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Reengineering EMU for an Uncertain World

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The euro area crisis has probably passed the acute phase, as the European Central Bank (ECB) has finally put its balance sheet in play via the Outright Monetary Transactions (OMT) and restored, to some extent, the risk free nature of euro area bonds. But it has entered a chronic and unstable phase of still fractured credit markets, too high funding costs, very weak growth, and dim expectations. This won't be solved only with more austerity and reforms at the national level. This paper argues that, to ensure its sustainability, the euro area needs to be reengineered along three lines: (1) restore political solidarity in the euro area to be able to deliver strong institutions; (2) convincingly end the debate on default and exit and launch a program of eurobonds, to provide the Economic and Monetary Union (EMU) with a credible risk free asset, the needed cyclical insurance mechanism, and a fiscal backstop for the banking union, and make it a credible currency in an uncertain world; and (3) refocus cyclical policies, including monetary policy, away from containing moral hazard and towards stabilizing the business cycle and boosting demand in order to contain the large downside risks to inflation that the euro area faces. It is time to end the mistaken view that demand policies are bad. Without growth, there is no hope, and societies are at risk of fracture.

The euro area crisis is not a fiscal crisis, or even a current account crisis. Outside Greece, the fundamentals of the euro area periphery are not materially worse from those of the United States, the United Kingdom, or Japan. The euro area is in external balance. It can solve its own problems, if it wants to. It is therefore a political crisis. Yes, European authorities have put in place policies and institutions that nobody would have imagined just two years ago.[1] But, at the same time, they have been tremendously ambiguous, and at times borderline irresponsible, about their will to do whatever it takes to make the euro a sustainable currency, inflicting a large economic cost on the global economy.

This crisis will be completely solved only when global investors are convinced, again, that the euro is a credible monetary union and will then stop treating euro area countries as recessionary small open economies at the zero bound with a fixed exchange rate.[2] The recipe of fiscal austerity plus internal devaluation in the periphery won't work as it worked for Germany in the 2000s because there is no offsetting demand stimulus from the euro area or the rest of the world and because it assumes that the economic infrastructure of the euro is adequate and doesn't require any changes.

If there is no political will to implement the needed changes at the euro area level, then the future could be very dark. Euro area financial markets have fragmented beyond self-repair and societies in several euro area countries are reaching points of fracture. When take-home pay and benefits are being by cut by double digit percents, when unemployment becomes widespread to the point that everybody knows somebody who is unemployed, when large cohorts of population lose the sense of hope, the vulnerability to any unexpected

1. See Bergsten and Kirkegaard (2012) for a positive interpretation of the euro area strategy.

2. See the discussion in Ubide (2012).

event, however small, and the risk of social accidents increases exponentially. Despite the recent improvement, the euro area is not in a stable equilibrium, and this should become clear to all euro area policymakers.

THE END OF POLITICAL SOLIDARITY

Pundits have spent thousands of hours in the last couple of years debating the economics of EMU while ignoring the fact that, at the end, it's all about politics. From an economic standpoint no currency area is optimal, and a necessary condition for a credible and workable monetary union is political solidarity that delivers the needed institutions to make the currency area sustainable. Unfortunately, when the crises erupted, euro area politicians, rather than credibly leading

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with the euro area interest in mind, quickly abandoned this solidarity and focused on their national electoral needs. This greatly increased the GDP cost of solving the crisis and may explain why the euro area, unlike the United States, has not recovered yet the pre-crisis GDP level (see figure 1), and its recovery is much weaker than the experience of past recoveries. Financial crises are very difficult to manage, not because we don't know what to do, but because the optimal policies are always politically costly and generate winners and losers—providing incentives for weak leaders to adopt suboptimal policies that prolong the crisis.

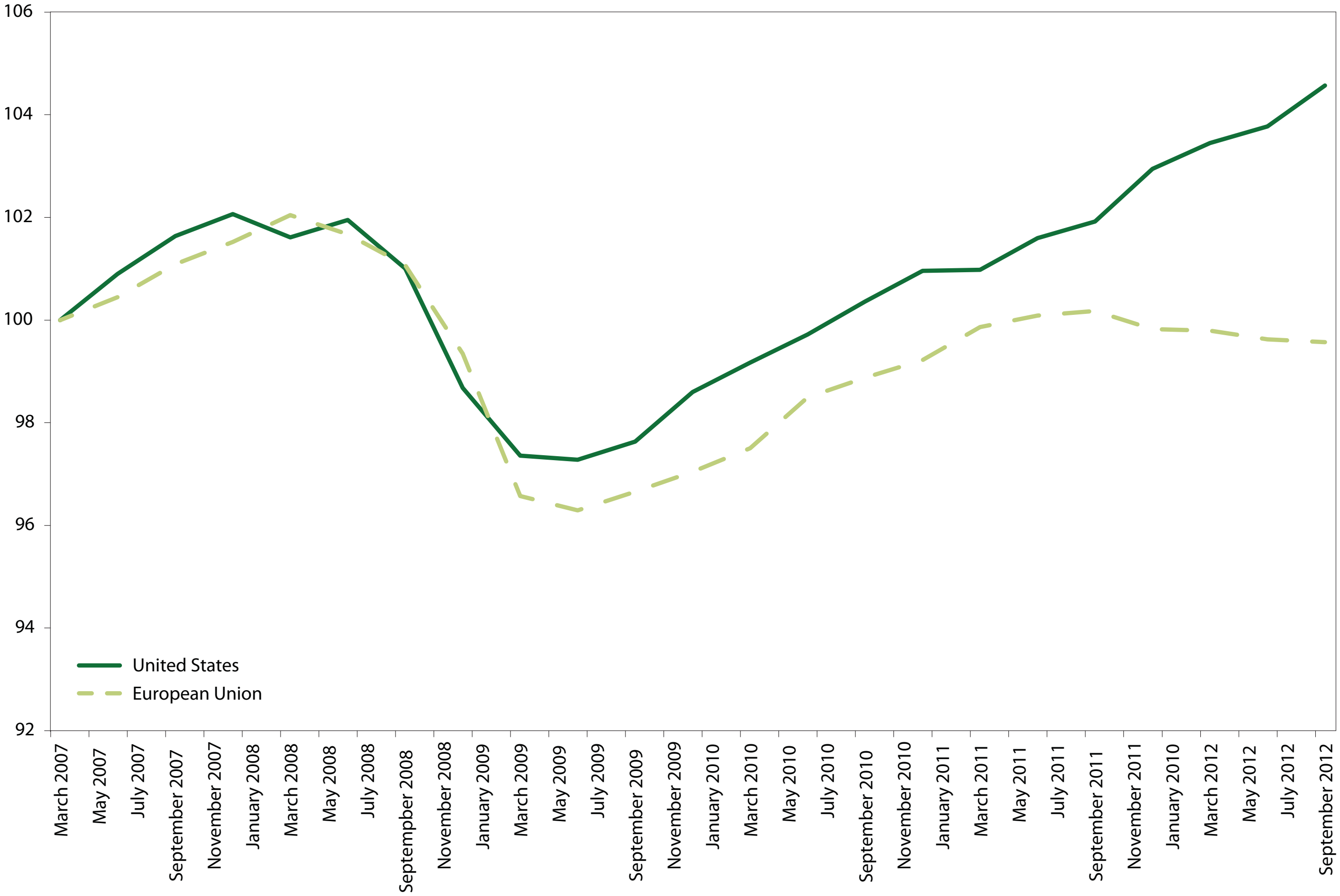
This myopic national focus has appeared in many countries, periphery and core alike. In the periphery, governments have struggled to own their reform strategies and typically put domestic politics first, unnecessarily delaying the adoption of important fiscal measures and reforms (for example, the delay in Spain of the 2012 budget to after the regional election in Andalucía or the long and painful process leading to the resignation of Berlusconi in Italy). But it also applies, even more critically, to the core: France, where the misguided focus on punishing speculators in 2010 was driven by presidential election politics; Finland, where the True Finns simply took the euro area hostage in order to maximize their election prospects; and, more importantly, to Germany. The German strategy during the crisis could probably be summarized in "maximizing the odds of reelection subject to avoiding a total collapse of the euro." Yes, there have been Constitutional constraints that have limited the room for maneuver—the EFSF could only be created by allowing the crisis to become systemic and thus be the rescuer of the euro area, and not of Greece—but the German government could have (and should have) been much more proactive in generating the necessary public and political support for the needed policy responses, rather than allowing the hard-core euro skeptics to take control and dominate public opinion.

The euro was built on the assumption of solidarity to integrate several economies at very different cyclical points. While most euro area countries entered the euro with a combination of cyclical upswing and structural catching up, Germany was completely out of sync: In the midst of its adjustment post-unification, with a large competitive disadvantage stemming mostly from the decision to integrate the East at parity. Germany was able to slowly regain its competitiveness while avoiding a long recession because there was plenty of demand support from the rest of the euro area and monetary policy was targeted mostly to cushion this adjustment in Germany, imposing a policy cost on the periphery for which monetary policy was way too loose. To be sure, periphery countries made important policy mistakes, allowed their economies to overheat, and failed to see the need for adjustment. At the same time, macroprudential policies were tried (countercyclical provisioning in Spain, for example) but were always imperfect, and the political economy of fiscal surpluses made it very difficult to tighten fiscal policy to the optimal surplus level and achieve the right policy mix. The leniency on fiscal policy towards Germany in 2003, when it breached the Stability and Growth Pact (SGP) as it was implementing structural reforms, was predicated on similar solidarity grounds. It enjoyed a very low interest rate, free flow of goods and capital despite a very grim growth outlook (recall its nickname "the sick man of Europe"), and one the weakest fiscal positions in the euro area, and a weaker exchange rate, which facilitated the very rapid increase in the current account balance from –2 percent of GDP in 2001 to +8 percent in 2007. A well-functioning euro area allowed Germany to adjust to the unification shock by containing wage growth in a smooth way rather than abruptly cutting salaries and benefits and hiking taxes. The German miracle owes a lot to euro area solidarity.

This solidarity, however, abruptly broke down during the crisis, at three critical moments. The first was the German decision in October 2008 that each euro area country would solve its own banking problems, rather than agreeing to a joint approach.[3] Second, the EFSF, created in May 2010, was

3. See Bastasin (2012) for a very good account of that debate.

Figure 1 GDP levels (100=2007Q1)



Source: Bloomberg.

clearly too small and inefficient (unanimity rule) to be a credible firewall. Third, the default and exit options introduced in October 2010 at the infamous Deauville declaration. By breaking the solidarity European leaders killed the essence of monetary union and led markets to treat euro area countries as small open economies trapped in a fixed exchange rate regime. This triggered a vicious circle of procyclical austerity and reforms where growth collapses and debt ratios steadily increase. The worst of all possible worlds—and certainly not what the euro area citizens wanted.

It could be argued that part of the reason for the breakdown of solidarity is that the current situation allows Germany and the core to enjoy an exorbitant privilege of excessively low interest rates, capital inflows, and easily captured foreign export market share, and thus there are strong incentives to do just the minimum necessary to avoid a collapse. By some estimates, Germany's real effective exchange rate is about 20 percent weaker than fundamentals would suggest, not taking into account fly to quality flows.[4] Were it not for the cushion of the euro, Germany's financial conditions would very likely be materially tighter via a stronger currency.

An important element of the solidarity breakdown is the absence of a common euro area narrative for the crisis. The most permanent impact of a crisis is the narrative, as it determines the policy response and subsequent institutional changes. Unfortunately, the crisis is explained and debated in different ways in different countries, complicated further by the different languages and the absence of common media vehicles, making agreement on a solution very difficult as the problem is defined differently in different places. Four important elements of the political narrative of the crisis must be changed for solidarity to return.

4. See Nathan Sheets (2012), "Alexander Hamilton and Germany's Windfall from Euro-Area Membership," Citigroup.

The first element is the misleading debate about transfer union. The concept of transfer union is the legacy of German Unification, and carries the concept of permanent transfers to equalize living conditions. EMU is not about transfers. It is not about achieving nominal convergence via convergence of economic systems. EMU is about providing the right environment to allow different economic models to coexist—to put it bluntly, it is not about Germany paying the Italian debts, it is about Germany allowing the establishment of the needed institutional setup so that Italy can pay its own debt—as discussed in the next section. It should be clear that it is perfectly fine to have an economic model based on domestic demand which generates current account deficits. It is impossible, and not really acceptable politically, to micromanage the imbalances and try to design all euro area economies along the same model. The second element is the misleading debate on TARGET2 as just a major German liability. It should be clarified that the balances in TARGET2 show not just the funding, in some cases, of the periphery current account deficits but also the funding of Germany's very large current account surplus. In other words, the large TARGET2 German credit shows the Bundesbank's financing of a large share of the German current account surplus and thus contributes to cushioning the blow of the periphery recession to the German economy. TARGET2 has played a critical stabilizing role for all euro area countries, smoothing out the adjustment in both current and capital accounts, and preventing the sudden stop to end in a catastrophic breakup of the euro and a devastating recession in Germany.[5] It is a monetary eurobond, and it must be replaced by a fiscal eurobond in order to be sustainable, as discussed below. The third one is the very narrow interpretation of stability union in the political debate. The long-standing German view seems to be that fiscal discipline, the no bailout clause and price stability are prerequisites for a stability union. The reality is that the combination of no bail out clause and common monetary policy is by construction unstable as it lacks the exchange rate or a fiscal insurance system as the ultimate stabilizers. Successful monetary unions, such as United States or Canada, all have a federal fiscal insurance system in addition to a no bailout clause for sub-federal levels of government. Markets have understood this and no longer see the euro as a stable currency—and if global investors don't believe in the currency, there is no such a thing as a stability union. In other words, the euro won't be a stable currency unless a euro area fiscal insurance system is created, as I discuss below. The fourth one, and perhaps the most important, is the confusing argument over the causes of the crisis and the allocation of blame. The standard story is that periphery countries let unit labor costs explode, thus their large current account deficits. Therefore, an internal devaluation is needed to correct this mistake. This story fits well with the German experience post-unification. The problem with this story is that it is not more than half true. As documented very well by Chen, Milesi-Ferretti, and Tressel (2012), the widening of current account deficits in periphery countries, in absolute but also in relative terms to Germany—was driven mostly by the steady appreciation of the euro during the second half of the 2000s and the rise of China in the world economy—which displaced periphery exports in global markets while increasing the demand for German capital exports (also boosted by the increase in income in oil-producing countries—heavy consumers of capital goods—generated by the steady appreciation of oil prices during the decade). Certainly, the ease of financing allowed the periphery to delay the needed adjustment. But the reality is that external shocks, more than failed policies, contributed the lion's share of the widening of current account differentials in the euro area.

5. See, among others, Cecioni and Ferrero (2012) and Cecchetti, McCauley, and McGuire (2012) for a detailed discussion of the determinants of TARGET2 imbalances.

CORRECTING THE ECONOMIC INFRASTRUCTURE OF THE EURO AREA

The euro area was built on four hypotheses that need to be corrected now that the crisis has disproved them. As a child of the Great Moderation, the euro area was created under the assumption of "certainty" about the business cycle. The very detailed set of rules essentially implied an assumption that all future states of nature could be envisaged ex ante. The crisis has been a humbling experience for the economics profession, and it should carry the same message for euro area policymakers. The world is by nature uncertain, and the euro area needs strong institutions to manage this uncertainty. Minimalistic approaches are doomed to fail. This Great Moderation assumption implied that the euro area was created with "small" shocks in mind. The financial crisis has demonstrated that the current economic—and perhaps more importantly, political—architecture of EMU can't withstand large shocks, especially when they have differential impact on EMU member countries. The nexus of the correction should rely on the establishment of a conditional insurance mechanism that completes the economic architecture of EMU. The insurance mechanism, in the form of eurobonds, would guarantee the existence of risk free assets in all euro area countries.

Four Failed Hypotheses and the Need for an Insurance Mechanism

In a context of German disinflation generated by the post-unification adjustment, the Great Moderation assumption led to four critical building blocks of the original economic infrastructure of the euro area.

First, it was assumed that a 3 percent deficit limit and a close to balanced fiscal situation in steady state would be enough to protect against future (Great Moderation size) shocks. The recent experience shows that his was clearly not enough—in fact, both Ireland and Spain had healthy fiscal situations in 2008—and there is no reason to believe it will be enough in the future.

The world is by nature uncertain, and the euro area needs strong institutions, including eurobonds,to manage this uncertainty. Minimalistic approaches are doomed to fail.

Second, it was assumed that a combination of a common monetary policy focused solely on price stability plus a balanced fiscal policy focused on ensuring long term sustainability would be enough to stabilize the business cycle and maximize the conditions for sustainable growth. Hindsight now makes clear that some countries should have been running large fiscal surpluses during the 2000s to offset their excessively rapid economic growth and asset price inflation. However, the pitfalls of real time estimation of potential growth and the complex political economy of fiscal surpluses made this an impossible mission: It is quite difficult to assess output gaps (and thus assess the true structural fiscal balance) and to justify large fiscal surpluses in countries that are growing rapidly but still have some catching up to do in terms of income per capita—as it was the case of Ireland or Spain, for example. There is always another public investment project to undertake in order to spend the surpluses.[6] In a small open economy the exchange rate would have likely appreciated and contributed to the adjustment. But this was just not possible inside EMU and therefore leaning against the wind was not fully possible—making clear that a robust institutional mechanism to stabilize a potentially large downfall is needed.

Third, it was assumed that intra-EMU current account flows would always be funded and, therefore, that a large current account deficit does not matter inside a monetary union. Thus the accumulation of very large external imbalances was largely ignored—as it is the case in well-functioning monetary unions. The assumption was correct—unless something happened that stopped the working of EMU, as it happened when the breakdown of political solidarity became clear. Once political solidarity vanished it became clear that the euro area was not a true monetary union: The internal funding of the current account flows was no longer "guaranteed," the implicit insurance mechanism broke down, and large current account deficits, even if mostly intra-European Union, were suddenly seen as unsustainable, triggering sudden stops.

Fourth, it was assumed that a single market for financial services was compatible with national banking policies and institutions. As always, politics played a big role in this assumption—countries gave priority to their desire to maintain control over their national champions, as the main area of economic sovereignty left for national governments in the euro area. And, again, the political economy of "success" was very difficult to overcome: If banking systems were very profitable, why fix them? The potential issues related to banks too big to save (in the Benelux, for example) or to dubious governance practices (in the Spanish *cajas*, for example) were already clear then, but the political desire to address it was nil.[7]

The crisis rendered these four hypotheses invalid, for four reasons. First, the euro area suffered a shock many orders of magnitude bigger than those of the Great Moderation. Second, the discovery of the Greek fiscal fraud broke the confidence on the outlook and policies of the periphery countries and called into high scrutiny the sustainability of their current account deficits. Third, the Deauville declaration in October of 2010, increasing the odds of forced restructurings, changed the risk free nature of periphery sovereign bonds by introducing default risk. Once sovereign bonds become credit, and thus their yields become negatively correlated with nominal GDP growth, a violent destabilization always follows. Fourth, the debate on euro exit tainted the nature of the euro and introduced redenomination risk. Once default and redenomination risk had to be taken into account by risk managers, it became almost impossible to evaluate the risk return of any investment in euro area periphery assets. The reputational risk of any investor willing to invest in periphery euro area assets became too large when faced by the strong and widespread media, pundit, and (apparently) political

6. In fact, Sweden is probably the only developed country that has developed a sustainable political equilibrium in favor of small fiscal surpluses, reflecting a self-insurance reaction to the early 1990s banking crisis.

7. See Belaisch et al. (2000) for an early and comprehensive discussion of these issues, including the governance of the *cajas* and the need for a European supervisor.

consensus supporting default and exit. The path of least resistance become to reduce or eliminate investments in the euro area periphery, and a violent sudden stop ensued.

To restore the credibility of the euro the euro area must address the four reasons that rendered the four hypotheses invalid: It needs a system to deal with outsized shocks; it needs to restore intra EMU financial flows; it needs to restore the bond nature[8] of periphery sovereign bonds; and it needs to eliminate redenomination risk. The OMT program of the ECB has partially addressed the default and redenomination risk, but it is not and it should not be a permanent solution. A permanent solution requires the establishment of a credible insurance mechanism and the unequivocal political commitment to the future of the euro as an irreversible currency—restore the lost solidarity. In practice, it requires (1) eliminating the uncertainty about Greek exit and periphery restructuring once and for all; (2) establishing a functioning banking union; and (3) starting the process for the creation of eurobonds, combined with steps towards political union to support it.

Greece and the Irreversibility of the Euro

The great contradiction in the German political debate is the impossibility of having a stability union with the permanent fear of exit. Currency unions can't survive if they are open ended. The use of Greek exit as a domestic political tool has been as misguided as the US Tea Party's use of the debt ceiling. Fortunately the views in Germany with regards to Greece seem to have changed lately.

The latest review of the Greek program shows that a credible solution to the Greek economic outlook, now that the majority of the debt is in the hands of public institutions, will require the restructuring of official loans. There is no politically feasible amount of fiscal tightening and internal devaluation the Greek government could implement, in a context of zero interest rates and absent an unexpected demand boom, which could deliver a sustainable fiscal and external outlook in the politically relevant timeframe absent official loan restructuring.

This restructuring must be done as soon as possible, to end the exit fears and allow the private sector to finally be able to evaluate the Greek economic outlook with some certainty. An important determinant of the depth and length of the Greek recession has been the impossibility of evaluating investment decisions in Greece, as it was impossible to assess what currency and what political environment would be in place in the near future. The decision to postpone it to after the German 2013 elections perpetuates the redenomination fears and the downward pressure on euro area growth—exactly the same result as the apparent strategy of Tea Party in the United States, which dragged out the resolution of the Fiscal Cliff. With redenomination fears always present, the private sector will rationally continue to retrench. It is understandable that in many euro area countries undergoing sharp budgetary adjustment there is no political desire to forgive Greek debt while announcing further cuts at home. But announcing a path towards the restructuring of official sector loans—in phases and conditional on the achievement of some further fiscal targets—should be possible and it would provide a positive incentive for both the Greek government and the Greek society to continue to work towards the resolution of the problem. This restructuring program could include, for example, further easing of the interest payment schedule and rates to allow for a smaller fiscal tightening near term, and the transfer of the bank recapitalization costs to the European Stability Mechanism (ESM), together with starting a Paris Club process for the official loans. It would greatly contribute to ease financial conditions in Greece, reduce the level of the primary surplus that Greece will have to sustain in the future, and increase the stability of the euro.

Banking Union for the Long Run, Not to Solve the Crisis

A European supervisory system is necessary for two reasons: First, because unless there is a perfect flow of information about systemically important banks, the ECB can't gauge the disruptions to the transmission mechanism of monetary policy strategy and can't fulfill its financial stability mandate. Second, because it is the only way to have a single market in financial services without constraining countries to have "small" banks, therefore allowing the existence of pan-European banks that are too big to save at the national level. The alternative is to have a fragmented financial system along national lines which precludes efficient risk sharing, facilitates sudden stops because of the home bias inherent in the system, and thus fails to fully reap the benefits of monetary union.

With this in mind, there is no need to have all euro area banks supervised at the euro area level. Only the banks that are systemic at the euro area level and/or too big to save at

8. Bond nature, meaning that bond pricing assumes sovereign bonds are essentially risk free, and thus reflecting mostly expected future short term rates, whereas credit pricing reflects expected default probability. Thus lower growth expectations typically lead to lower sovereign bond yields, in a countercyclical fashion. However, when default fears prevail, sovereign bonds become "credit" and lower growth expectations lead to higher bonds yields, in a procyclical fashion, as happened to several euro area countries.

the national level should be supervised at the euro area level. Banks with assets above some percent of national or euro area GDP should become European. The tiered system is, in spirit, similar to the approached followed with the systemically important financial institutions (SIFIs), who are deemed systemic and thus required to hold more capital and higher scrutiny. Banks should be able to choose between a national banking license and a euro area banking license. The current agreement on the Single Supervisory Mechanism (SSM) to directly supervise all banks with assets above €30 billion fits this model—although the decision to exclude the German Sparkassen system shows, again, how politics trump rationality and it is worryingly reminiscent of the reasons given not to reform the Spanish *cajas* a decade ago.[9]

The banking union is not a crisis resolution device, for two reasons. First, the promise of direct recapitalization of banks as a way to break the *current* link between sovereigns and banks has been abandoned—the decision that direct recapitalization won't apply to legacy assets is another clear example of the breakdown of solidarity—and the SSM won't be active until sometime in 2014. In fact, the decision to move towards banking union in mid-2012 was another example of politics trumping analysis: It was the action that carried the minimum political cost in the creditor countries, as it only implied activating the noncontroversial article 127.6 of the Maastricht Treaty that gave supervisory responsibility to the ECB. The politically costly yet better decisions, such as ECB purchases of bonds or the launching of eurobonds, were rejected.[10] Second, the needed deposit guarantee and resolution fund that should accompany the SSM will never be credible without a strong fiscal backstop. A look at different schemes around the world shows that deposit guarantees are rarely designed to manage systemic problems. This applies to the Federal Deposit Insurance Corporation (FDIC) in the United States as much as to national European deposit guarantees—which are also of many different natures, and thus very difficult to harmonize let alone fund in a unified manner in the near term.[11]

Likewise, resolution funds cannot really exist without a fiscal backstop. If they are small, they defeat the purpose. If they are large enough, a problem arises of how to invest the large amount of funds that the resolution fund will be endowed with. If it needs to invest is very safe assets, then it makes little sense and it is a waste of resources. All systemic banking rescues around the world have been resolved with recourse to the general budget, not with recourse to an especially dedicated, prefunded fund—the Troubled Asset Relief Program (TARP) in the United States being a good recent example. In other words, a banking union without eurobonds is not a credible banking union and won't, by itself, restore cross-border flows and preclude a repetition of the events of the last few years.

Eurobonds and the Need for Insurance

The key piece of the puzzle for the sustainability of the euro is therefore the creation of eurobonds as an insurance mechanism at the euro area level that creates a euro area risk free asset, corrects for the absence of the exchange rate as the ultimate stabilizer, and provides a credible fiscal backstop to the banking union. A common currency transforms exchange rate risk into credit risk, and the crisis has now transformed a theoretical argument into a realistic possibility, which means that investors and risk managers will have to factor this scenario in their investment decisions for many years to come. Eurobonds would partially insure against this credit risk. Without this insurance mechanism, the euro area won't be a stability union and won't be able to achieve its maximum potential. As the crisis has made very clear, without a euro area wide risk-free asset, countries can't implement optimal countercyclical policies in the presence of large shocks, the ECB can't implement monetary policy properly, and banks can't perform maturity transformation and become very procyclical during downturns.

A system of eurobonds would allow a combination of credible insurance at the euro area level and a credible no bailout clause at the national level (similar to other federal systems such as the United States, Canada or Germany). The alternative to not having Eurobonds is to declare that no euro area country will ever fail, and drop the no bailout clause. To support this, and given the recent experience, each and every euro area country will likely want to build its own self-insurance mechanism and run a large current account surplus, and perhaps even build its own sovereign wealth fund, similar to the response of emerging markets to the 1997 crisis.[12] This alternative is tremendously inefficient and potentially deflationary, as it will suppress domestic demand and, by generating a euro area current account surplus, will only worsen the

9. See Veron (2012) for a detailed discussion on the banking union.

10. It could be argued, though, that the launching of the SSM was an irreversible step towards eurobonds, as a banking union will not be credible without a strong fiscal backstop. Once the banking union is in place, making the case for eurobonds could be politically easier as it won't be a rescue operation but rather a forward-looking step.

11. See Demirguc-Kunt, KaraKaovali, and Laeven (2005), and references therein, for a comprehensive discussion of deposit guarantee systems around the world.

12. See the discussion of the need for an IMF insurance facility along similar lines in Ubide (2007).

global imbalance problem. Eurobonds are a financial stability tool, more than a fiscal tool.

Launching a process of creation of eurobonds would accomplish two additional very important objectives: First, enhance the crisis management framework by creating a convergence process that markets can understand and, if credible, would end the convertibility premium and fragmentation of EMU banking system and lower financial conditions in the private sector of the periphery. Second, generate an exit strategy for the ECB from the long-term refinancing operations (LTROs) and the OMT by allowing the transition from the current imperfect monetary eurobond to a properly designed fiscal eurobond—and therefore reduce the increasing politization of the ECB.

Eurobonds would not necessarily represent a cost to Germany and the other creditor countries, for two reasons. First, eurobonds would increase the stability of the euro area—they should reduce default risk and funding costs for the euro area as a whole and therefore increase potential output and growth in the euro area. Bund yields will likely increase a bit, as Germany loses the monopoly over euro area risk-free assets, but that would only correct the current anomaly and restore yields to more normal levels. Second, the relevant comparison is not between funding costs, but between GDP paths. From the discussion above it should be clear that the alternative to eurobonds is not the return to the pre-crisis steady state, but possibly many years of very weak growth and instability in the euro area, while still risking the potential breakup of the euro area, if it were to suffer a large enough shock. From this standpoint, eurobonds are almost cost-free.[13] Some of the alternatives to eurobonds being floated seem directed towards a minimalistic approach—such as "funding for reforms"—that won't solve any problem. Other options, such as stabilization funds, are too dependent on precisely defining ex ante the likely contingencies. It should be clear by now that we live in a stochastic world, where shocks are not predictable, and thus these minimalistic approaches are doomed to fail. And, more importantly, launching eurobonds as the way to complete the euro area should be taken with a higher sense of purpose. Alexander Hamilton's reasoning to assume the states' debt and move towards a federal system was quite clear: Establish the United States as a creditworthy nation to attract foreign capital, guarantee liquidity and cheap financing for military operations, and strengthen the loyalty of bondholders and citizens to the federal government. It was sense of political purpose that took him in that direction—and then he adapted the system, through trial and error, to make it work. At a time when the opinion of euro area citizens about the euro area is at historically low levels, it is time for euro area leaders to move forward with similar big horizons in order to restore the positive image of the euro.[14] Again, reminding the German public opinion that the euro area stability was key for Germany to achieve its adjustment post-unification could contribute to changing the political opposition towards eurobonds.

The precise form and process of creating the eurobonds is beyond the scope of this paper, but it is critical to start the debate by first answering the question of what eurobonds are for. If eurobonds are intended to be the euro area insurance mechanism, then they have to be risk free, with a predictable outlook (and thus not dependent on veto decisions by the Bundestag or any other national parliament) and large enough to cover, ex ante, the impact of large shocks. History shows that banking crisis and natural disasters can cost as much as 20 percent of GDP. Adding some safety buffer, a model of eurobonds along the blue/red type[15]—that is, each country's financing needs would be covered by a mix of joint and several eurobonds (blue bonds) and national bonds (red bonds)—with the blue component representing initially no more than 30 percent of GDP, would be ideal. There would a sizable insurance component (the blue eurobond), while there would be market discipline (and enough liquidity) in the red national bond to complement the structural discipline embedded in the legal framework discussed below. This system would provide an adequate backstop to the banking union—as systemic bank recapitalizations would be backstopped by the eurobonds—and provide an insurance to adopt countercyclical policies against asymmetric shocks, while keeping automatic stabilizers at the national level, consistent with the subsidiarity principle.

The institutional and political framework will need to be strengthened, even if recent reforms of the fiscal policy framework—the Fiscal Compact, the Six Pack, and the Two Pack—already introduce very tough ex ante conditionality via very intrusive surveillance for countries in an excessive deficit procedure. This should be further reinforced by giving legal status at the national level to this euro area surveillance in legislated constitutional amendments, in addition to the prioritization of debt service.[16] In addition, the creation of a euro area Fiscal Policy Council—with a similar concept

13. Similar in spirit to the conclusions of the seminal work of Diamond and Dybvig (1983) in banking, who argue that deposit insurance in banking systems is essentially cost-free as it eliminates the bad equilibria.

14. See Henning and Kessler (2012) for a very good discussion of the evolution of US fiscal federalism as it applies to the current European situation.

15. See von Weizsacker and Delpla (2011)

16. Prioritization is a key issue that is often overlooked in the debate but that greatly reduces the degree of mutualization. The Constitutional Reform that Spain undertook in 2011 incorporates both provisions.

to the ECB, with six independent "governors," plus euro area ministers and the Commission providing the technical recommendations plus the economic outlook and output gap estimates, with decisions by majority—would be a welcome step to buttress the credibility of the process. A key question mark would be whether Germany would be able to agree to such an intrusive framework that would severely reduce the budgetary authority of the Bundestag when Germany next becomes again the subject of fiscal woes.

Complementing all this, a further step towards political union would be needed to enhance legitimacy via the direct election of the Commission president—for example, via European parliament elections where each European party group would have a presidential candidate, thus de facto converting the elections of the European parliament into a direct election of the president of the Commission. This would make the Commission president the only official elected by all euro area citizens, similar to the president of the United States. This would create a structure where the European Council would be akin to a European Upper House, the European Parliament akin to a European Lower House, and the Commission akin to a European executive branch.

BUT WITHOUT GROWTH, THERE IS NO HOPE

There is a critical corollary to the efforts to improve the economic infrastructure of the euro area that seems to be forgotten in euro area policy discussions: Without growth, there is no hope. Given the fragility of the euro area political, social, and economic equilibrium, a long lasting recession could sink all the efforts to restore normalcy and create the euro area of the future. If one adds the very high risk of hysteresis effects—which would depress potential growth—if demand doesn't bounce back soon, the risks to the outlook are tremendously asymmetric to the downside, once this wider viewpoint is taken into account.

It is very important to understand that supply reforms require demand expansion to be successful; otherwise they generate a negative vicious circle, especially at the zero bound. Supply reforms adopted to manage a crisis are almost always about reducing permanent income and increasing uncertainty. Economic theory makes clear that reducing permanent income and increasing uncertainty reduce demand, absent some offsetting policy action. Yes, supply reforms will make the economy more resilient in the next downturn, but they won't do anything to restore growth in the near term.

The ECB has been playing a role beyond its monetary policy mandate because of the insufficiency of the euro area governments' actions, as discussed above. But this also implies that the ECB has become a strongly politicized institution—with members of the governing council voting along national lines, and no longer as independent individuals. This should end now—especially as the risk of further politization increases with the establishment of the SSM. The ECB's mandate—price stability and promoting the objectives of the Maastricht Treaty—is seriously at risk of not being achieved. With fiscal and regulatory policies very tight and focused on

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restoring long term equilibria, the ECB must now focus on boosting demand to ensure that societies don't break, supply side reforms bear their fruit, hysteresis effects suppress potential growth, and the euro has a future. With OMT in place as a conditional last resort firewall, the time to worry about moral hazard is over. The time has arrived for the central bank to step out of the business of imposing conditionality and to focus on its core mandate, ensuring price stability, stabilizing the business cycle, and boosting demand. If a country requests the OMT, the ECB should step outside the Troika and just execute the program as designed.

It is now time for the ECB to focus on its core competence: monetary policy. It is almost impossible to believe that the ECB can be satisfied with the current economic forecast of well-anchored inflation and a very mild improvement in growth. Based on the December ECB's forecast, the economic outlook has sharply deteriorated since the summer, when the ECB last eased policy. The medium term inflation outlook remains close to 2 percent, but only because increases in indirect taxes resulting from the fiscal tightening programs keep headline inflation levels elevated while underlying inflation has markedly declined. It would be easy to see the asymmetry and procyclicality of this stance: If indirect taxes were to be slashed to stimulate the economy, thus exerting downward pressure on headline inflation, it would be difficult to see monetary policy arguing that, as a result, the risks to inflation were to the downside. The ECB must end this asymmetric stance towards inflation, it has accumulated enough credibility capital to move forward and support the economy in a more effective manner—especially in the midst of a very intense wage deflation process across the periphery. Further easing is in order. The modalities can be debated but, at a minimum, with OMT ruled out as an easing tool, it should include a commitment to keep rates at zero for as long as needed and a program of asset purchases. These could be plain vanilla quantitative easing (QE) via purchases of government bonds (which are perfectly compatible with the Maastricht Treaty, as the Bank of England's QE program shows,[17] and would reduce risk premia across the euro area) and/or a program to purchase and/or fund private assets, focused mostly on alleviating financial conditions for small and medium enterprises, in a similar spirit to the Bank of England's Funding for Lending Scheme (FLS). Financial conditions in the euro area are too tight, and in some countries, where funding costs are well above nominal GDP growth, are oppressive.

In addition, it is time to break the taboo that demand policies are bad policies. A stability-only policy framework may work for an economic model based on exports, but that is not the case for all euro area countries and economic models can't be changed at short notice. There are options to boost demand in the euro area while keeping a credible fiscal consolidation path. One would be a much more active use of the European Investment Bank and the structural funds of the European Commission. Given the very drastic cuts in spending budgets in most periphery countries, there will surely be plenty of investment projects (or active labor market policies that can minimize the impact on the NAIRU (nonaccelerating inflation rate of unemployment) of the sharp increase in unemployment in some countries) that can be funded with European funds—just relax the coinvestment rules, or even suspend them. These are not ordinary times. Another option would be to exempt public investment from the deficit targets to improve the quality of the fiscal adjustment. Sharp deficit reductions typically overweight the cuts on public investment—the easiest parts of the budget to cut without generating social unrest—putting strong downward pressure on potential growth and thus doing little to improve the long term sustainability of public finances. With OMT in place to contain sudden stops, there is a strong case to be made now to redefine the deficit rules—or at least give waivers for carefully planned public investments, which would support potential growth and provide a boost to demand growth in the near term. Most balanced budget rules in United States are defined this way.

17. The Bank of England, as part of the European Union, is also governed by the Maastricht Treaty and yet has interpreted its quantitative easing program as compatible with the prohibition of monetary financing of governments.

CONCLUSION

The euro area has both over and underachieved in the last two years. It has put in place policies and mechanisms that nobody would have believed possible before the crisis, such as the ESM and the SSM. At the same time, it has always been a penny short and a minute late, driven by a lack of long term vision and domestic political considerations in different countries that have significantly increased the welfare costs of addressing the problems.

There is now a window of opportunity for the euro area to accelerate the process of achieving a sustainable monetary union. The retreat of market pressures is not a reason to relax, as the euro area remains an imperfect monetary union and normalcy won't be restored unless changes are made. This paper has discussed the three elements that are critical to success: (1) restore political solidarity in the euro area to be able to deliver strong institutions; (2) convincingly end the debate on default and exit and launch a program of eurobonds to provide EMU with a credible risk-free asset, the needed cyclical insurance mechanism, and a fiscal backstop for the banking union, and to make the euro a credible currency in an uncertain world; and (3) refocus cyclical policies, including monetary policy, away from containing moral hazard and towards stabilizing the business cycle and boosting demand in order to contain the large downside risks to inflation that the euro area faces. Supply reforms without a complementary boost to demand are contractionary. And adjustment processes need both; it can't possibly work only with reforms.

Euro area politicians sometimes ask for advice on how to solve the crisis. Here is the answer in a nutshell: Euro area political solidarity must return. There is no such a thing as an optimal currency area. Monetary unions are endogenous, they work if the needed political leadership and cohesion exists so that robust institutions are created. Without it, the euro will not be a credible monetary union, and it will fail to achieve its objectives.

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