prior to the financial crisis of 2008, but it has been dismal since. Since peaking in the 1960s, EZ average GDP growth each decade fell steadily through

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the 1990s. The introduction of the euro saw a brief uptick, but growth has collapsed since the 2008 financial crisis. That story is mirrored in the unemployment rate which steadily increased through to the 1990s, then fell slightly with the euro's advent, but surged to sustained record highs after the financial crisis.

Table 1 EZ output growth and unemployment rate

| | Region | 1961-70 | 1971-80 | 1981-90 | 1991-98 | 1999-2008 | 2009-2015 |
|---|--------|---------|---------|---------|---------|-----------|-----------|
| Average GDP growth rate at 2010 market prices (%) | EZ-12 | 5.3 | 3.4 | 2.4 | 1.9 | 2.1 | 0.1 |
| | EZ-19 | | | | | 2.1 | 0.1 |
| Average unemployment rate (%) | EZ-12 | 2.3 | 4.0 | 8.5 | 10.0 | 8.5 | 10.8 |
| | EZ-19 | | | | | 8.7 | 10.8 |

Source: Statistical Annex of the European Economy, Spring 2016 (Tables 3 and 10) plus author's calculations

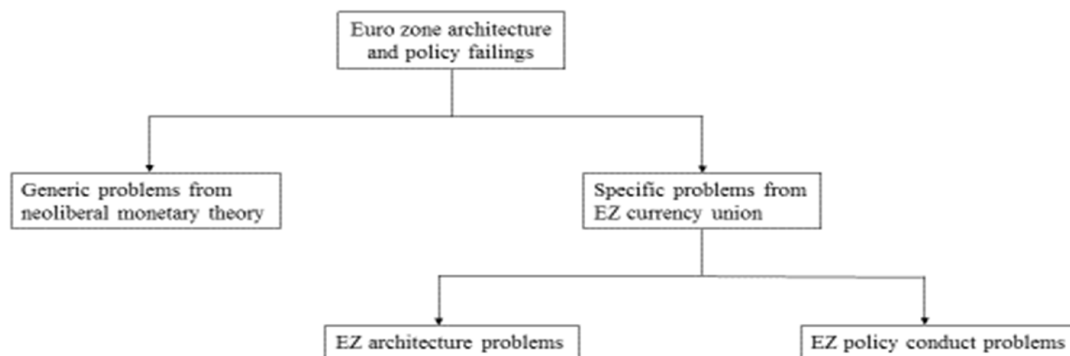
Behind this data is a dismal economic policy history. That history begins with the adoption of tough anti-inflation policy in the late 1970s, which turned into neoliberalism in the early 1980s. Consequently, Europe never fully recovered from the dislocations of the 1970s. The neoliberal turn was further locked in place in the 1990s with the first steps to monetary union via the Maastricht Treaty and its imposition of strict euro zone economic convergence criteria, requiring a deflationary policy posture to meet them. Come the euro, there was a brief boom in the 2000s fueled by the intersection of low interest rates and speculation. However, when the bust arrived with the 2008 crisis, the design flaws in the euro's monetary architecture and policy conduct surfaced with a vengeance. Those flaws are systemic and remain largely unresolved. Consequently, they now pose an existential threat to the euro.

The weakness of the EZ's economic performance is significantly rooted in its monetary architecture and monetary policy conduct. As regards architecture, the design of the euro's monetary policy institutions has massively shrunk the space for national fiscal policy and also exposed government finances to market instability. Under the old system of national currencies, each country government had a central bank that acted as the "government banker". Thus, national central banks helped governments finance their budget deficit, and also defended government bonds against speculative attack. This government banker function was completely and mistakenly ignored by the euro's creators, thereby weakening governments' ability to finance fiscal policy and giving financial markets massive power over them (Palley, 2011a, 2011b).

Simultaneously, EZ monetary policy conduct has been sub-optimal. It was blind to asset price bubbles before the crisis; was slow to respond in the crisis; and the two percent inflation target risks being an unnecessary brake on performance if the EZ escapes the current stagnation.

Figure 1 outlines the nature of the problem. It decomposes the challenge of EZ monetary reform into generic problems related to the neoliberal construction of monetary policy, and specific problems concerning the euro as a currency union. The currency union problems are then further decomposed into architecture problems and conduct of policy problems.

Figure 1 A diagnosis of the failings afflicting the EZ's monetary architecture and policy



3. New Classical economics and the origins of the euro zone's monetary architecture and policy failings.

To understand the EZ's failings and the case for reform, it is necessary to begin with new classical economics which inspired and underlies the EZ's architecture and policy conduct. New classical macroeconomics (i.e. Chicago School macroeconomics) has under-pinned neoliberal economic policy, and it asserts:²

- A) Money and inflation are neutral and have no effect on the real economy;
- B) Inflation is caused exclusively by money supply growth;
- C) The real economy automatically and quickly returns to full employment in response to negative shocks via price and nominal wage adjustment;
- D) Financial markets are efficient and stable and determine a natural interest rate that delivers full employment;
- E) Fiscal policy is ineffective.

Given the above theoretical framework, optimal policy involves having an independent central bank implement a credible transparent interest rate rule aimed at targeting stable low inflation. According to the policy rule, the equilibrium short-term interest rate should equal the inflation target plus the estimated natural real rate of interest. Furthermore, inflation targeting, implemented via the interest rate rule, is all that is needed to secure full employment because the economy goes there automatically and quickly.

This view of economic theory and optimal policy was hegemonic in the 1990s when the euro was designed and implemented, and it remains hegemonic today – albeit with less self-confidence. Its hegemonic standing meant that Social Democrats (like Jacques Delors and Wim Duisenberg) also accepted it. Consequently, it provided the theoretical template for designing the euro zone's architecture and policy conduct.

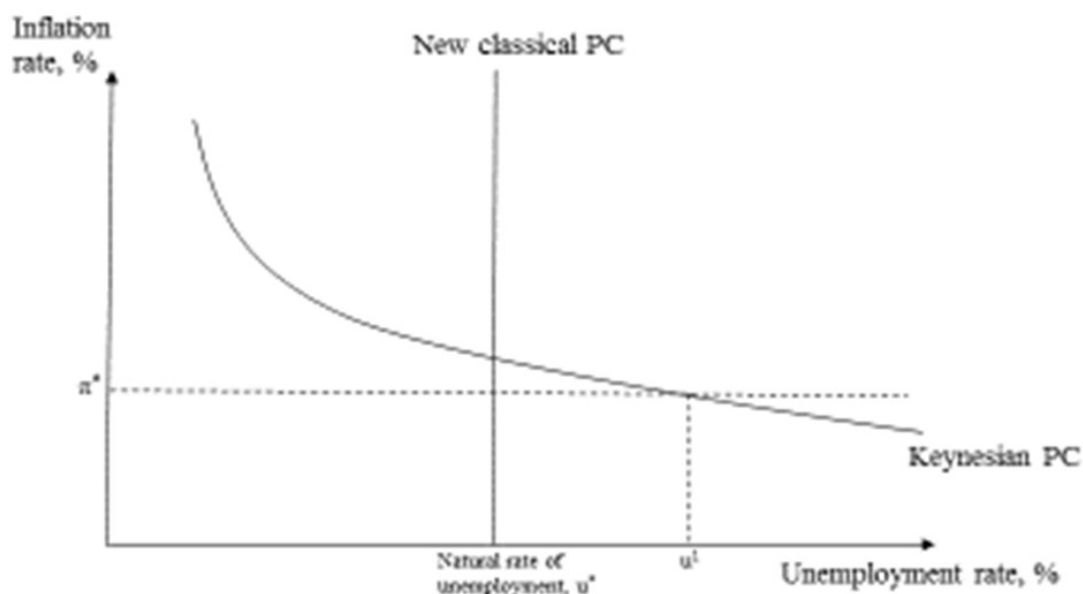
² Though somewhat more caveated today, new classical macroeconomics remains mainstream economists' dominant theoretical frame, which explains their incapacity to understand the problems of the EZ and resistance to reform. New classical macroeconomics' standing in relation to mainstream macroeconomics parallels the standing of neoclassical competitive general equilibrium theory to mainstream microeconomics.

3.a) Generic problems of new classical monetary policy

The new classical construction of monetary policy and central banking produces three grave generic problems that have afflicted monetary policy in both Europe and elsewhere. The first problem concerns mistakenly low inflation targeting. The problem stems from Milton Friedman's (1968) natural rate of unemployment hypothesis which claims money and inflation have no permanent real effects. Consequently, there is no trade-off between inflation and unemployment so that the long-run Phillips curve is vertical. This contrasts with the Keynesian view that a trade-off exists and the Phillips curve is negatively sloped because modest inflation helps grease the wheels of labor market adjustment (Tobin, 1972; Palley, 1994, 2012).

Figure 2 shows the new classical and Keynesian Phillips curves. Neoliberal macroeconomics recommends an ultra-low inflation target (π^*). The argument is that inflation is undesirable and confers no unemployment gain because the economy always gravitates to the natural rate of unemployment (u^*). From a Keynesian perspective, that will cause significant unnecessary unemployment as inflation of π^* implies a higher unemployment rate ($u^1 > u^*$) according to the Keynesian Phillips curve.

Figure 2 New classical (neoliberal) vs. Keynesian Phillips curves



A second generic problem concerns central bank support for the so-called “labor market flexibility agenda” which aims to diminish workers’ rights, protections and bargaining power. Natural rate theory argues the natural rate of unemployment is determined by frictions and rigidities within the labor market. Those frictions and rigidities are argued to include trade unions, minimum wages, unemployment insurance, and worker rights and protections. Since central banks believe in natural rate theory, that explains why they have persistently and vigorously lined up in support of the “labor market flexibility agenda” which has contributed to wage stagnation and increased income inequality.

The third generic problem of neoliberal economics is its belief that “flexible” labor markets and interest rate policy, targeted on low stable inflation, are all that is needed to secure full

employment. This belief stems from the assumptions of new classical economics about the economy's adjustment capacities and the character of financial markets. The important implication is it predisposes central banks against the need for financial market regulation or the need to intervene in asset markets to address asset price bubbles (Palley, 2003, 2006a). It also explains the retreat from and resistance to quantitative monetary policy (e.g. regulation of the asset side of banks' balance sheets), which was an important component of policy in the "golden age" three decades after World War II.

3.b) EZ monetary architecture problems: the rupture of the money – fiscal policy link

The major monetary architectural problem of the EZ concerns its divorce of the monetary authority from national fiscal authorities (Goodhart, 1998). From a new classical perspective, this divorce is inconsequential because fiscal policy is ineffective and increases in the money supply only cause inflation. Consequently, there is no need for money-financed fiscal policy and a hard divorce of the monetary and fiscal authorities is desirable.

According to new classical economics, if governments want to run budget deficits they should compete for finance with the private sector in financial markets. That is the efficient way to allocate capital. Additionally, in the context of a currency union, divorce of the monetary and fiscal authority is needed to prevent fiscal moral hazard. If member countries know the central bank will step in and finance their deficits, that would provide an incentive for countries to run larger and larger deficits.

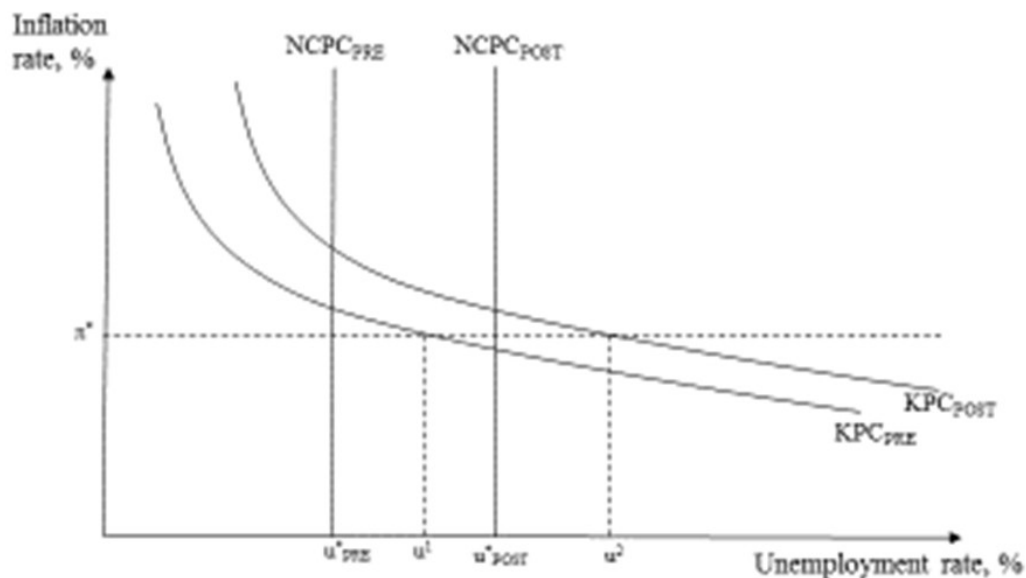
The divorce of the monetary authority (i.e. the central bank) from the fiscal authority (i.e. the national state) is predicated on the assumptions that fiscal policy is ineffective, money financed deficits only cause inflation, and financial markets are stable and efficient. Once those assumptions are rejected, the new classical monetary architecture becomes dangerously dysfunctional.

The loss of national central banks and the divorce between monetary policy and fiscal policy leave national governments dependent on financial markets for their budget deficit financing needs. Consequently, governments may be unable to finance needed expansionary fiscal policy (Goodhart, 1998). Additionally, financial markets will have the power to veto fiscal policy via bond market sell-offs, and governments will also lack the means (i.e. a central bank under their control) to intervene and stabilize national financial markets in the event of financial panic (Palley, 1997). That is exactly what has happened in the EZ after the financial crisis of 2008.

3.c) EZ monetary policy conduct problems: too low an inflation target

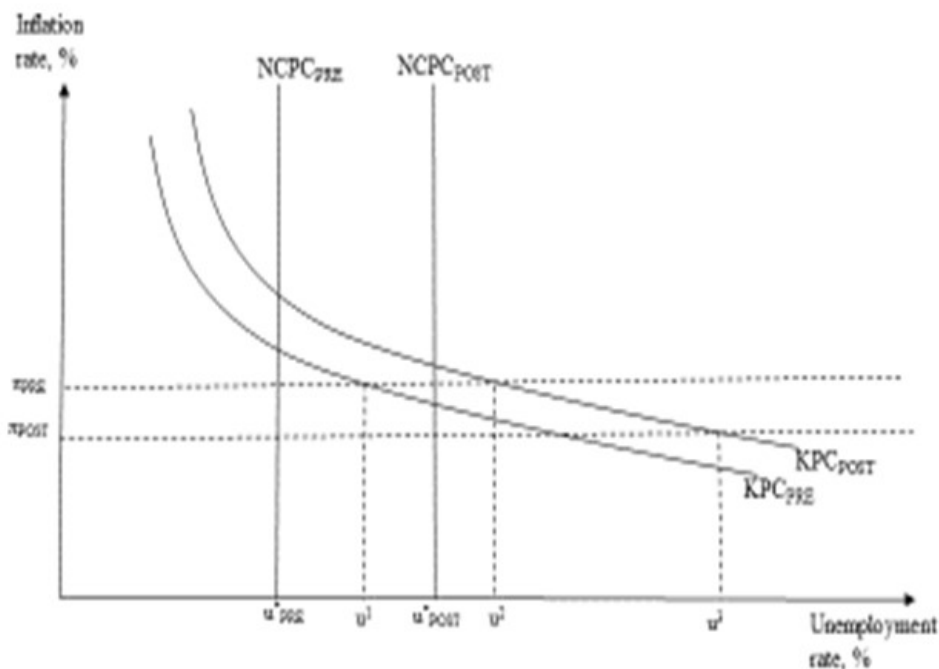
As regards the conduct of EZ monetary policy, the generic policy problem of excessively low inflation targeting is amplified in a currency union (Palley, 1997, 2006b). This is illustrated in Figure 3. For new classical economists, a non-optimal currency union may increase the natural rate of unemployment for the currency union as a whole ($u^*_{PRE} < u^*_{POST}$). However, from their perspective, there is no cost in sticking with the pre-existing inflation target since monetary policy cannot affect the new natural rate of unemployment. In sharp contrast, a Keynesian perspective counsels differently. The Phillips curve shifts right from KPC_{PRE} to KPC_{POST} , so that preventing further increased unemployment requires the currency union to adopt a higher inflation target. If the target is unchanged and held at π^* after monetary union, the unemployment rate will rise to $u^2 > u^1$.

Figure 3 The effect of currency union on the Phillips curve



Additionally, the higher unemployment caused by the EZ's low inflation targeting problem has been further compounded by the fact that Germany's Bundesbank monetary policy was adopted as the template for the euro. The Bundesbank has long been dominated by monetarist thinking that is staunchly opposed to inflation. Its monetarist approach was imported into the ECB in the form of an inflation target mandating less than 2 percent inflation. In effect, the creation of the euro was used to lower the EZ's overall inflation target ($\pi_{POST} < \pi_{PRE}$) as shown in Figure 4. That caused an even larger increase in EZ unemployment to $u^3 > u^2$.

Figure 4 The effect of adopting the Bundesbank's ultra-low inflation target



In sum, from a Keynesian perspective, not only did monetary policy fail to raise the inflation target to combat higher unemployment caused by monetary union creating a more diverse economy with more dispersed economic outcomes, it lowered the inflation target for many member countries which had higher targets prior to the euro. That made for a double failure in the conduct of monetary policy.

4. The crisis and the failure of neoliberal economics

The financial crisis of 2008, the Great Recession, and the ensuing stagnation should have entirely discredited neoliberal economics. These events have shown financial markets can be unstable and can greatly misprice assets; economies do not automatically and quickly rebound to full employment; fiscal policy can be highly effective; and inflation is not exclusively and automatically generated by money supply growth. That speaks to remaking the EZ's monetary architecture and redesigning the conduct of monetary policy as events have shown the current architecture and policy design are founded on flawed theory.

5. Remedying the EZ's monetary architecture and monetary policy

5.a) Repairing the money – fiscal policy link via a financing union

The euro's divorce of the monetary and fiscal authorities has created grave problems for governments' ability to finance fiscal policy and defend against financial market speculators. The conventional wisdom is the EZ needs "fiscal union" to overcome these architectural failings, but EZ countries do not politically want that. Instead, I (Palley, 2011a; 2011b; 2016) have argued for a "financing union" that involves collective issuance of debt, the proceeds of which are distributed among members on a per capita basis.

A financing union would require establishment of a European Finance Authority (EFA) governed by the finance ministers of euro zone countries. The Finance Authority would issue bonds jointly and severally backed by all member countries, which the ECB could buy.

The Authority would engage in no spending, and would simply pay issue proceeds to member countries on a per capita basis, with countries liable for debt service on the same per capita basis. Each year the EFA would determine the appropriate budget deficit for the euro zone, issue bonds, and distribute the proceeds to member countries to use as they deemed fit.

Those countries wanting fiscal stimulus could spend the proceeds: others could use them to buy EFA bonds, thereby covering their obligation and leaving their net debt position unchanged.

Countries could also issue their own national bonds to finance additional stimulus over and above that financed by EFA, and these national bonds would constitute a form of junior national debt.

Lastly, an accompanying bankruptcy mechanism would be established. Country national debt would be subject to a junior bankruptcy mechanism similar to the Chapter 9 provision in US law for states and municipalities. EFA debt would be subject to a senior sovereign bail-out mechanism that could permit conditionality arrangements.

The financing union proposal has many significant advantages, but three stand out. First, it permanently remedies the euro's original sin, creating both a permanent policy mechanism for deficit financing and a bond that can be bought without qualification by the ECB. Second, it avoids the great political pitfall of fiscal unions regarding usurping control of the purse from the state or imposing transfers between countries. Countries choose how they spend EFA proceeds. Third, it reconnects money and the state without creating fiscal moral hazard as countries are not bailed out by the EFA or ECB.

5.b) Conduct of monetary policy: a higher inflation target

With regard to conduct of monetary policy, the first change should be a higher inflation target in the region of 3 – 5 percent. Some mainstream economists (Blanchard et al., 2010) are also moving in this direction. Their argument is that a higher equilibrium inflation rate is needed to raise nominal interest rates, thereby providing space for the central bank to lower interest rates if the economy gets in trouble.

Such support is welcome, even if the reasoning is stuck in failed monetary theory. However, it would be far better if the Keynesian Phillips curve rationale were adopted as that would also bury the natural rate of unemployment hypothesis. As long as central banks hold to that hypothesis, there will be a perennial risk that central banks are drawn back into actively supporting the mistaken and damaging labor market “flexibility” agenda.

5.c) Conduct of monetary policy: target the bond rate on newly issued EFM bonds.

A financing union would create a steady growing supply of EFA bonds, and the ECB could then target the long bond rate as well as set the short-term interest rate. Neoliberal monetary theory recommends targeting just the short-term interest rate. The assumption is the combination of efficient financial markets plus a credible transparent interest rate rule ensures long term interest rates reflect expectations of future short-term interest rates markets. Consequently, there is no need to target the long rate.

Such indirect management is unreliable and imprecise as it rests on markets having correct expectations and understandings of future policy. The behavior of financial markets should have punctured that belief long ago. In future, rather than relying on market expectations to determine long rates, the ECB should directly target long rates using EFA bonds as the benchmark (Palley, 2013).

5.d) Asset based reserve requirements (ABRR)

Interest rate targeting should be supplemented by a system of ABRR which would extend margin requirements to a wide array of assets held by financial institutions (Palley, 2000; 2003; 2004; 2006b; 2010). ABRR require financial firms to hold reserves against different classes of assets, with the regulatory authority setting adjustable reserve requirements on the basis of its concerns with each asset class. One concern may be that an asset class is too risky; another may be that an asset class is expanding too fast and producing inflated asset prices.

A system of ABRR that covers all financial firms has multiple policy benefits. Most importantly, it enables central banks to target sector imbalances without recourse to the blunderbuss of interest rate increases. For example, if a monetary authority was concerned about a house

price bubble generating excessive risk exposure, it could impose reserve requirements on new mortgages. This would force mortgage lenders to hold some cash to support their new loans, raising the cost of such loans and cooling the market.

For the EZ, ABRR are additionally attractive because they can help address the policy instrument gap at the national level created by the euro's introduction (Palley, 2006b). That can be done by implementing ABRR on a geographic basis. For instance, requirements on new mortgage loans can vary by country, or even by region within countries.

5.e) Banking union

Just as the design of the EZ neglected fiscal policy and the need for a government banker, so too it neglected the problem of cross-country bank runs (as has happened with money fleeing from the EZ periphery crisis countries to Germany).

The ECB's TARGET2 balance system has plugged the hole by making liquidity available to banks losing deposits. However, it is an inefficient system that recycles liquidity *ex-post* rather than preventing its flight *ex-ante*. It also creates banking regulatory moral hazard across countries, since countries know their banks have access to emergency liquidity from the ECB. That speaks to the need for full banking union with deposit insurance and common regulatory standards and capital requirements for bank asset and liability structures.

6. Radical reform of central bank thinking: bring back pluralism and Keynesianism.

Lastly, there is need for profound radical reform of ECB thinking and practice. Over the last three decades, central banks have been arrogant and closed minded, ignoring all economists outside central banks' narrow sociological circle, and dismissing all who disagreed with their belief that low inflation targeting was sufficient. Events have proved central bank economists wrong and shown the assumptions of neoliberal monetary theory to be disastrously flawed.

At the euro's outset, the focus of mainstream economics was the EZ's properties as an optimal currency area (OCA), and mainstream discussion was conducted exclusively through that lens. The principal concern was the euro was not an OCA (see for instance Bayoumi and Eichengreen, 1992; 1994) The fear was individual countries within the EZ would suffer macroeconomic losses from giving up their own currency and surrendering the exchange rate and interest rate as tools of country economic policy. Those losses from not having one's own currency would outweigh trade and capital flow gains. Feldstein (1997) argued those costs of not being an OCA would cause the euro to ultimately fail in a few decades, possibly even generating military conflict within the EZ.

These mainstream concerns were generic and not policy helpful. They contrast with the concerns of Keynesians (Godley, 1992; Palley, 1997; Goodhart, 1998) who, not only identified the OCA aspects, but also correctly identified and emphasized specific flaws in the euro's neoliberal monetary architecture and monetary policy design.

Godley (1992) argued the euro had a blind spot regarding need for a European federal institution to undertake counter-cyclical fiscal policy:

“The incredible lacuna in the Maastricht programme is that, while it contains the blueprint for the establishment and modus operandi of an independent central bank, there is no blueprint whatever of the analogue, in community terms, of a central government” (Godley, 1992, p.3).

Goodhart (1998) emphasized the importance of the link between the fiscal authority (i.e. the state) and the monetary authority (i.e. the central bank), and identified the dangers for financing fiscal policy of divorcing the monetary and fiscal authorities.³

“In particular, the participating nation states will continue to have the main fiscal responsibilities; but in the monetary field, their status will have changed to a *subsidiary* level, in the sense that they can no longer, at a pinch, call upon the monetary authority to create money to finance their domestic national debt. There is to be an unprecedented divorce between the main monetary and fiscal authorities” (Goodhart, 1998, p.410).

Palley (1997, 2006a) identified the importance of the central bank’s policy preferences and the interaction of those preferences with economic understandings of the Phillips curve. Making the euro successful required a higher inflation target. It also required introduction of quantitative monetary policy and ABRR to supplement interest rate inflation targeting policy, thereby giving member countries additional policy instruments to replace those lost owing to currency union.

Additionally, Palley (1997) argued the divorce of the monetary and fiscal authorities would give bond markets the power to discipline governments who pursue economic policies that financial markets dislike. That is because governments would no longer have a central bank to buy their bonds and protect against capital flight:

“Thus, if financial capital dislikes the stance of national fiscal policy, there could be a sell-off of government bonds and a shift into bonds of other countries. This would drive up the cost of government borrowing, putting a break on fiscal policy” (Palley, 1997, p.156).

This feature is cruelly ironic as part of the intention of the European monetary union was to protect against capital market flight, such as had undermined the policies of France’s President Mitterrand in the early 1980s.

In sum, the record clearly shows Keynesians had a far superior understanding of the monetary macroeconomics of currency unions and anticipated many of the operational problems of the euro. That suggests it is time to heed the Keynesians by reforming the EZ along the lines they have advocated.

More broadly, the superior analytical insights of Keynesians regarding monetary union provides another case study of mainstream economics failure, and adds to the record of failure which has been accumulating for three decades. Given that record, it is also time to

³ Goodhart is perhaps the only establishment economist to have anticipated specific structural problems of the euro, as against generic concerns regarding the euro being a non-optimal currency area. That said Goodhart is a distinguished “grey beard” who was admitted to the circle of central bankers before the ideological boom came down in the 1980s and put an end to pluralism in economic thought.

break the new classical monopoly on monetary theory and monetary policy, and to open central banking to a wider range of perspectives.

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