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Europe's Tragic Political Economy

ERIK JONES

The World Bank issued a report in January warning that the European economy is slipping toward "secular stagnation," a prolonged period of very low inflation and very low growth. Should it come to pass, this development will have a profound impact on all aspects of the region. It will lower opportunities for each successive generation while at the same time increasing pressure on European governments to curtail the welfare state. It will make it easy for populist political movements (and political entrepreneurs) to rally opposition to traditional political parties, governing elites, and national constitutional arrangements. It will heighten antagonism between Europe's "indigenous" peoples and its more recent immigrants. It will sap support from European integration as a political project. And it will constrain Europe's ability to play a more prominent and constructive role in the world, either as a collection of individual nations or, where they can find agreement, as a common voice or entity.

Fortunately, Europe's political leaders are aware of the threat—both narrowly, in terms of economic performance, and more broadly, in terms of the many negative implications of secular stagnation. They can see the fragility of Europe's recovery from the recent economic and financial crisis; they know about the weakness of business and consumer confidence; and they face a wide array of new or newly invigorated political challengers on the right (parties such as the Alternative for Germany, the French National Front, the Italian Northern League, and the UK Independence Party), on the left (Syriza in Greece, Podemos in Spain), and in the center (the Italian Five Star Movement). Europe's leaders disagree on how likely secular stagnation is—whether a near certainty or still only a "tail risk" of unknown probability or consequence—and they also disagree on how much time is available to take remedial action. Nevertheless, they are united in acknowledging that the threat of secular stagnation is real and that it should be avoided.

The tragedy is that Europe's political leaders seem unable to escape a fate that none of them desires. The explanation is political more than economic. Although it is easy to find fault in many of Europe's market institutions, the deeper problem is that European policy makers emphasize consensus over solidarity, pay more attention to principle than to interdependence, and weaken common institutions at the European level even as they overemphasize these institutions' influence in domestic politics. This combination of tendencies not only prevents Europe's heads of state and government from acting decisively, but it also ensures that the problems they face will become more intractable.

CONSENSUS VS. SOLIDARITY

Europeans emphasize consensus over solidarity in general terms, but the most relevant manifestation of this tendency is in the conduct of monetary policy by the European Central Bank (ECB). This is clear both in the design of the institution and the drafting of its policy mandate, and in the making of monetary policy decisions, including the January 2015 announcement of large-scale asset purchases, or quantitative easing (QE).

The ECB is the world's most politically independent central bank. It is also the central bank whose statutes are the world's hardest to change. And it

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operates according to a very narrowly drawn price-stability mandate, which it alone is empowered to interpret. These characteristics are all consequences of European decision making by consensus. They reflect a broad acceptance by the signatories of the 1992 Maastricht Treaty that political discretion and monetary policy should not mix, that monetary authorities should promote price stability, and that the achievement of price stability is the main contribution that monetary authorities can offer to the macroeconomic policy mix.

Indeed, successive ECB presidents have reiterated that point about the primacy of price stability time and again in response to questions about whether the bank could do more to promote macroeconomic performance in terms of other variables like growth and employment. The only way to change this situation would be to amend the European treaties. From time to time, as during the early days of the European constitutional convention, voices argue in favor of such amendments. But the proposals never find traction. Treaty amendments would require consensus among Europe's heads of state and government, but the only consensus has been to avoid opening up the ECB statutes for renegotiation.

This design by consensus works against solidarity because it means that countries have to adapt themselves to the ECB no matter how challenging that may be. By contrast, the ECB finds it harder to adapt to changing circumstances. This does not mean that the ECB is wholly inflexible. It means only that any flexibility is circumscribed by the ECB's mandate. Consider the definition of "price stability." The ECB has the unique power to decide what that means. When it started in 1999, the ECB announced that price stability would be defined as an expected rate of annual inflation over the medium term of less than 2 percent. Many economists complained that such a definition had no lower bound; prices could be "stable" even when falling. The ECB initially rejected these arguments, but it came around to a more symmetrical definition of its policy target after Germany experienced a short bout of deflation in the summer of 2002. Since May 2003, the ECB has defined price stability as below "but close to" 2 percent. That change is important in the current context.

Whatever it takes

Another important change is the commitment of the ECB to support governments in distress that ask for its assistance (and accept some form of binding European supervision over their macroeconomic policy making) by promising to purchase "unlimited" amounts of the country's sovereign debt with a short residual maturity. This is the commitment ECB President Mario Draghi made when he promised on July 26, 2012, to do "whatever it takes" to safeguard the euro as a single currency. When he made that commitment, he prefaced his pledge with the words "within our mandate" and he couched the whole policy in terms of restoring "the monetary transmission mechanism," which is the means by which any change in monetary policy by the ECB in Frankfurt translates into changes in the pace and intensity of economic activity elsewhere in the euro area.

A number of plaintiffs in Germany—supported by the German Bundesbank—took exception to Draghi's interpretation of the European treaties and filed a complaint with the German Constitutional Court charging that the ECB exceeded its authority. In turn, the German court referred the interpretation of the treaties up to the European Court of Justice (ECJ) for an authoritative interpretation. That decision is still pending, although the ECJ's advocate general issued an opinion on January 14, 2015, that is supportive of the ECB.

A third change is how the ECB deals with banks in distress. The issue here concerns liquidity provision and not banking supervision. When banks get into trouble, they usually have to rely on the central bank as a lender of last resort. For banks in the euro area, this means they turn to their national central banks for "emergency liquidity assistance"—loans made by the central banks to the banks in trouble against assets that the ECB normally would not accept as collateral. Such emergency liquidity assistance poses three problems for the ECB. First, it props up a bank that should probably be put into resolution (or receivership). Second, it brings low-quality assets (and therefore higher risk) onto the balance sheet of the central bank. Third, it creates liquidity (or money) outside the usual context of monetary policy making.

For all these reasons, national central banks have to ask permission from the Governing Council of the ECB to provide emergency liquidity assistance. And the question that inevitably arises is what would happen if the ECB were to prevent a national central bank from supporting a commercial bank in distress. This happened in Cyprus in March 2013, and the result was a major political crisis. The ECB explained that it was acting "within its mandate." In January 2015, the

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ECB announced that the access of Greek banks to liquidity is conditional on the Greek government's compliance with the terms of its bailout program. Again, this is "within its mandate."

This is where the decision making of the ECB becomes important. Typically the Governing Council—like most European institutions—acts on the basis of consensus. Time and again, when successive ECB presidents have announced major monetary policy changes (or non-changes) at their monthly press conferences, journalists have asked whether a vote was taken and who came down on which side of the issue. Usually the response is that no vote was necessary because the decision was made by consensus. As the ECB has strayed into more unconventional monetary policies, however, the divisions within the Governing Council have become more apparent and the dissenters more outspoken. In May 2010, then–Bundesbank President Axel Weber came out loudly against the ECB's first outright purchases of sovereign debt instruments via the "securities markets program"; in August 2011, ECB Executive Board member Jürgen Stark followed Weber's example and announced his resignation from the board while the markets were still open, in what many regarded as an act of protest. This was all while Jean-Claude Trichet was still ECB president.

Europe's fate is tragic only so long as Europeans accept the belief that stagnation cannot be avoided.

ENOUGH EASING?

Once Draghi took office in November 2011, the ECB became even more innovative. The "whatever it takes" speech was only the most dramatic event in a series of major changes. During his September 6, 2012, press conference, Draghi was asked whether there was any opposition to the introduction of "outright monetary transactions." In a break with tradition, Draghi admitted that there was one voice of dissent. He left it to the assembled journalists to identify that dissenter as Weber's replacement as Bundesbank president, Jens Weidmann. This isolation of the Bundesbank was only possible because German Chancellor Angela Merkel threw her support behind Draghi, as did the German member of the ECB Executive Board, Jörg Asmussen.

Since then, Asmussen has been replaced by Sabine Lautenschläger, who is closer to Weidmann (and the mainstream of the Bundesbank). Merkel has maintained her support for Draghi, but his ability to isolate or ignore Bundesbank opposition has diminished. The challenge for Draghi, therefore, is to make concessions in the design and use of new policy instruments in order to build consensus among different groups in the Governing Council. This is apparent in the debates that surrounded the many unconventional measures that the Governing Council introduced in 2014—including negative deposit rates, targeted long-term refinancing operations, and outright purchases of asset-backed securities and covered bonds. However, it is even more apparent in the debate over quantitative easing—the large-scale purchase of sovereign debt by the ECB.

The quantitative easing debate brings us back to the threat of secular stagnation. Most economists agree that a big bond-purchasing program is the best instrument that the ECB has in its arsenal to inject some kind of macroeconomic stimulus. That does not mean most economists agree that it will work—just that it is better than the alternatives. To work, however, the program needs to be big and it needs to inject liquidity into all parts of the euro area economy—meaning countries that have had the worst of the crisis, like Greece, Spain, and Italy—and not just those countries such as Germany that are already flush with credit.

As part of his efforts to win over reluctant Governing Council members like Weidmann, however, Draghi has had to scale down his ambitions for European quantitative easing. Still, he was able to announce a program that was larger than most market participants expected. Starting in March 2015, the ECB will purchase roughly 60 billion euros per month worth of assets in a range of instruments including asset-backed securities, covered bonds, and sovereign debt obligations. These purchases will continue at least until September 2016 or until expected price inflation in the euro area begins to converge at a satisfactory rate on the ECB's target of less than but close to 2 percent per year.

This 1.1 trillion euro program was a victory for Draghi within the ECB. But the QE program includes measures to avoid sharing the risks associated with the assets that are purchased across countries, which means that each national central

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bank will be responsible for any losses incurred on its own country's sovereign debt. The implication is that the policy will have less macroeconomic impact than it could have if the risks of asset purchases were shared across countries, and its effects will be more significant in countries that are not suffering as much from the crisis than in those that are most in distress. In other words, once again solidarity will give way to the requirements for consensus.

It is far from clear that such concessions in the design of the policy will soften German opposition. Weidmann explained his position in a widely reported interview in December 2014. His argument is that a very large-scale bond-purchasing program might work, but it would have many potential downsides and would fall outside the ECB's mandate. A smaller and more carefully targeted bond-purchasing program—possibly even as large as the one Draghi announced—could fit within the ECB's mandate but it would be unlikely to have any macroeconomic effect. Although Draghi claimed that his QE program had a substantial majority behind it on the ECB's Governing Council, Weidmann did not offer his support. Lautenschläger used her first press interview of 2015 to announce her own skepticism about any bond-purchasing program. Instead, she argued that the Governing Council should wait and see whether the measures adopted in 2014 would be sufficient. She retained that view at the Governing Council meeting where the QE program was decided. Once again, the Bundesbank was in opposition; this time, much of the rest of Germany was with it.

Too often the ECB has been left as the only institution capable of responding to the crisis.

PRINCIPLE VS. INTERDEPENDENCE

The argument over consensus and solidarity dominates the monetary side of the EU macroeconomic policy dilemma. To understand the fiscal side, it is more useful to focus on the tension between principle and the logic of interdependence. Europeans have long recognized that the close connections between their economies make it impossible for them to ignore the impact of policy changes in one country on economic conditions in all the rest. Since 1991, the various iterations of the European treaties have included a requirement that all member states—whether or not they participate in the single currency—regard their macroeconomic policy as a matter of common interest. So the question is not so much whether it makes sense for Europeans to conduct macroeconomic policy as a matter of consensus; it is whether the macroeconomic policy they adopt makes any sense in the context of interdependence that all European heads of state and government have acknowledged repeatedly.

This is where the principles of sound finances, balanced budgeting, and other forms of economic virtue that dominate European policy making become important. These are simple rules of thumb like "redistribution should be avoided," "debt is bad," "current account surpluses are evidence of competitiveness," and "national governments should be responsible for whatever happens in their own economies." Many of these principles are associated with Germany, but it would be a mistake to assume that the German economic policy-making community is alone in holding these views. On the contrary, there are quite a few countries—like the Netherlands, Finland, Slovakia, or the Czech Republic—where many of the same views are equally if not more strongly entrenched.

Each of these principles is attractive in isolation. What country would not be proud of being independent, debt-free, competitive, and responsible? The problem is that it is hard to imagine an integrated multinational marketplace where there is no redistribution and no debt, where every country runs a current account surplus, and where every national government is responsible for whatever happens within its national boundaries.

Consider the problem of redistribution. There are two sides to every transaction and many different dimensions to any exchange. We can think about a "sale" as a transfer of goods for money, but such a simple description ignores how the transaction is financed and settled, how it is contracted, what assurances are provided by the counterparties, and where any disputes are resolved. Any one of these dimensions can be described as a "transfer"—of risk, rights, and legal jurisdiction. Moreover, it is impossible to calculate all these transfers into the price, even assuming that the counterparties are equally matched in terms of market power. You can come up with a price that they are willing to accept for the deal to be completed, but that does not mean there will

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be no surprises for either side in the transaction. The only way to avoid "redistribution" is to avoid the exchange altogether.

This point about redistribution sounds abstract but it has very concrete implications. Consider the May 2010 Greek bailout. Europe's governments bailed out Greece by pooling their resources to lend money to the Greek government so that it could refinance its debts, as opposed to defaulting. There were many advantages for the other governments involved in this arrangement. They prevented a disorderly default that would have created further turmoil in already unsettled markets; they bought time for French, German, and other private investors to pare down their exposure to Greek assets; they gained some joint oversight for the International Monetary Fund, the European Commission, and the ECB over Greek economic policy making; and they locked in a positive rate of return on the money they loaned to Greece, above and beyond the cost they faced as individual governments in borrowing that money on private capital markets. In other words, they received a number of systemic or structural advantages, and they got paid on top of that. They also had to accept the risk that Greece would need to re-profile (or change the terms of) its debt at some point in the future. Given what has happened to Greece since the first bailout, with deepening economic hardship, a second European bailout, and grinding austerity—and now with Syriza having emerged as the largest Greek political party after the January 25, 2015, elections—that risk is significant.

The question is whether to accept that risk as part of the cost of doing business or to take a principled stand against the implicit redistribution. Most economists agree that Greece will need further debt relief and the sooner it gets it, the better off everyone will be. But Finnish Prime Minister Alexander Stubb has already made it clear that his government will not accept such an outcome, and he is not alone in objecting as a matter of principle to any change in Greek debts. ECB Executive Board member Benoît Coeuré made a similar point, insisting that any assets held by the ECB must be paid in full and cannot be renegotiated; any re-profiling of such assets would be "illegal."

Unfortunately, this means that the vast majority of Greek sovereign debt instruments should be treated as sacrosanct. Should the debt turn out to be unsustainable given the country's macroeconomic performance, it is unclear what the Greek government should do about that fact. That is why there is growing speculation that Greece might be accidentally forced out of the euro—because economists believe the only solution for Athens will be to reintroduce its own national currency and then let inflation burn away the debt. The result could be disastrous for the euro as a single currency, and it would also create large costs for the European single market (and anyone who does business with Greece). This is where the logic of principle collides with the reality of interdependence.

Moral hazard

Another case made for resisting any change in the debt burden of Greece is that it would create conditions of "moral hazard." This is a prime concern of many European policy makers, most prominently German Finance Minister Wolfgang Schäuble. The argument is that any effort to relieve Greece of its debt now will only encourage Greek governments to take on more debt in the future. This argument can be made more generally in the case of fiscal consolidation. As Schäuble explained to public audiences in Washington last October, governments should be encouraged to pay down their debts rather than to increase them. The principle here is not just that there should be no transfer across countries; it is also, more simply, that debt is bad.

European policy makers like Schäuble do not believe that governments should aim for Keynesian demand stimulus through deficit financing, because they suspect that the result will only be to increase uncertainty among other market participants. So they argue that the best way for governments to restore market confidence is to get rid of "bad" debt and to provide reassurance that excessive borrowing will not be repeated. This is the thinking behind the EU's fiscal compact, a 2012 treaty setting limits for member states' budget deficits and debts. The problem here is that if all parts of the euro area engage in fiscal consolidation at the same time, then their individual efforts to cut deficits and pay down debts will work at cross purposes across the single market and create a drag on economic performance. Again, this is the logic of principle versus the reality of interdependence.

At a deeper level, it is worth considering whether debt is really "bad." Savings for one group is always a liability for some other group—at least so long as that savings is remunerated and

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not hidden under a mattress (and even then the liability exists for whomever issued the currency). So if governments want to encourage their populations to save, they are going to have to hope that there is someone, somewhere, who is willing to take on the debt. This is particularly true for those countries that want to run current account surpluses, because they end up exporting as much capital (or surplus savings) as they send out net in goods and services.

Indeed, this explains why Germany was such a staunch proponent of capital-market liberalization in the late 1980s and early 1990s, and also why the German government was so eager to engage in the integration of European financial markets in the late 1990s and early 2000s. The goal was not simply to make it easier for German exporters to succeed in other parts of Europe's internal market, but also to ensure that German savings found a higher real rate of return than it could by relying primarily on domestic assets. Now that situation has reversed with the disintegration of European financial markets: German exporters are having a hard time selling to other parts of Europe and German savings is suffering from very low—and often negative—real rates of return. By encouraging governments to consolidate their finances and to push their own economies to run current account surpluses (through the "excessive imbalances procedure"), European policy makers are making the situation for countries like Germany even worse. The principle sounds reasonable, but it does not work in a context of interdependence.

TAKING RESPONSIBILITY

The treatment of European institutions is an additional problem. Europe's heads of state and government have tended to blame European institutions either for not performing adequately or for imposing irrational policies, but it is actually the national governments that have the greatest responsibility to respond to the crisis and national politicians who make—or fail to make—the key European decisions. This is true primarily in the areas of fiscal policy or market reform. But it has implications for monetary policy as well.

Too often the ECB has been left as the only institution capable of responding to the crisis. As a consequence, it has burned through its arsenal of conventional and unconventional monetary policy instruments without adequate support from the member states' governments. The monetary stimulus has bought time, but it has not generated enough momentum to respond to the crisis. And now the ECB is almost out of room for maneuver. This is a common complaint made by members of the ECB Executive Board. Unfortunately, there is not much they can do unless the member-state governments accept responsibility for the macroeconomic situation of the euro area as a whole. So far, none has expressed any willingness to do so. Indeed, many have praised the virtues of self-reliance at the national level.

The European Commission is in a similar dilemma, insofar as it is responsible for enforcing the principles that Europe's heads of state and government have written into the framework for macroeconomic policy coordination. The Commission is also responsible for overseeing the bailout programs for countries like Greece, Portugal, and Ireland. That responsibility has garnered many enemies and few friends. Whenever the Commission tries to introduce some element of flexibility, it is accused by those countries that are not under scrutiny of applying double standards or undermining the principles of sound macroeconomic policy making. Within such a bind, it is hard for European commissioners to exercise their right to take the initiative, and it is much easier for them to retreat behind the requirements for consensus.

Europe's fate is tragic only so long as Europeans accept the belief that stagnation cannot be avoided. There is no good reason for European leaders to resign themselves to such a fate. On the contrary, they have strong reasons to resist it. To do so, however, they will have to put solidarity ahead of consensus, embrace the logic of interdependence (and systems dynamics), and change domestic political discourse to give Europe a more positive image.

In practical terms, this means that they will have to stimulate macroeconomic performance while at the same time building the common institutions necessary to stabilize the integrated European marketplace. It also means that national politicians will have to explain to their electorates how their economies will be better with Europe than without it. This is a challenging argument to make; yet the alternative of failing to meet that challenge is to accept a future defined by very low inflation and very low growth, together with all the political and social dangers that entails. ■

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