HOW TO REFORM THE EU AND EMU*

ABSTRACT

The paper starts from the observation that the theoretical foundations of the EMU are largely outdated and European institutions have shown a number of faults. These can be summarized in the fact that there are frictions at work – which mainly derive from existing national borders – and adjustment issues that are not tackled, at least in a reasonably long period, by the single currency, free markets and constraints on national policies. It then suggests the broad lines along which the EMU could be reformed and indicates different growth and short-term strategies for the institutions as well as macroeconomic and microeconomic policies.

Keywords: Monetary Union, Institutions, Theoretical Foundations, Reforms
JEL Classification: B20, E42, F00

RIASSUNTO

Come riformare l’UE e l’UME

Il lavoro parte dall’osservazione che i fondamenti teorici dell’UME sono del tutto obsoleti e che le istituzioni europee hanno mostrato ampie carenze. Queste possono essere sintetizzate nell’esistenza di frizioni – la cui principale causa è data dal permanenza di confini nazionali – e di problemi di aggiustamento irrisolti, almeno in un ragionevole lungo periodo, da moneta unica, libertà dei mercati e vincoli alle politiche nazionali. Il lavoro suggerisce poi i tratti essenziali di una riforma dell’UME, le diverse strategie di lungo e di breve periodo, nonchè le opportune politiche macro e microeconomiche.

1. INTRODUCTION

The Great recession has shown the invalidity of policies advocated for a long time by pro-market mainstream economics and international organisations as well as the fragility of European institutions, as these are featured by an incomplete currency union, with an ECB – practically

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until recently the only common institution – having inflation as its primary goal and unemployment less of a priority.

The financial crisis has also shown that industrialized countries are not immune from contagion and that in the end international imbalances can have high costs for all countries. Moreover, regional agreements, such as the EMU, do not isolate countries from shocks, but, on the contrary, may exacerbate them if they are not ruled by appropriate institutions and policies. The Great Recession, the wave of immigration and the Covid crisis, with their negative economic and political consequences, could be an incentive to change, but will not necessarily ensure strengthening the EMU governance in order to remove the negative institutional features. In fact, first the Recession has added to the factors determining the general crisis of the project that sustains the Monetary Union:

‘a worsening legitimacy problem, dysfunctional institutions, the limits of collective leadership and, not least, a decision-making system still largely based on the principle of “one-decision-fits-all”’ (Majone, 2014: 211).

This is in clear contrast with the current situation, where

‘the European project has been increasingly associated with crisis and austerity rather than with opportunities and growth’ (Beck, 2017: 22-23).

In addition, on the one hand, the EU has not been able to find a common strategy towards immigration, adding to the demand for closing national borders and to populism; on the other, more recently, the shocking impact of the virus has shown that defect of a common strategy towards it can add to the negative consequences of the infection.

The line of reasoning of this paper is as follows: after having sketched in the next section achievements and shortcomings of the Union, we deal first with theoretical advances that entail the obsolescence of the EMU institutions and policies as well as the need for reforming them (Sections 3 to 6). Three sections follow that indicate some possible meta-objectives of reforms (Sections 7-8) and a new division of tasks between the different levels of European institutions (Section 9). Other specific suggestions on institutional reforms are deferred to Section 10.
2. WHAT HAS WORKED IN THE EMU AND WHAT HAS NOT

One can draw a number of lessons from the experience so far about the Union’s performance. Non-economic benefits in terms of avoiding conflicts between the various countries must be accounted as a possible relevant benefit of the Union\(^1\). However, the deterioration of inter-country relations as an effect of its erroneous design and the way the financial crisis, the immigrant’s policy and the Covid virus have been faced can be of detriment for their long-run development. The recent roots of rising populism and localism – a trend certainly not specific of Europe that is due to various factors, among which neoliberalism - in the EZ derive in particular from the excessive austerity and the double-dip recession, which certainly lead people to seek liberation from ‘euro shackles’ or from ‘the Germans’\(^2\). A contrast had been noticed between the pre- and post-Maastricht periods. In the latter, support for EMU and the EU has dropped as a direct consequence of the austerity imposed by the institutions chosen, as well as, possibly, of the pressure to harmonise or integrate countries’ social security programs. Some authors find a loss of confidence in the EU since 1992, even if still there is support now for the common currency. Europe seems trapped: there is no desire to go backward, no interest in going forward (see also Beck, 2017), but it is economically unsustainable to stay still. However, this may simply be due to the high and uncertain costs of withdrawal. The situation seems to disprove Jean Monnet’s claim according to whom a ‘chain-reaction’ effect would have operated: a crisis would have triggered a jump forward to more integration. Spolaore (2013) suggests reasons that can make Monnet’s prophecy to be overoptimistic.

Passing now to the economic limits of the European construction, the issues are indeed numerous. Here we group them in a short- and a long-run aspect, not excluding the possibility that some issues pertain to both.

In relation to the former, two specific issues should be dealt with: the ways to prevent the next economic crisis in the EMU; the ways to cope with it, if it takes place. For both, desirable and realistic solutions should be compared. Both have to do with the design of European institutions

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\(^1\) One must, however, consider that land grabbing by wars in developed countries may have lost its appeal, because there are other ways to pursue dominance, economic - such as foreign direct investment, export penetration and the like - or political - such as a hegemonic role in regional or other international organisations, which can be instituted rightly for the purpose of controlling other countries’ action.

\(^2\) From this point of view Kaldor was a good prophet already in 1971, when in criticizing the Werner Report he wrote the risk that it is dangerous to believe that a monetary and economic union can precede the political union and that ‘if the creation of a monetary union and the Community control over national budget generates pressures which lead to a breakdown of the whole system it will prevent the development of a political union, not promote it’ (Kaldor, 1971: 206).
(a long-term issue), in addition to the effects of the policies implemented for facing the crisis. As for the long run, the central issue is: why has the Euro-zone grown less than other countries or regions, even before the recent crisis?

Both the short and the long-run issues are tied to the imbalances arising in a monetary union with pronounced asymmetries that have derived from the absence of proper institutions to tackle them. In terms of the long-term performance, asymmetries allowed for uneven growth and nourished these imbalances, which generated or enhanced the conditions for an export-led economy growing in some countries, to the detriment of other member countries, in a generally deflationary environment. This, in turn, led to asymmetric shocks, as an effect of the financial crisis. In fact, Pasimeni (2014) argues that asymmetric shocks can be intrinsic to a monetary union featured by structural divergences, which happens in the absence of a banking union and a mechanism for restructuring unsustainable debts, with a central bank that does not perform the role of a lender of last resort for sovereign institutions. Conceptually, this runs counter the idea of a currency union. Practically, it abolishes automatic and non-automatic stabilizers. Governments are exposed to financial speculation, which leads to sovereign risk premiums and self-fulfilling crisis and debt overhang, thus making it impossible for national states to provide stabilization (De Grauwe and Ji, 2013).

The recent crisis has alerted at least part of the public opinion in the EZ on the need to amend its institutional design. As to this design, the implementation of the need to balance rule-based policymaking with some discretion has turned out to be highly politicised, to the advantage of the most powerful countries, as shown by the experience of the decision to absolve France and Germany for their violation of the Stability and Growth Pact (SGP) in 2003-2004. There is indeed a ‘German problem’ in the design and management of the EZ, which largely derives from the crude version of ordoliberalism adopted especially by the Bundesbank, and the public at large in order to protect Germany’s narrow interests.

As a consequence of the crisis, a kind of inconsistency has emerged rather clearly, implying the necessity to adjust: the final goals of the EZ institutions (in particular with respect to the concept of fairness inspiring them and the cooperative or non-cooperative strategies to implement); the type of architecture governing the Union and the relations between the upper and the state level; macro- and micro-economic policies to make use of.
The path followed until now in the relevant political institutions has pointed to a direction almost opposite to a discussion of the soundness of the EMU institutional architecture, as shown by a few examples. First, the focus of the European Parliament until 2019 has not been on the institutional design, as this issue has often been mixed with, or substituted by, that of national policies. Thus, the issue of prompting further integration has not been on the main agenda and the reform package suggested in the recent years by the EU Commission led to the fiscal compact\(^5\) – almost a transposition of Germany’s ‘debt brake’ (*Schuldenbremse*) – and to an asymmetric Macroeconomic Imbalance Procedure (MIP)\(^4\).

The diagnosis underlying the former is wrong, since in the majority of cases public deficits and debts were not a determinant, but a consequence, of the crisis. And insisting on debt consolidation has at least negative short-run effects. Focus has been on the spending rather than the revenue side, also because this can avoid discussing the issue of tax competition (largely practiced by Northern countries), which has not been addressed until recently. No special allowance is made in country budgets for those public expenditures that tend to raise potential output most, i.e., investment expenditures, which, however, can be cut more easily, as the experience has shown, both in the phase of admission to the Union and after the fiscal compact.

As to external macro imbalances, the asymmetric constraint set for their value has been justified on the ground that deficits are worse than surpluses, which also implies that the burden for adjustment should be on deficit countries more than on surplus countries\(^5\). Certainly, both surpluses and deficits are the effect of a different price and demand dynamics in the various countries (a consequence of the existing asymmetries), but to cope with this the Macroeconomic Dialogue could be strengthened and expanded to help coordinate adjustments of nominal wage and price trends as well as aggregate demand by surplus countries. According to Blanchard and Milesi-Ferretti (2011), these countries should be obliged to expand their economies and reduce their surplus. This would not be so much on the ground of a repeated-game argument, according to which a similar rule could also benefit them in the future. In fact, this argument appears less credible to those in the surplus countries who firmly believe in their ability to continue along the

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\(^3\) This prohibits structural deficits higher than 0.5% of GDP, as measured over the business cycle, and prescribes reductions of the debt/GDP ratio each year by at least 1/20\(^\text{th}\) of the excess over 60%.

\(^4\) MIP requires member countries to comply to the prescriptions of the SGP and to keep their current account deficits below 4% of GDP on a 3 year average, whereas the boundary for surpluses is 6%. It is then clear that it has been tailored to the German and Dutch interests.

\(^5\) In addition, it is not even respected, as in practice current account surpluses (e.g., Germany’s) go beyond the limit set by the MIP.
current path. Instead, more credible appears the argument that running a current account surplus derives from beggar-thy-neighbour strategies. At a more pragmatic level, expansion of their domestic demand and wages could be beneficial for growth not only to the rest of the world, but also to countries with a current account surplus, as expansion abroad would translate to some extent into higher demand for their goods. Especially so, we could add, if other countries could retaliate in some way. More generally, coordination of national macroeconomic policies should be improved, as required by the Maastricht Treaty⁶.


Many economists and observers warned about the fragility or the limits of the EMU project. Their number decreased as the Union proceeded and seemed to gain success. However, the theoretical bases of the project soon revealed their weakness. More than a decade ago, Alan Blinder claimed that

‘a sharp revision of the naively optimistic views (about the capacity of economic policy to control the economy) held by some economists circa 1966 was called for. But … the pendulum may have swung just a bit too far’ (Blinder, 2004: 26),

producing similar naively optimistic views about the virtues of markets and asking for restraining government action.

Blinder’s words are even more actual nowadays as economic theory has further questioned the system of analytical conclusions and beliefs that had emerged in the twenty years or so after 1966, a system that, however, still retains some assumptions that led to the propositions featuring that credo. Three decades later, Rip van Winkle’s⁷ faith in the credo would again be crowded out by the analytical developments (and some empirical findings) intervened in these years. Think of:

- the limitations re-emerged in the functioning of markets, especially capital markets, with specific reference to: herd behaviour; realization of conditions subject to which freedom of

⁶ In a demand-oriented model Thirlwall (2007) argues that balance of payments imbalances and slow growth can be alleviated by fiscal policy as a compensatory mechanism.

⁷ Rip van Winkle is the character created by Washington Irvin and evoked by Gordon (1976). After sleeping for twenty-years he woke up in the republican America and made a terrible ‘environmental’ mistake, by declaring himself a devote subject of King George III.
capital movements and the mechanism of risk sharing can be justified, mainly equal tax treatment of capital across countries, adequate information available to investors to avoid herd behavior, existence of well-regulated capital markets;

- the limited practical relevance of the surprise effect, recognized by Lucas (1996) himself;

- the disproval of the Lucas critique, e.g., with reference to changes in structural parameters as a consequence of a change in policy rules;

- the irrelevance of many critiques to the ‘classical’ theory of economic policy (in particular, to Tinbergen’s ‘golden rule’ about controlling the economy) based on rational expectations (REs) when the policymaker has a sufficient number of instruments available to pursue his targets, as he can make use of appropriate announcements of future policies and exploit REs in order to pursue his targets in a shorter period of time (Acocella et al., 2013);

- the theoretical and practical limits to time inconsistency - when policymakers have enough instruments - and thus to related prescriptions of the monetary and fiscal policy rules that should replace discretionary action (Acocella et al., 2013: ch.11);

- existence of a long-run non vertical Phillips curve (Hughes Hallett, 2000, Acocella et al., 2013);

- the need for a more active fiscal policy and regulation (especially of financial markets and institutions) once some unrealistic assumptions of current models are ruled out⁸;

- critique by Posen (1994) and Hayo (1998) of the arguments put forward by Rogoff (1985) in favour of political independence of central banks;

- sub-optimality of a conservative central bank in a monetary union with active trade unions, but benefits from fiscal coordination when a conservative central bank operates (Acocella et al., 2007);

- critique of the Friedman rule and need for an inflation target well above zero (Di Bartolomeo et al., 2015) when due account is taken of the difference between the effects of public transfers and public consumption on consumer behaviour;

- empirical findings suggesting that: 1. reputation effects of tying one’s hand through fixed exchange rates can be rather limited, whereas credibility depends on country policies and

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⁸ We refer to the assumptions leading to full inter-temporal consumption smoothing – such as perfect foresight or REs, infinitely-living agents, absence of liquidity constraints, etc. - and limiting the effectiveness of fiscal policy. As to the possible negative impact on real activity of imperfections in financial markets, see, e.g., Greenwald and Stiglitz (1988).

Europe and the US have slowly moved to introduce tough regulation in this field. Remarkable is the new position of the IMF, which now advocates exceptional (even if limited) direct controls of capital movements, reversing the pro-free market position adopted in the previous 40 years (IMF, 2012).
‘fundamentals’; however, in the case of Greece, credibility soon emerged as a result of its participation to the EMU and the anti-inflationary attitude of the ECB (with spreads significantly below those that would be predicted by fundamentals), whereas after May 2010 actual spreads have exceeded those predicted by some 400 basis points; this makes it to doubt the ability of financial markets to make correct forecasts according to fundamentals and to be ‘wardens’ of a proper policy conduct; 2. countries that adopt inflation targeting have not attained better monetary policy performance relative to a control group of highly successful non-inflation targeters;

- recent analytical developments about the validity of the Optimal Currency Area (OCA) impinging on the overall foundations of European institutions. We have already said that the EMU, as such, does not respect the prescriptions of this theory. Whether or not the Union designers were conscious of this, some policies (mainly in terms of prescriptions to the national policymakers) have been implemented based on marginal adaptation of labour and product markets to the conditions prescribed for the existence of an OCA.

We will be selective and illustrate only some of these developments in the next sections.

4. THE NEED FOR REVISITING THE INFLATION TARGET

With specific reference to the optimality of the Friedman rule and thus to the very foundations of the ECB statute, consider a standard NK macro-model characterized by price stickiness (calling for zero inflation), augmented with transaction costs (calling for deflation, according to the Friedman rule) and tax distortions to finance public consumption expenditures set at 20% of GDP (calling for positive inflation according to Phelps’s argument). In this model the optimal inflation rate is negative, but close to zero. Increases in public expenditures lead to significant increases in optimal inflation only for implausibly high levels of public spending (Schmitt-Grohé and Uribe, 2004). The rising labor supply increases the tax base and makes an increase in the distortionary tax rate unnecessary. However, if public transfers are also considered in addition to public consumption expenditures, conclusions change. Increasing these on the top of the 20% public consumption expenditures (that indicate the baseline calibration) pushes optimal inflation remarkably up. With the same ratio of public consumption to GDP (20%), but for values of public transfers to GDP of 10-15%, an inflation target between 2% and 4% (rather than price stability) becomes optimal, as shown in figure 1. In this figure the inflation rates and the
amount of expenditures are indicated, respectively on the vertical and horizontal axis. Along the abscissa SGU stands for Schmitt-Grohé, Uribe. The reason for this outcome is simply that transfers have a different impact on tax and inflation revenues and there are thus different incentives for using taxes or inflation to finance them. In fact, as long as public expenditures increase, private consumption declines and labor supply increases, which raises the tax base and then also taxes, reducing the incentive to use inflation as a tax or to increase in the distortionary tax rate. By contrast, transfers have no impact on overall consumption and labour supply and thus do not favour ordinary tax financing of public expenditure vis-à-vis an inflation tax (Di Bartolomeo et al., 2015).

**FIGURE 1 - Optimal Inflation Rates with Public Transfers or Public Consumption**

![Graph showing optimal inflation rates with public transfers or public consumption](image)

*Source: Di Bartolomeo et al., 2015.*

5. FISCAL MULTIPLIERS, CONSOLIDATION AND EUROPEAN INSTITUTIONS

5.1. The Issue of Multipliers and Fiscal Policy

The initial fiscal institutional set up of the EMU assumed ineffectiveness or low effectiveness of fiscal policy. This had an influence on the management of the sovereign crisis⁹. More recently, the fiscal compact has followed the same route and has certainly lagged the recovery from the crisis and negatively affected reduction of the public debt. This section deals with the issue of multipliers. We defer to the next Section discussion of the consequences of prescribing fiscal consolidation by contractionary policies.

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⁹Think of the conditions imposed on countries in need of financial assistance by the EMU and the IMF.
Doubts with respect to some tenets of the assertion of very low spending and tax multipliers were first raised by Blanchard and Perotti (2002), who gave a substantially Keynesian answer to the issue of the effects of the tax increases and expenditure cuts needed for consolidation. In fact, they found that the former have a contractionary effect, while the latter are expansionary, thus disproving the doctrine of expansionary austerity. The authors did not engage in a discussion about expansionary debt consolidation strategies, but, accepting their arguments, one could hardly assert that a policy of expenditure reductions and (to a less extent) of tax increases, while certainly contributing to the reduction of the numerator of the debt/GDP ratio, would give an impulse to the denominator. Instead, their findings might support a Keynesian-type attitude of debt consolidation not based on a budget contraction, at least in so far as the direct effects on income are concerned.

Again, of specific relevance are some analyses that take account of open economies (in some cases the EMU) and spillover effects, which have been quantified by many authors. Beetsma et al. (2006) found that on average a public spending increase (tax reduction) equal to 1% of GDP implies 2.3% (0.6%) more foreign imports over the first two years. If Germany initiates such budget change, the effect on the GDP of its trading partners is 0.23% (0.06%) over the first two years. These figures are likely to indicate lower bounds for the effects that will actually occur. Beetsma et al. (2008) found that a 1% public spending impulse produces a 1.2% output rise on impact and a 1.6% peak response of output. In addition, rising imports and falling exports together produce an impact fall in the trade balance as a ratio of GDP of 0.5% and a peak fall of 0.8%. The public budget moves into a deficit of 0.7% of GDP on impact. Similar results are in Beetsman and Giuliodori’s (2011) estimation of the multiplier of government purchases on income in open European economies, which is higher than 1 on average in the short- to medium-run. The public and trade balance deteriorate. Existence of leakages strengthens the rationale for a concerted fiscal expansion between European countries and, by contrast, implies that decisions to introduce fiscal discipline – either independently decided by a country or imposed by some common rule – have cumulative negative effects that may impair reaching the target of a reduction in the debt/GDP ratio throughout the Union.

Recent analyses have shown that the value of multipliers is strictly dependent on the time of reference of the effects as well as on the state of the economy: in particular, the timing of
consolidation policies (i.e., whether they are short- or long-term), the monetary policy stance, the expansionary or contractionary nature of budget policies of other countries. Fiscal consolidation is likely to be beneficial over the long-term, but in the short-term it could be dangerous, in particular if the consolidation is not smooth or the interest rates are near zero (as monetary policy has little room for partially accommodating its deflationary effects) or, finally, there is a low likelihood of a currency depreciation and the policies of other countries are less expansionary. More generally, fiscal multipliers are shown to be asymmetric and regime-dependent, ‘being stronger in recessions than in expansions, in particular in presence of financial market stress, so that contractionary effects can become very severe when fiscal consolidations are pursued’ (Semmler and Semmler, 2013: 2)\(^{10}\).

5.2. Institutions and Policies in Time of Crisis: Short- and Long-Run Effects of Fiscal Consolidation

As said, the low value of multipliers in open economies strengthens the rationale behind a fiscal expansion concerted among European countries. By contrast, it implies that decisions to introduce fiscal discipline – either decentralized or imposed by some common rule such as the SGP - have cumulative negative effects that may impair reaching the target of a reduction in the deficit and debt/GDP ratios, at least in the short run.

In addition, the foundations of the SGP (and of the fiscal compact) are weakened when one reconsiders the relationship between fiscal and monetary action in the Union in the light of progress in theoretical findings, adding to, and confirming, the practical failures of the EMU institutions and policies to face the crisis.

Variability and regime-dependency of multipliers make it necessary to distinguish between the different possible aims of fiscal action. If the aim is that of expanding the economy, a short-run multiplier larger than one is enough to suggest the need for an expansionary fiscal action during a crisis, whereas fiscal consolidation is self-defeating. This should have no negative effect on the deficit- and debt-to-GDP ratios, in the short run at least. On the contrary, the effect on these should be positive. Thus, the ‘new’ conventional wisdom of an expansionary fiscal consolidation (the doctrine of expansionary austerity) that inspired a number of policy attitudes and

\(^{10}\) Both the asymmetry of fiscal policy according to the regime and the need for concerted action by European countries are stressed by Blanchard and Leigh (2013).
interventions in the last couple of decades, from Japan in 1996 to the EMU more recently, has been disproved. In the words of H. Rey, ‘the austerity policies put in place to deal with the crisis are self-defeating. More fiscal austerity, and especially the generalized, front-loaded fiscal austerity undertaken in a number of the peripheral countries, means weaker economies and possibly increases rather than decreases in debt-to-GDP ratios’ (Rey, 2012: 221). In addition, in the short run fiscal consolidations in one country have negative spillover effects, in addition to the negative impact on the GDP of that country. A fiscal consolidation of the order of 1% of GDP in 10 EZ countries can reduce the combined output by 0.6%, out of which half is driven by indirect effects from fiscal spillovers.

However, a high value of short-run multipliers does not guarantee that the effect of fiscal expansion is positive also in the long run. In this context, a necessary and sufficient condition for an expansionary fiscal action to lead to a reduced debt/GDP ratio in the long run is that the long-run multiplier is higher than the inverse of this ratio (Cozzi, 2013, Nuti, 2013). This is especially good news for highly indebted countries, as this condition widens the range of the values of multipliers that make for expansionary fiscal policy to reduce the debt/GDP ratio. For a country such as Italy, a value higher than .7 would be enough to suggest a fiscal expansionary action as an instrument of fiscal ‘consolidation’. In any case, one must be sure that the multiplier considered is a long-run, not a short-run, one. This condition may not be satisfied for Italy, and – changing what needs to be changed - for other European countries as well. In case, a two-stage exit strategy could be followed within the EMU. In the first stage, a coordinated fiscal stimulus could raise the Union’s GDP and alleviate the negative effects of the crisis. As the positive effects of the stimulus tend to fade away, a phase of smooth consolidation of public debt could follow, either through more traditional policies or by revising other aspects of the EMU institutional set-up.

6. THE THEORY OF OPTIMUM CURRENCY AREAS, THE FOUNDATIONS OF THE EMU AND THE REASONS FOR REDUCED SUPPORT IN IT

The OCA theory originated with Mundell (1961), who stated the conditions for its smooth functioning and viability. With fixed exchange rates, internal balance can be obtained only when borders are redrawn in a way that within them labour mobility or price and wage flexibility are ensured. From this point of view, as many observed at the time, the Euro-zone did not possess
the necessary pre-requisites of an OCA. Some authors held different ideas on the conditions for an OCA and Mundell himself changed his assessment of the EZ as being an OCA.

However, the conclusion of the long debate on OCA can be taken as follows. In order to get the desired economic adjustment, careful design of the currency area is needed. Money alone cannot ensure the needed adjustment and the currency area should be only part of a political union and all the policy tools, both macroeconomic and microeconomic, should be at hand at the European level. Mario Draghi contends the view that the EZ is not a political union (Draghi, 2014). It seems to us that this position has a feeble foundation. It is true that a number of decisions in the Monetary Union – such as those on admittance to the EZ and appointments - are of a political nature. However, the issues of democratic accountability and parliamentary control are largely outside the EMU institutions.

In the historical experience until now, cases of a monetary union with no political union are limited to very specific situations, all characterized by economic (and political) disparity of power, like those of very small countries or former colonies, which tie their currency to that of a larger country or to the home country’s (Fratianni, 1994).

‘Political integration ... appears as a necessary and inescapable accompaniment of monetary integration’, according to Bordo and James (2006: 400).

All the findings mentioned in the present and the previous three sections have important consequences for our topic, in so far as both institutional and short run policy implications are concerned. We will briefly deal with both in the next section. Here we would finally underline that all these findings lay the foundations for a modern revaluation of Keynesian theory and its application to the EMU, even if this latter consequence would not be an easy task. In fact, differently from the US, where at least some improvements have been introduced, neither the theoretical progress of the 1990s and the following decades nor the depth of the crisis that has hit the EMU countries have produced a substantial change in the institutional architecture of

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11 He says: ‘A common misconception about the European Union – and the Eurozone – is that they are economic unions without underlying political union. This reflects a deep misunderstanding of what economic union means: it is by nature political ... Fiat money is a political construct and monetary union could not operate without adequate political structures’.
EMU and current policy attitudes. The deflationary bias of the former has even been stressed by the fiscal compact\textsuperscript{12}.

7. FOR A FAIRER EMU AT THE SERVICE OF CITIZENS AND NOT PRONE TO FINANCIAL CRISES AND STAGNATION

The design of the Union has proved to be conducive to divergence of the strategies of growth of the different countries as well as to financial speculation, crisis and deflation. According to Bibow (2007), the Maastricht regime was built in a way to foster instability itself, as it features powerful built-in destabilizers nourishing divergences and fragility. These outcomes are unfair, as they not only add to inequality between countries, but also negatively influence static and dynamic efficiency. Proposals for re-building the system to make it exempt from such faults should start from these needs\textsuperscript{13}.

Thus, the Euro-area’s institutional architecture should be designed anew, taking account of the novelties in economic analysis and the (scarce) achievements of the Union in the last decades. Mostly, a new contract between the member countries should be drafted, as new goals – or a redefinition of the previous goals and/or rebalance of their relative weights – must be agreed upon. If these new targets are accepted, with a reduction in the relevance of monetary stability, a higher weight on employment, growth, financial stability and fairness, reasoning on the most appropriate reforms and instruments is easier.

More generally, a complete and satisfying re-design would require:

- Institutional reforms putting less emphasis on the virtues of the operation of markets and the common currency.
- Institutions and policies allowing for the emergence of the conditions that ensure the validity of the OCA. They must be created not so much by states in terms of labour market flexibility (especially in times of crisis), but at the EMU level. This must be done by completing the union with federal institutions and policies that would make the EMU– in

\textsuperscript{12} From this point of view, Rip van Winkle would certainly not be hit by the institutional changes introduced in the EMU. He could still declare himself a convinced supporter of the theories asserted by Friedman or Barro, Lucas, Sargent Wallace, without repeating an ‘environmental’ mistake.

\textsuperscript{13} Milone (2017) covers this issue, mainly by reviewing an extensive literature and dealing with problems often debated within public organizations such as the IMF and OECD. He refers specifically to reforms that appear necessary after the crisis, which to a large extent has stressed some urgencies already evident before. Necessary changes differ among the various countries, but should aim at increasing both static and dynamic efficiency, reducing excessive income inequality and reforming structural political institutions.
addition to ensuring more powerful fiscal action to combat depressions - to eventually fit the conditions for an OCA, such as a fiscal union and the central bank as a lender of last resort for governments.

- A change in the ECB goals and statute, starting – as said – from the redefinition of the inflation target, to set a higher ceiling, downgrading the predominant role of anti-inflationary policies in a way to leave more room for the employment and financial stability goals and, in addition, giving it the possibility of serving the government objectives. The model of the Bank of England could be followed, with no political independence and the goals of inflation, set, in our case, on an annual basis by the European Commission.

- An increased role of other common policies, in particular fiscal policy. The common budget should thus be increased in order to permit anti-cyclical action as well as to design common investment strategies to foster a uniform growth throughout the Union. The budget should perform a stabilization role proper (for symmetric shocks) and an insurance function (for asymmetric shocks). A common welfare system and other microeconomic policies should be devised to make structural adjustments of the economies possible in the direction of a higher efficiency and equity. This, again, requires an increase in the size of the common budget. Macroeconomic policies to reduce the existing asymmetric actions foreseen in the macroeconomic imbalance procedure devised in 2011 should also be enacted. The fiscal policy rules should drastically be changed, by introducing the golden rule of public finance.

- Introduction of a system of incentives to change, as the one suggested by Steinbach (2016). This author proposes to redesign treaties and statutes by introducing either contractual agreements between the EU and individual Member States, underpinned by financial support offering an incentive, or mutual agreements concluded between Member States for the implementation of structural reforms. According to Belke (2016), the Excessive Deficit Procedure does not offer incentives and sanctions to countries better than those of market-based interest rates. It must be added that incentives and sanctions should be referred also to surplus countries. Some studies have even found a negative effect on yield spreads of announcements of excessive debt.

- Enhancement of structural policies, avoidance of opposing strategies of growth by member countries and reduction of the current account imbalances permitted.

Redesign of the EZ along these lines would not be an easy task. Political objections would be numerous to both their basic tenets and their specific structure and features. Recently, timid
openings for a change of the current structure have emerged. These are contained in the
documents, speeches and declarations of the representatives of the ECB and the European
Commission (Juncker Plan) and are proved to some extent by the practical implementation of
some innovative policies, as in the case of unconventional monetary policies and a banking
union. Most likely, the necessity of the reforms outlined above could be more widely recognized
if reforms were diluted through time and a rather long path to their final realization were
devised. This implies that their main body would be implemented only with the next generation
or two. However, it would be important to realize their need and agree on a timetable right now.

8. A COMMON GROWTH STRATEGY INSTEAD OF COMPETITIVE STRATEGIES BY DIFFERENT COUNTRIES

Various types of imbalances within the Union have derived from the adoption of different
strategies of growth (export-led or credit-led) as between the member countries. This dual
strategy had a negative influence on imbalances and implied low growth and the possibility of
crises in the Union as a whole. In fact, some countries (mainly Germany) lowered their real
wages and aimed at creating an export-led economy. Lower wages also lowered their prices.
Other countries (mainly Southern countries), having a higher price level (and thus a lower real
interest rate), found it profitable to import capital from countries with a lower level of prices
which could thus enjoy higher real interest rates. They pursued a credit-led growth. The effects
were then a current account surplus and a capital account deficit in low-wage countries and, vice
versa, a current deficit and capital account surplus in peripheral countries. When the financial
crisis began, there was a reversal of capital movements, which caused bank difficulties that could
only be overcome by public lending to these institutions. To avoid these negative effects a
program of reconstruction and redesign of the EZ institutions should be devised from a short-
term, a medium-term and a long-term perspective.

In the short run, the issue is to prevent a new financial crisis and stabilize peripheral economies.
This requires a mechanism like the one suggested by Bofinger (2016) and others, as the
mechanisms provided by the ECB might be insufficient to this end in the event of insolvency of a
(rather) big country. Common policies of relief, in particular directed to the financial sector,
together with its regulation, are required.

In the medium term, internal imbalances in both the current account and the public sector
should be reduced. As to the current account, the MIP should be amended, by making imbalances symmetric and reducing their size. All policies on the side of costs and demand not shared with other member countries that trigger current account surpluses for one country are beggar-thy-neighbor and should then be avoided, also because the associated capital account surpluses impress a short-run expansionary impulse to other countries, leading there to bubbles and distortions in the structure of production. Rebalancing can indeed take place through either inflation and expansion of demand in the core or deflation and contraction in the periphery or both. This would have different implications on unemployment, which would rise in the periphery in case of deflation of wages and prices, whereas it would shrink with expansionary policies in the core. Expansion by Germany and other surplus countries might imply a public deficit and an increase in public debt there, but would allow a reduction in the deficit and public debt of other countries. In addition, a cut in demand in peripheral countries usually implies a cut in public investment, which worsens the gap in the productivity trend between the core and the periphery. It should then be avoided. The issue of excessive outstanding debt should be faced in the medium-long run through a redefinition of the EMU institutions (next section) and policies based on different goals and attitudes of monetary and fiscal policy, as indicated in the next sections.

In the long-term, a new strategy should be implemented, based on a common program of investment and growth. However, this should be devised – or, at least, outlined – soon, in order to inspire short- and medium-run interventions, recognizing that

‘social investment can promote demand in a manner that sustains rather than drains the private sector’ (Garofoli and Holland, 2017: 4).

The common growth strategy could be a way to address not only phenomena, but their underlying causes, which really derive from the past divergent growth strategies. In addition, it should be decided jointly. This common strategy should allow getting rid of the numerous fiscal rules and lead to joint decisions, once its guidelines have commonly been accepted. It could be

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14 The rise could also benefit Germany. In fact, the ratio of public investment to GDP in this country is a little higher that 2%, well below the EZ average, close to 3%, and the country badly needs public intervention for coping with decaying infrastructures. One could add that also the private component of the formation of German capital stock has shown a very low growth profile, in comparison to other European countries.
supported by Eurobonds, an initiative usually ascribed to Jacques Delors\textsuperscript{15} - i.e., issuance of ‘Union Bonds’ to finance infrastructure investment. They could be issued not only in order to mutualise part of the outstanding debt and stabilize financial markets, but also to complement expansionary fiscal policy. All new EZ sovereign borrowing should be in the form of jointly guaranteed Eurobonds or, more cautiously, the EU guarantee could be limited, in order to induce the government to reduce debt, and made conditional on the implementation of sufficient structural reformism, privatisations, opening up of product markets, more flexible labour markets and increased efficiency for public good provision. Finally, new financial instruments especially dedicated to social infrastructure, such as social bonds, could be issued in order to finance EU-wide social investments. In quantitative terms, a recent analysis re-establishes a number of classic arguments in favour of a EA-wide public investment project\textsuperscript{16}, as it finds that this would have a multiplier close to 2 (higher than 3) in case of a FG assurance offered on the short- (long-)run interest rate. The multiplier would be higher (in the short run) in case of investment for productive goods and debt- (rather than tax-)financed.

In practice, in November 2012 a framework for the issuance of ‘Project bonds’ has been approved. These are a financial instrument launched by the European Commission and the European Investment Bank as an innovative response to the needs for investment in large EU infrastructure projects, as a part of the Europe 2020 Project. ‘Stability Eurobonds’ have been proposed in order to reduce and share the default risk and the EU Commission has also suggested some guidelines for their introduction.

9. THE EMU, THE STATE AND THE LOCAL LEVEL: MORE, STRONGER (AND MORE ACTIVE) COMMON INSTITUTIONS OR INSTITUTIONAL COMPETITION?

Institutional redesign and reforms of the EZ have long been debated, especially after the Great Recession, also in the light of the outcomes produced by those implemented more recently, such as the MIP, the fiscal compact and the banking union.

\textsuperscript{15} The proposal had already been suggested before, but received its official christening by the Delors Commission’s White Paper (Delors Commission, 1993).

\textsuperscript{16} The study warns that the literature leads to mixed conclusions on the effectiveness of public investment, with, e.g., the International Monetary Fund (2014) in favour and Garin (2016) against.
It has been noted that power and competencies have spread across multiple centres of governance. On the one hand, the legal impact on national and local authorities of decisions taken at the EU level has risen continually, mainly for microeconomic policies. The EU level has to some extent increased its role in imposing its directives on the lower levels. A lesser role has been played by the EU level in enlarging the scope of its direct macroeconomic intervention. The motto guiding this level seems to have been: not acting, but forcing to act (by imposing constraints). On the other hand, the European Committee of the Regions has been empowered with some responsibilities and dialogues directly with the EU level, adding to the shift of balances toward this third level of governance. We do not discuss this level of governance further and prefer to concentrate on the relationship between the EU and the country level, with the latter still having a dominant role in most fields. From our previous analysis the need arises of discussing this state of affairs and possibly suggesting changes, in different fields.

From some points of view, we could say that the current state of the EU institutions still evokes an old debate which arose at the beginning of the European construction: whether and how much to harmonise or to let competition play between different national institutions. Certainly, that debate must be updated in the light of experience, particularly after the Great Recession.

The current debate reflects partly the positions of the different countries about the relative roles of the two EU levels of government and partly ideological disputes and partisanship of the various government officials and the citizens. The ‘Euro-marketeer’ or ‘Euro-socialist’ role of EU top officials in the contention about the direction of EU policy is testified by the results of an empirical survey of their opinions offered by Hooghe (2000). Left-wing (right-wing) oriented officials are more (less) in favour of regulating the EU economy. According to these results, political orientation is more important than the country orientation which would tend to pursue of national benefits when bargaining about EU policy.

Numerous benefits and costs arise from each level of governance. Rodrik (2013) and others present a detailed list of both, but in some cases the same issue can be seen from different points of view. Let us consider fairness. One can say that the ‘level playing field’ adds to it. However, one could also hold that different institutions should be maintained, if they correspond to
differences in needs and preferences\textsuperscript{17}. In addition, one can say that on the side of harmonisation there are the economies of scale that can be gained, deriving from cuts in the transaction costs implied by diversity. An objection to this is that these economies favor big companies and monopoly\textsuperscript{18} and that – echoing the argument already presented - rule diversity corresponds to different preferences inherited from history. Confidence can however be put on the possibility that these preferences can evolve, as diversity can make people and governments learn from different experiences. Similarly, in more specific fields, such as tax harmonisation, there are gains in that this could avoid a race to the bottom of the state tasks (in particular of the welfare state), due to the competition, but there would also be costs, in neglecting the preferences of citizens in some countries for low state involvement.

As a general conclusion, institutional reforms are necessary in order to promote economic convergence. In other terms, the former are in many ways (but not always) a precondition for the latter. In general, the best institutional solution is likely to be an intermediate one between differentiation and harmonisation (see, e.g., Rodrik, 2013). With specific reference to the EMU, most of all it is important to change some existing links between the EU and the country level. In fact, as noted recently by Papaioannou (2016: 222),

‘it is hard to imagine an “ever closer” union in Europe with the currently large institutional gap in courts, public administration, red tape, corruption, and fiscal capacity. The asymmetries in national institutions across the EZ are destabilising both because they impede real economic convergence and because EU-EZ policies depend crucially on local institutional structures, disparities and imbalances.’

Possibly, peripheral countries should be helped in reforming their malfunctioning institutions. The Great Recession has somewhat changed the picture of the best solution with respect to the one that could be devised before. In fact, it has indicated the need for some policies to be implemented at the EU level – such as active fiscal coordination and/or raising the size of the EU

\textsuperscript{17} It is often the action of firms that pushes towards (somewhat artificial) differentiation of technical specifications of the product features. Take, for instance, the case of petrol’s diversity. However, in most cases consumer preferences are precisely towards harmonised rules, at least in the area of consumer goods. More generally, Sen (2009: 143) notes: ‘There is something of a tyranny of ideas in seeing the political divisions of states (primarily, national states) as being, in some way, fundamental, and in seeing them not only as practical constraints to be addressed, but as divisions of basic significance in ethics and political philosophy’.  

\textsuperscript{18} This is not true in at least one area. Think of tax-treatment diversity. This is fundamentally unfair, as it favours big transnational companies and richer people, which can devise tax-elusive solutions. But also in other fields, such as environment or technical standards, smaller firms can support too high costs to face diversity.
budget, issuing Eurobonds or Union bonds or similar types of bonds\textsuperscript{19} – which should enter the stage. At the same time, common regulation, especially in the financial field, creation of a common social welfare system and structural intervention should be strengthened.

A more complete perspective can be gained if, in addition to discussing harmonisation vs. institutional competition, we deal with multi-level governance. In fact, the different levels can be complementary: there can be areas where decisions ought to be taken at the EU level and others where a lower level is more productive. Or, for the same area some decisions – possibly, on criteria and lines of conduct to follow – should be taken at the former level, while others should be decentralized.

10. OTHER REFORMS

Among the most needed reforms, some are crucial. One refers to current account imbalances, which need to be limited and made symmetric. Another should be requiring also symmetric duties to limit public deficits, introducing a duty to limit also surpluses\textsuperscript{20}, which requires departing from the policy most favoured by some researchers and countries, based on an internal devaluation strategy in peripheral countries that implies deflation of wages and prices. In fact, apart from considerations of fairness, this might not be an easy way out. The simple prospect of price deflation would create a ‘fundamental contradiction’ that makes the internal devaluation strategy impossible or very hard to pursue as the debt burden becomes heavier, which requires further cutting public spending and increasing taxes to service public debt. Banks can be in a situation similar to the government. One way out would be debt haircut and restructuring of debt, e.g., conversion of bank debts into equity or their writing off, if banks are insolvent. Similar haircuts or restructuring or a prolongation of maturity might be necessary for public debt. However, also this route would not be an easy one. As an effect of such operations being implemented in a country, a contagion to other countries being in a similar position – and, at the same time, a flight to ‘quality’ or to ‘safety’ towards sound countries – could ensue. While contagion is certainly dangerous for the countries interested, flight to quality would mainly

\textsuperscript{19} EuroUnionBonds have been suggested by Prodi and Quadrio Curzio (2011). These should be issued by a European Financial Fund, which would receive gold reserves, bonds and shares conferred by member states. Quadrio Curzio had also made a number of proposals on this topic and Quadrio Curzio (2011) suggests a type of bonds slightly different from the EuroUnionBonds.

\textsuperscript{20} German leaders should convince their constituents that these policies can be in their longer-run interests. In fact, these could even be a premise to more cooperative policies, leading to completion of the union and more rapid and uniform growth.
benefit the country towards which investors direct their capital, by relieving its public debt financing. This country, however, could be endangered by the reduction of exports to the country experiencing a crisis. Finally, the most important reform, now that macro-prudential policy has been implemented at the EU level, is that of fiscal policy, as sketched in the previous section.

Some steps for pursuing over the next years not only economic and political goals, but also democratic accountability and effective governance are indicated in the paper recently prepared by the EU Commission (EU Commission, 2017). In addition to them, the European Commission could be elected either indirectly via the European Parliament or directly by the EU citizens. As to the ECB, in confirming its independence one can think of subjecting it to oversight, either by the EU Parliament and the Eurogroup and/or by national parliaments of member countries. Finally, bailout funds and austerity programs can be subject to approval and scrutiny by national parliaments or referendums ratifying them. A solution to the democratic deficit would thus require not only a change in the orientation and the modes of current decisions, but also and mainly a radical change in the institutional setting of the EMU. This would be difficult to implement in the absence of a process of

‘re-envisioning of the EU’s socio-economic policy, ... in concert with the people, through pluralist processes, and by the representatives of the people at both national and EU level, through more politics ... In addition to the political and economic reforms, ... the EU needs to re-envision its identity and change its decision rules ... [in particular] by eliminating the unanimity rule’ (Schmidt, 2009: 38).

Most of these proposals have some likelihood to be implemented only if they are backed by enough political support from the member countries. In particular, this should be the case, on the one hand, of some core countries (the ‘New Hanseatic’ league, in addition to Germany), which should converge to a common strategy not focused on export-led growth and fiscal discipline, and, on the other, of peripheral countries, which must not only implement necessary structural reforms, but also get rid of spreading populistic orientations.
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