

Why further integration is the wrong answer to the EMU's problems: the case for a decentralised fiscal stimulus

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Abstract

The global financial crisis exposed the euro's original sin of depriving member states of their fiscal autonomy without transferring this spending power to a higher authority. This left member states utterly defenceless in the face of economic crises, as the 2008 booms-gone-bust would make amply clear. Yet, the crisis didn't bring about, as one may have expected, a loosening of the budgetary constraints imposed on individual governments (thus allowing them to pursue counter-cyclical stimulus policies) or by moving towards a fully-fledged fiscal union (or at least a modicum of economic coordination between surplus and deficit countries). Instead, we got the worst of both worlds: further restrictions on the fiscal autonomy of member states and no increase in the fiscal capacity at the federal level in Europe. The result, predicted by many non-mainstream economists, has been a deeper and more prolonged crisis than that of the 1930s (resulting in all-out humanitarian crises in a number of countries). There are now a number of proposals on the table – most notably the European Council's 2012 *Towards a Genuine EMU*, the European Commission's 2015 *Completing Europe's Economic and Monetary Union* and several reports by the European Parliament – that propose to address this structural flaw by creating a fiscal and political union. This would be a welcome development, were it not for the fact that the 'new eurozone' envisioned by these proposals falls very short of the kind of fiscal and political union advocated by progressive federalists and raises a number of worrying issues from both political and economic standpoints. Politically, it raises serious problems of accountability and democratic scrutiny and participation. Economically, it doesn't foresee any real spending powers for this new supranational authority (which would require the ability of EMU itself to run budget deficits with the support of the ECB, fiscal transfers from richer to poorer countries, etc.), and is likely to revolve first and foremost around the creation of a European budget commissioner with the power to reject national budgets. It's not hard to see why such a development would be politically unsustainable, further exacerbating the union's centrifugal tendencies. At the same time, we have to acknowledge that the political conditions are not ripe for a move towards a fully-fledged fiscal and political union, along the lines advocated by progressive federalists. So – barring a break-up scenario – what options does that leave us within the context of the EMU? This paper argues that the only sensible solution in the short-medium term is to acknowledge that a number of eurozone countries, especially those of the periphery, are in balance sheet recession and in desperate need of a fiscal stimulus, and should thus be allowed to pursue much more expansionary fiscal policies until private sector balance sheets are repaired. Such a solution would have a number of economic and political benefits: not only would it have an immediate macroeconomic impact (thus leading to increased debt sustainability), it would also engender a more positive attitude towards European institutions (which would no longer be seen simply as enforcers of watertight fiscal rules), thus slowly re-creating the conditions – in the longer run – for moving towards a true solidarity-based and democratic fiscal and political union.

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Introduction

The global financial crisis has exposed the deep flaws of the euro, and particularly Maastricht's original sin: to have deprived member states of their fiscal autonomy – by taking away their power to issue money and by imposing strict (and totally arbitrary) limits on government deficits through the Stability and Growth Pact (SGP) – without transferring this spending power to a higher authority, i.e., some form of central government. Or, to put it differently, to have created a monetary union (with, importantly, full capital mobility) without foreseeing the creation of a fiscal and political union capable of addressing structural imbalances and asymmetric negative shocks across the union. This left member states utterly defenceless in the face of economic crises, as the 2008 booms-gone-bust would make amply clear. Yet, the crisis – which, it is worth remembering, was caused by a build-up of private, not public, debt – didn't awake European leaders to the need to relax the Maastricht straitjacket, by loosening the budgetary constraints imposed on individual governments (thus allowing them to pursue counter-cyclical stimulus policies) or by moving towards a fully-fledged fiscal union (or at least a modicum of economic coordination between surplus and deficit countries). Instead, we got the worst of both worlds: further restrictions on the fiscal autonomy of member states and no increase in the fiscal capacity at the federal level in Europe (on the contrary, the already meagre EU budget has been steadily shrinking since the start of the crisis). The result, easily predictable from a Keynesian perspective, has been devastating in economic, social and political terms (Fazi 2014; Fazi and Iodice 2016).

Completing the EMU?

There are now a number of high-level reports on the table – most notably the European Commission's *Completing Europe's Economic and Monetary Union*, also known as the 'five presidents' report' (European Commission 2015), which echoes similar reports prepared by the European Council, the European Central Bank and the Eurogroup (see, for example, European Council 2012a) – that propose to address this structural flaw by creating a fiscal and political union. The basic premise of all these reports is that the current architecture of the EMU – that of a 'currency without a state' – is untenable. That is, it is not realistic to maintain a monetary union with a centralised monetary policy but lacking a common fiscal and economic policy capable of addressing the systemic macroeconomic imbalances that are bound to arise between member states. So, in order to survive, the eurozone needs to swiftly move towards a banking, economic, fiscal and ultimately political union. This would be a welcome development, were it not for the fact that the 'brave new EMU' envisioned by these proposals falls very short of the kind of fiscal and political union advocated by progressive federalists and raises a number of worrying issues from both political and economic standpoints. Economically, it is based on the same flawed assumptions that have underpinned the entire EU response to the crisis. The main one is that the fiscal profligacy of governments and lack of competitiveness of certain countries, rather than the recklessness of banks – and in more general terms, the systemic imbalances created by thirty years of financial deregulation and neoliberal policies – are at the root of Europe's problems, and thus that governments need to be straitjacketed and weaker countries need to be made more 'competitive'. Meanwhile all that Europe's financial sector needs is tighter supervision, not systemic reform.

The banking union

This is exemplified by the banking union, the first pillar of the European establishment's plans for a more tightly integrated and centralised Europe (and the only one to have been implemented so far). The banking union – an EU-level banking supervision and resolution system – has been the most significant regulatory outcome of the crisis – 'a change of regime, rather than an act of institutional tinkering', as Christos

Hadjiemmanuil of the London School of Economics writes in a comprehensive paper on the topic (Hadjiemmanuil 2015) – and it is widely agreed that ‘even in its current incomplete form, [the banking union] is the single biggest structural policy success of the EU since the start of the financial crisis’ (Véron 2015). A closer look, though, reveals the banking union – in its current form at least – to be simply the latest step in the EU’s post-crisis creditor-led path of austerity and asymmetric adjustment.

In its original intention, the banking union was supposed to ‘break the vicious circle between banks and sovereigns’ by mutualising the fiscal costs of bank resolution (European Council 2012b). This was the result of a belated acknowledgement by European decision-makers, various years into the crisis, of the non-fiscal – namely, banking and monetary – nature of sovereign distress in the EMU. Hence, even though the focus on austerity as the main policy response remained unchanged, there was a recognition of the need for substantial changes in the European policy stance on bank resolution, aimed at relieving individual countries of the fiscal responsibility for bank-rescue operations and putting an end to the fragmentation along national lines of banking and monetary conditions. The establishment of a joint public funding mechanism – a so-called common ‘fiscal backstop’ – for the whole euro area was considered essential for this purpose. The prerequisite for a mutualisation of bailout costs, however, was the centralisation of the responsibility for banking supervision and resolution in the euro area, so as to preclude the externalisation of the fiscal costs of regulatory failure by countries with lax regulatory regimes. Such were the considerations that drove European leaders on 29 June 2012 to explicitly affirm the need to break the ‘vicious circle between banks and sovereigns’, adding that ‘when an effective single supervisory mechanism is established, involving the ECB, for banks in the euro area the ESM could, following a regular decision, have the possibility to recapitalize banks directly’ (European Council 2012b).

In the course of the construction of the banking union, though, its actual premise (that is, the centralisation of the fiscal backstop for bank resolution) was all but abandoned. In its place, a very strict and inflexible burden-sharing hierarchy was introduced, aimed at ensuring that (a) the use of public funds in bank resolution would be avoided under all but the most pressing circumstances, and even then kept to a minimum, through the application of a strict bail-in approach; and that (b) the primary fiscal responsibility for resolution would remain at the national level, with the mutualised fiscal backstop serving as an absolutely last resort. In short, when a bank runs into trouble, existing stakeholders – namely, shareholders, junior creditors and, depending on the circumstances, even senior creditors and depositors with deposits in excess of the guaranteed amount of €100,000 – are required to contribute to the absorption of losses and recapitalisation of the bank through a write-down of their equity and debt claims and/or the conversion of debt claims into equity (European Commission 2016b). Only then, if the contributions of private parties are not enough – and even then, at very strict conditions – can the Single Resolution Mechanism’s (SRM) Single Resolution Fund (SRF) be called into action. Notwithstanding the banking union’s problematic burden-sharing cascade – for reasons that we will examine shortly – the SRF presents numerous problems in itself. The fund is based on, or augmented by, contributions from the financial sector itself, to be built up gradually over a period of eight years, starting from 1 January 2016. The target level for the SRF’s pre-funded financial means has been set at no less than 1 per cent of the deposit-guarantee-covered deposits of all banks authorised in the banking union, amounting to around €55 billion. Except if all unsecured, non-preferred liabilities have been written down in full – an extreme measure that would in itself have serious spillover effects, for reasons that are easy to imagine – the SRF’s intervention will be capped at 5 per cent of total liabilities. This means that, in the event of a serious banking crisis, the SRF’s resources are unlikely to be sufficient (especially during the fund’s transitional period).

If a bank remains undercapitalised even after all the aforementioned sources of resolution financing have

been exhausted – and even then, at very strict conditions – countries may request the intervention of the existing European permanent bailout fund, the ESM, through its new direct recapitalisation instrument (DRI). The way in which the instrument has been implemented, however, raises doubts as to its practical significance. As Hadjiemmanuil notes, the DRI's rules 'raise significant barriers to the activation of the DRI even in situations where recapitalisation with public funds appears justified' (Hadjiemmanuil 2015). Most importantly, the country eligibility criterion takes explicitly into account the alternative of indirect bank recapitalisation by the ESM, by way of a loan to the relevant national government; unless this form of assistance is bound to trigger by itself a drastic deterioration of the recipient country's fiscal prospects, it should be preferred over the DRI. In other words, the DRI is only available in situations where a country is unable to finance on its own account a bailout without thereby undermining its fiscal prospects; in all other cases, the national government must provide itself financial support to the troubled bank(s), either by raising the requisite sums in the capital market or, in the worst case, by accessing the ESM for a loan. In the latter case – reliant upon the approval of the Commission, in liaison with the ESM's managing director, the ECB and, wherever appropriate, the IMF – requesting member states will not be spared the *troika's* dreaded conditionalities, 'including where appropriate those related to the general economic policies of the ESM Member concerned' (European Council 2013). In other words, those states whose banks (not governments) run into trouble and thus require financial assistance by the ESM will likely be forced to implement the same kinds of austerity and structural adjustment programme – public-sector cuts, wage reductions and so on – as the recipients of sovereign loans have been forced to implement in recent years. Oddly, even in the unlikely event that a bank is granted access to the DRI, before it can receive direct injections from the shared fund, the requesting government must either provide the capital needed to raise the bank's minimum capital ratio to 4.5 per cent of its assets or, if the institution already meets the capital ratio, make a contribution ranging between 10 and 20 per cent of the ESM contribution. In other words, national governments will be saddled the primary financial responsibility in relation to publicly assisted bank bailouts.

More in general, even the IMF has openly expressed doubts about the planned backstop, noting that 'centralized resolution resources may not be sufficient to handle stress in large banks' (IMF 2014a). The overall amount that the ESM will be allowed to disburse for all bank recapitalisation has been capped at a relatively puny €60 billion (though the limit is allegedly flexible), more or less the same amount expected to be raised through the privately funded SRM. Though a large sum, it is a drop in the ocean compared with the balance sheets of Europe's massive banks. The euro area is home to a very large banking sector, with total assets amounting to more than three times the region's GDP, concentrated for the most part in the hands of large systemic banks, including a number of global systemically important banks, whose recapitalisation could conceivably require huge resources. To get an idea, the average balance sheets of the European Union's 30 and 15 largest banks (€800 billion and €1.3 trillion respectively) are 13 and 21 times larger than the proposed recapitalisation limit (EBA). Not only are these banks too big to fail – they are too big to bail. The failure of any of them – even assuming that it would take place in isolation, rather than as part of a wider systemic crisis – would require the mobilisation of huge financial resources. This is also proven by the recent crisis, with certain large banks receiving public assistance in excess of €100 billion.

With all this in mind, one could still argue that the bail-in mechanism represents a step forwards vis-à-vis the bailouts of recent years, by limiting the burden placed on sovereigns and thus the 'socialisation' of banking crises. The crucial point to understand here is that the bail-in is indeed a great tool to have at one's disposal, as there are undoubtedly numerous cases where a bail-in might be preferable to a bailout. But this has to be decided on a case-by-case basis. The problems arise when member states are forced to resort to the bail-in as the primary method of bank resolution, regardless of the potential consequences of such a move, of the nature of the bank's problems, of the wider macroeconomic context, etc. – which is

precisely what the banking union prescribes. This is especially true in light of the extreme disequilibrium between banking systems in the EU, itself a reflection of the wider social and macroeconomic imbalances between core and periphery countries. As a result of the new banking rules, periphery countries (where the banks with the largest capital shortfalls are located) will have little choice in dealing with their ailing banks than to (a) force losses on the banks' bondholders – often amounting to small savers/taxpayers – or (b) accept a take-over by foreign capital (given the limited availability of national capital). Viewed through the lens of the unresolved inter-capitalist struggle between core-based and periphery-based capital, as argued most notably by Emiliano Brancaccio, we can posit that this will almost certainly lead to an increased 'centralisation' of capital, characterised by a gradual concentration of capital in Germany and the other core countries of the monetary union, through mergers, acquisitions and liquidations, and to the relative 'mezzogiornification' of the weaker countries of the union (Brancaccio and Fazi 2016). In this sense, the banking union is likely to exacerbate, rather than reduce, the core-periphery imbalances.

The banking union also raises a number of potentially even more troubling issues. A core one is regulatory capture, the process in which a regulatory agency, purportedly created to act in the public interest, instead advances the commercial or special concerns of interest groups that dominate the industry or sector it is charged with regulating. According to various studies, regulatory failure was one of the fundamental causes of the 2007-8 crisis (see, for example, Lau 2010). From this perspective, granting the ECB such sweeping powers of supervision over Europe's largest institutions creates a dangerous precedent. Europe's central bank suffers from a very serious lack of transparency (European Parliament 2009). There are worrying links between the European Union's top brass and the financial industry, and there is the wider, and yet unresolved, issue of financial lobbying at the EU level (CEO 2014). This is related to the wider issue of the accountability (or lack thereof) of the ECB. Even if we accept the debatable proposition that the monetary policy of countries (or groups of countries, in the case of the EMU) should be managed by institutions that are entirely independent of democratically elected institutions, since the start of the euro crisis the ECB has evolved into something very different from a 'normal' central bank (if it ever was one). It has gone well beyond its purely monetary prerogatives and has taken on the form of a 'full-blooded political actor engaging in a strategy aimed at forcing EU political leaders to embrace fiscal rectitude', as Jacob Funk Kirkegaard, research fellow at the Peterson Institute for International Economics, writes (Kirkegaard 2011). As EU policy analyst Protesilaos Stavrou puts it, the ECB is more akin to a 'dealer of last resort' than to a lender of last resort (Stavrou 2013). Thus, assigning the ECB even more sweeping powers, within the framework of the banking union, is bound to deepen the EU's democratic deficit even further. This brings us to the second pillar of the European establishment's plans for 'completing' the EMU: the fiscal union.

The fiscal union

Ever since the euro crisis erupted in 2010, the European Commission and the Council have adopted, behind closed doors and beyond public scrutiny, a complex system of new laws, rules, agreements and even a treaty – the Fiscal Compact – aimed at enforcing austerity, whatever the cost. The proposed fiscal union basically consists of a strengthening of these new rules, first and foremost the Fiscal Compact. It has been argued that the EU's already-existing democratic deficit has hugely widened in past years, through a constitutionalisation of market-making economic policy and a deepening of the process of depoliticisation, by which macroeconomic decisions are removed from the realm of representative-democratic deliberation and social choice (Radice 2013; EuroMemo Group 2016). The handling of the Greek crisis represents a great case in point. The negotiations between the left-wing SYRIZA-led government, which emerged from the January 2015 elections, and Greece's euro area creditors exposed the secrecy and the bias on which EU policy rests. Particularly pernicious – in both political and financial terms – was the behaviour of the ECB,

which ‘cut off its liquidity assistance deliberately in order to destabilize further the Greek payments system and force the SYRIZA government into accepting the harsh austerity measures (Seccareccia 2015). The Greek experience laid bare serious issues of constitutionalism: namely, the tendency of the EU institutions to restrict the area of democratic decision-making by democratically elected governments, focusing instead on technocratic rules imposed by undemocratic decision bodies (EuroMemo Group 2015, 2016). In this respect, the democratic deficit that is inherent in the construction of the executive-led EU has been amplified by the crisis and the response of the ruling elites to it, with the EU’s extensive post-crisis reform of its system of economic governance representing a radicalisation of this new constitutionalism (which has been dubbed ‘authoritarian constitutionalism’) (Oberndorfer 2015). First, the scope and level of intrusions into national sovereignty have been greatly enhanced; structural economic policy now explicitly falls within the domain of the Memorandums of Understanding (MOUs). Second, although in the past the new constitutionalism conformed to certain minimum definitions of the rule of law, the new economic governance has taken on an increasingly authoritarian form (European Parliament 2014). This has reinforced the technocratic character of EU governance. The current system of European economic governance (six-pack, two-pack, Fiscal Compact, European Semester, MIP, etc.) is highly unbalanced: the focus is almost exclusively on fiscal stability and (wage) competitiveness whereas concerns over economic recovery, more and better jobs and social cohesion are largely ignored (ETUI 2015, 2016).

The European Commission’s proposed ‘fiscal union’ will serve to reinforce the technocratic and undemocratic character of EU governance, while providing little (if anything) in terms of federal-level funding. In fact, if the German finance minister Wolfgang Schäuble’s recent call for a ‘fiscal and political union’ backed by a ‘euro budget’ – echoed by the governors of the German and French central banks, Jens Weidmann and François Villeroy de Galhau – is anything to go by, it is likely to revolve first and foremost around the creation of a European budget commissioner with the power to reject national budgets (Schäuble and Lamers 2014; Villeroy de Galhau and Weidmann 2016). Schäuble is right to advocate institutional changes that might provide the eurozone with its missing political mechanisms, but we have to ask: is fiscal union – and, more specifically, the kind of fiscal union advocated by the German finance minister – what Europe needs at the moment? As noted by Philip Arestis and Malcolm Sawyer, an effective fiscal union would require tax-raising powers at the EMU level in the order of at least 10 per cent of GDP; fiscal transfers from richer to poorer countries; a federal authority with the capacity to engage in deficit spending; the support of the ECB in the operation of fiscal policy; a proportionate transfer of democratic legitimacy, accountability and participation from the national to the supranational level; etc. (Arestis and Sawyer 2012). Unfortunately, the fiscal union proposed by Schäuble is very different: it revolves around the creation of a European budget commissioner with the negative power to reject national budget – a supranational fiscal enforcer – but doesn’t foresee the creation of a federal institution with positive legislative and spending powers (Varoufakis 2015).

Equally worrying is the German plan to curtail banks’ sovereign bond holdings (Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung 2015). Ostensibly aimed at ‘severing the link between banks and government’ (just like the banking union) and ‘ensuring long-term debt sustainability’, it calls for: (i) removing the exemption from risk-weighting for sovereign exposures, which essentially means that government bonds would longer be considered a risk-free asset for banks (as they are now under Basel rules), but would be ‘weighted’ according to the ‘sovereign default risk’ of the country in question (as determined by credit rating agencies); (ii) putting a cap on the overall risk-weighted sovereign exposure of banks; and (iii) introducing an automatic ‘sovereign insolvency mechanism’ that would essentially extend to sovereigns the bail-in rule introduced for banks by the banking union, meaning that if a country requires financial assistance from the European Stability Mechanism (ESM), for whichever reason, it will have to lengthen its sovereign bond maturities (reducing the market value of those bonds

and causing severe losses for all bondholders) and, if necessary, impose a nominal ‘haircut’ on private creditors.

It is not hard to see why such a rule would result in the exact opposite of its stated aims. The first effect of it coming into force would be to open up huge holes in the balance sheets of the banks of the ‘riskier’ countries (at the time of writing, all periphery countries except Ireland have an S&P rating of BBB+ or less), since banks tend to hold a large percentage of their country’s public debt; in the case of a country like Italy, where the banks own around 400 billion euros of government debt and are already severely undercapitalised, the effects on the banking system would be catastrophic (Lanotte et al. 2016). It has been argued that the banking union’s rules are already causing a slow-motion bank run on periphery banks, with periphery countries experiencing massive capital flight towards core countries, as bondholders and depositors flee the banks of the weaker countries (Fazi 2016 on the basis of ECB data). Extending that same rule to sovereigns as well would simply mean doubling down on a measure that is already exacerbating core-periphery imbalances and increasing (rather than reducing) the risk of banking crises.

Moreover, the proposed measure, far from ‘severing the link between banks and government’, would almost certainly ignite a new European bond crisis, as banks rush to offload their holdings of ‘risky’ government debt in favour of ‘safer’ bonds, such as German ones (as the German Council of Economic Experts report acknowledges, ‘as a result of the risk-adjusted large exposure limit, there is more leeway for holding high-quality government bonds than with a fixed limit’). The report estimates that banks will have to divest around 600 billion euros of government debt. As Carlo Bastasin of the Brookings Institution writes:

Sovereign bonds have a unique and pivotal role for the financial systems of the euro-area. So, once sovereign bonds in some euro-area countries become more risky, the whole financial system might turn frail, affecting growth and economic stability. Ultimately, rather than exerting sound discipline on some member states, the new regime could widen bond rate differentials and make debt convergence simply unattainable, increasing the probability of a euro-area break-up (Bastasin 2015).

A recent Bank of Italy report also warned about the potential spillover effects of the proposed reform:

[T]he role of the sovereign in a modern economy is so pervasive and crucial that sovereign debt turmoil inevitably translates into severe economic damage. Sovereign debt tensions usually cause widespread defaults in the household and corporate sectors, financial market tensions, and ultimately have a severe impact on the banking sector. Therefore, a change in regulation aiming at insulating a banking system from the default of its domestic sovereign is unlikely to achieve its target... In terms of policy implications, this leads to the conclusion that the microeconomic and macroeconomic costs of a reform could be sizeable, while the benefits are uncertain (Lanotte et al. 2016).

As noted by the German economist Peter Bofinger, the only member of the German Council of Economic Experts to vote against the sovereign bail-in plan, this would almost certainly ignite a 2012-style self-fulfilling sovereign debt crisis, as periphery countries’ bond yields would quickly rise to unsustainable levels, making it increasingly hard for governments to roll over maturing debt at reasonable prices and eventually forcing them to turn to the ESM for help, which would entail even heavier losses for their banks and an even heavier dose of austerity (quoted in Evans-Pritchard 2016). It would essentially amount to a return to the pre-2012 status quo, with governments once again subject to the supposed ‘discipline’ of the markets, even though the 2011-12 sovereign debt crisis has clearly exposed the inability of financial markets to efficiently assess and manage the public finances of countries (Gaillard 2013).

In more general terms, the new European institutional framework outlined in the aforementioned reports – what we might call ‘the coming, or emergent, brave new Europe’ – raises a number of worrying issues from both political and economic standpoints. Politically it raises very serious problems of accountability and democratic scrutiny and participation. As we have seen, the top-down ‘federal’ solution currently being proposed and pursued by the EU establishment consists in a game-changing and unprecedented transfer of sovereignty from the national to the supranational level, in terms of banking supervision (through the banking union) and more importantly, fiscal and budgetary policies (through the fiscal union). From an integrationist perspective, the problem is not the transfer of sovereignty as such; this might indeed be the only way forward for Europe in an increasingly complex and globalised world. The problem is that this transfer of sovereignty is not being paralleled by an analogous and proportionate transfer of democratic legitimacy, accountability and participation from the national to the supranational level (that is, from national parliaments to the European Parliament). In other words, the democratic procedure is not being elevated to the European level; it is simply being usurped from the national level. This amounts, in the words of German philosopher Jürgen Habermas, to ‘a post-democratic exercise of political authority’ (Habermas 2012).

As Protesilaos Stavrou writes, we are witnessing ‘a rapid and forceful emergence of a technocratic *sovereign* state *within* the EU’ (Stavrou 2012). Even though the various ‘roadmaps’ and ‘blueprints’ produced by the Council and the Commission all stress that greater integration ‘should go hand in hand with greater democratic accountability, legitimacy and institutional strengthening’, it is clear that democratic legitimacy and accountability is not equivalent to genuine democracy (see, for example, European Commission 2012, 2015). In this sense, as Stavrou notes, the future role envisaged by the EU establishment for the national and European parliaments is very similar to the role reserved for them in relation to the *troika* programmes, whereby parliaments labouring under duress were pressured into rubber-stamping decisions taken elsewhere (Stavrou 2012). Thus, the call for an increased cooperation between the increasingly marginalised national and European parliaments does little to diminish the profound democratic deficit of the European Union, and simply obfuscates the lack of an elected executive and of a genuinely democratic decision-making body at the European level. Stavrou’s comparison between the ‘post-democratic exercise of political authority’ (in Habermas’ words) envisioned by the five presidents’ report (and other similar reports) and the policies imposed by the *troika* in bailed-out countries is particular apt. In fact the emerging European Union’s democratic deficit, what we might call its political architecture, appears to be closely linked with, and maybe even a precondition for, its economic architecture. We have seen that the fiscal union (and in particular the Fiscal Compact) amounts to a form of perpetual austerity for Europe. Since these reforms are obviously very unpopular, the tactic consists in avoiding democratic discussion of them. To this end, automatic correction mechanisms and quasi-automatic sanctions in the event of non-compliance with the rules are introduced to remove any of element of discussion and/or decision making at either the European or national level, thus achieving a complete separation between the democratic process and economic policies, and the death of active macroeconomic management. As Hugo Radice, life fellow at the University of Leeds, writes:

These proposals, when fully implemented, will not only enforce a permanent regime of fiscal austerity, but also further remove macroeconomic policy from democratic control... In essence, it is the politics of depoliticisation (Radice 2013).

This brings us to the following point of our discussion.

Is a democratic European political union feasible?

In contrast to the kind of authoritarian or ‘executive federalism’ that the European elites are currently pursuing, various authors and civil society organisations have proposed a radically alternative ‘federation of citizens’, centred precisely around those values that arguably make up the continent’s post-war cultural and political DNA: democracy, human rights, social welfare, workers’ bargaining rights and the like (see, for example, Lacaita and Vallinoto 2014). In this way, it is argued, we could defend – indeed, improve – the social democratic model that for decades has made Europe a beacon of humanity in the world. As for the question of how to best democratise and politicise the European Union and monetary union, there are obviously differing views, given the complexity of the matter. But there is a relative consensus among progressive thinkers that European democracy should rest, first and foremost, upon a significantly empowered European Parliament. It has also been argued that a parliamentary chamber for the eurozone should be created alongside the European Parliament comprising of a selection of members of the national parliaments of the eurozone countries (Piketty et al. 2014; Glienicker Group 2013). As for the executive branch, it is claimed that a revamped European Commission with a directly elected president (who would in effect become the president of Europe) would transform it from the technocratic (and radically neoliberal-minded) body that it is today into a fully-fledged political body, capable of pursuing right-wing or left-wing policies on the basis of an electoral programme chosen by the people. Further, it is often maintained that the ECB should be placed under some degree of democratic scrutiny, if not outright control (Fontan 2015).

While we agree with these proposals in principle, we harbour serious doubts about the extent to which such a system of supranational democracy could be made truly representative and respectful of the needs of the weaker states of the union. Let us take the central argument of progressive federalists: the need for a significantly empowered, ‘sovereign’ European Parliament, and the notion that the only viable alternative to the current ‘intergovernmentalisation’ of the EU is the latter’s ‘parliamentarisation’. Firstly, we should be clear that the move to a supranational euro area democracy means – in the best-case scenario – handing all the major economic, fiscal (and monetary?) policy decisions concerning the EMU over to a democratically legitimated (through the EP, and possibly a second eurozone parliament) ‘European government’. There would be little space for power sharing with national parliaments on these crucial issues. With that in mind, we have to ask ourselves: are European citizens ready to accept the legitimacy of the European Parliament? One may argue that those policy decisions are already largely out of the hands of member states, and that a ‘European government’ already exists – it is just a question of ‘democratising’ it. This is largely true, but it is an insufficient response in our opinion. It is easy to argue that a supranational decision-making system centred around the European Parliament would be *more* legitimate than the current system of technocratic governance, but would it be legitimate *enough* to ensure that European citizens accept its majority-vote decisions in the same way that today they accept (to a large degree) the majority-vote decisions taken by national parliaments? Furthermore, as noted by Sergio Fabbrini, director of the LUISS School of Government in Rome, the ‘parliamentarist’ model of European integration ‘fails to acknowledge the key difference between a nation state and a union of states’, which is also the difference between a federal state (emerging from the disaggregation of a previously unitary state) and a federal union (created by the aggregation of previously independent states). As Fabbrini writes:

The EU cannot adopt a parliamentary form of government due to structural, rather than contingent, reasons. Regardless of the parliamentary rhetoric celebrated in the treaties, parliamentarism cannot give a feasible answer to the two main systemic constraints within the EU: the demographic asymmetries between its member states and the national differentiation between the latter’s citizens. Given these systemic constraints, it would be

unacceptable to recognise only the European Parliament as the source of governmental authority in the EU, if not as the source of the EU's democratic legitimacy. If this were to occur then the representatives of smaller member states (currently around three quarters of the total) would consistently be in a minority, given the national differentiation between citizens cannot be regulated through the same 'left vs. right' axis that exists at the national level (Fabbrini 2015).

Progressive integrationists usually respond to this by stating that a supranational democracy needs to go in hand with the creation of a 'post-national or supranational electorate'. For the great majority of ordinary European citizens, though, linguistic barriers and cultural differences impair the opportunity for political participation at a supranational level (Belot 2014). This became apparent in the debate over the *Spitzenkandidat* system, used for the first time in the 2014 European elections to select the Commission president. Following the elections, many argued that Juncker's appointment was democratically legitimated by the fact that he was the candidate of the parliamentary group with the largest number of MEPs. Habermas and other prominent intellectuals wrote in support of Juncker's appointment suggesting that European citizens have the right to choose who leads the European Commission and that the election results showed that Juncker was 'the people's choice' (Habermas et al. 2014). From a purely formal standpoint, they were right. But most of those who voted for the national parties that are members of EPP did not even know what EPP was or who Juncker was. This episode shows that there is a very real risk of EU-level democracy resulting in a form of supranational 'depoliticised democracy'. How do progressive integrationists propose to overcome these obstacles?

Oligarchic capture

More in general, any debate about the 'parliamentarisation' of the EU needs to take into account the crucial difference between the formal electoral-representative process and true popular control. As argued by Lorenzo Del Savio and Matteo Mameli, further integration, even if accompanied by a strengthening of the electoral-representative component of the EU, is not necessarily equivalent to more popular control (Del Savio and Mameli 2015). It is assumed that an enhanced version of the EU parliament would suffice for proper democratic control over the union's major decisions. But this ignores the question of oligarchic capture, Del Savio and Mameli note:

Oligarchic capture does not just affect regulatory bodies and unelected officials. It also affects elected representatives. Augmenting the powers of elected officials that are vulnerable to oligarchic capture means augmenting the power of economic oligarchies. It means weakening popular control. Elected national parliaments and executives are highly imperfect tools for achieving popular control over decisions that affect people's freedom and wellbeing. Supranational parliaments and executives are even more inefficient in this respect (Del Savio and Mameli 2015).

The problems relating to lobbying and to the revolving doors issue – not just between big businesses and regulatory agencies but also between big businesses and elected offices – are in fact exacerbated at the supranational level.

It is for this reason that, in general, the transfer of sovereignty to international loci of political decision-making contributes to the weakening of popular control. International loci are in general physically, psychologically, and linguistically more distant from ordinary people than national ones are. This distance means more room for oligarchic capture. International loci of political decision-making are usually designed in such a way as to make it extremely difficult for ordinary citizens to understand how decisions are taken and to be able to influence and contest such decisions in an effective manner. This enhances the effectiveness of the mechanisms of oligarchic

capture (Del Savio and Mameli 2015).

Post-democracy

These are issues that cannot be sidelined and that need to be addressed head-on. In general terms, they point to a wider crisis of electoral-representative democracy. It is widely agreed that in recent decades we have witnessed a ‘hollowing out’ of democracy and sovereignty at the national level (see, for example, Mair 2013). In the long-established democracies of Western Europe, electoral turnouts are in decline and membership is shrinking in all major parties. This is particularly evident in Europe. Colin Crouch coined the term ‘post-democracy’ to describe this new normal, defined as a society that continues to have and to use all the institutions of democracy, but in which they increasingly become a formal shell, and the energy and innovative drive pass away from the democratic arena and into small circles of a politico-economic elite (Crouch 2000). There are generally two ways of framing this phenomenon. One is that this is a somewhat inevitable – one may even say ‘natural’ – result of economic and political internationalisation, which has seriously eroded the ability of individual countries to decide their own destinies, and thus of national electoral-representative systems to formulate a general will that can bend the institutions of public power to sovereign ends (Rodrik 2007). According to this narrative, the shift – in the European context – from a multiplicity of (increasingly powerless and non-sovereign) national democracies to a single (and truly sovereign) European supranational democracy is inevitable, whether we like it or not. But there is another way of framing the shift towards post-democracy. And that is that this isn’t the inevitable consequence of ‘global dynamics’ but the result of an explicit process of depoliticisation aimed at removing macroeconomic policy from democratic control and putting crucial areas of administration – such as monetary and fiscal policy – outside of political contestation (Heartfield 2007). According to this narrative, the depoliticisation of individual nation states – including through a self-imposed reduction of their ‘sovereignty’, understood as the expression of popular will – can be understood as a way to roll back the democratic and social/economic gains that had previously been achieved by subordinate classes. If that is the case, further ‘democratising’ the institutions of the EU/EMU may not be the best way forward. Furthermore, federalist arguments often seem to ignore the fact that any serious Europe-level structural change – such as a true ‘democratisation’ of the system – requires national governments agreeing to such a change. If not, how else? This brings us to another aspect of the problem.

The return of German nationalism

The progressive federalist approach takes the survival of the EU/EMU for granted. But that remains to be seen. Various authors have argued that the threat of forced Grexit, at the height of the Greece-*troika* negotiations, was part of a wider strategy, aimed at radically restructuring the EMU into a smaller union of fiscally-tight, export-led core economies – *Kerneuropa* – by forcibly ejecting those countries deemed structurally unfit (such as Greece), in turn disciplining those governments that might be tempted to challenge the existing/new rules (such as in Italy or France) (Montani 2015). German author Hans Kundnani, in his book *The Paradox of German Power*, argues that this reflects Germany’s rise as the hegemonic (or rather semi-hegemonic) power within the union (Kundnani 2014). The crucial concept at the basis of Kundnani’s analysis – which in turn is drawn from the classic work of German historian Ludwig Dehio – is that of semi-hegemony:

The unified Germany was too big for a balance of power in Europe and too small for hegemony. The German historian Ludwig Dehio would later aptly identify Germany’s problematic position in continental Europe during the *Kaiserreich* as one of ‘semi-hegemony’: it was not powerful enough to be perceived as a threat by other powers. Thus its size and central location in Europe – the so-called *Mittellage* – made it inherently

destabilising. This, in essence, was what became known as the ‘German question’ (Kundnani 2014).

Kundnani argues that Germany’s economic success in the first decade of the euro, during which it went from a current account deficit to a huge surplus – largely as a result of two factors: the restructuring of German manufacturing by way of outsourcing to the Eastern *länder* and Eastern European countries, leading to the creation of a German transnational value chain; and Germany’s policy of internal devaluation (wage restraint) – also had the effect of dramatically altering the perception of the German identity, leading to what Kundnani dubs ‘*Exportnationalismus*’: essentially, a new form of ‘economic nationalism’ based on the supposed superiority of the German hyper-mercantilist economic model (*Modell Deutschland*). Kundnani’s conclusion is that Germany can now be viewed as a geo-economic semi-hegemonic power. Guido Montani, professor of international political economy at the University of Pavia, has argued that this has further entrenched the ordoliberal views of the German monetary and political establishment (and especially of the Bundesbank, considered to be the temple of ordoliberal orthodoxy) (Montani 2015). On this point, he quotes the president of the Bundesbank, Jens Weidmann:

It was a long-held belief, above all in Germany, that in the long run monetary union would, out of necessity as it were, culminate in political union. Addressing the Bundestag in November 1991, Helmut Kohl remarked that ‘the idea of sustaining economic and monetary union over time without political union is a fallacy’. I believe, however, that monetary union can also function without political union. The Maastricht framework, which was adjusted in the light of the crisis, offers a sensible foundation for this in principle (Weidmann 2014).

This view seems to be fully shared by the finance minister Wolfgang Schäuble. In other words, Germany’s current monetary and political establishment (or a significant part of it) believes that monetary union can function just fine without political union; all that it needs is tighter rules and strict punishment for non-compliance. This leads us to conclude that there is little reason to believe that that Germany and the other countries of the ‘ordoliberal bloc’ would yield to a reform of the EMU in a more Keynesian, progressive direction, even in the unlikely event that we could get a sufficient number of countries to back such a proposal. If such a situation should emerge, the most likely outcome would be a German exit from the monetary union (leading to a possible collapse of the entire currency system).

This leads us to conclude that the development of the EMU into a democratic and economically sustainable political union is *not* a realistic option in the foreseeable future¹. So – barring a break-up scenario – what options does that leave us within the context of the EMU?

¹ Interestingly, a recent study commissioned by the European Parliament’s ECON Committee reached the same conclusion: ‘Shortcomings in the output legitimacy of EMU have been exposed by the crisis and its incapacity to mitigate the adverse effects. Shortcomings in the input legitimacy of EMU governance have their origin in the initial conception of the project itself, which gave priority to the delivery of results over democracy, but these have been exacerbated by the recent changes. The institution of a fully-fledged political union with fiscal capacity would not only help to overcome these two shortcomings, it would also reduce the system’s vulnerability to citizens’ disapproval. As is the case at the national level, citizens’ support would then revolve around specific policies and actions rather than questioning membership and the whole structure itself. *A federal approach, however, is nowhere close on the near horizon. Nor is it at all clear that EU citizens will ever accept such a solution*’ (Alcidi et al. 2014).

The renationalisation of fiscal policy

There is a growing consensus, even at the mainstream level, on the fact that the essence of the problem today, in advanced countries in general but particularly in the EMU, lies in the lack of, and need for, fiscal expansion (see, for example, IMF 2014a, 2015; OECD 2016; Cohen-Setton 2016; Turner 2016; Summers 2014; Wolf 2013; Münchau 2016). This holds particularly true for a number of European periphery countries. In light of this, and given the problems associated with the implementation of any form of federally-financed stimulus program (as exemplified by the failure of the so-called ‘Juncker plan’; see OECD 2016), we believe that the only sensible solution in the short-to-medium term is to allow individual member states to adopt a more expansionary fiscal stance. Achim Truger has argued that this could be realised within the current institutional framework – for example by making optimal use of the ‘flexibility’ contained in the SGP or by reconsidering the Commission’s method of cyclical adjustment – to obtain a eurozone-wide expansionary fiscal stance of two to three per cent of GDP (Truger 2015a). While this would be a welcome improvement, we believe that for some countries it would be insufficient, given the extensive damage caused by years of fiscal austerity.

We posit that a better way forward would be to adopt a balance sheet recession approach to the problem, as suggested most notably by Richard Koo (Koo 2012, 2014, 2016). This means understanding that a number of eurozone countries, especially those of the periphery, are in so-called balance sheet recession – a situation in which individual and companies, following the burst of a debt-financed bubble, collectively focus on saving rather than spending, thus reducing aggregate demand – and should thus be allowed to pursue much more expansionary fiscal policies until private sector balance sheets are repaired. More specifically, it means that private-sector savings levels have to be taken into account when evaluating the ‘optimal’ fiscal stance of member states. Unfortunately, the EMU’s current budgetary rules make no provision for this type of recession. As Koo explains:

In particular, the [Maastricht Treaty] prohibits member governments from running sustained budget deficits of more than three per cent of GDP regardless of the size of private-sector savings. This means that even if the private sector is saving 7 per cent of GDP, the government can borrow only 3 per cent of GDP, leaving the remaining 4 per cent of GDP as un-invested savings to start the deflationary spiral... With eurozone member governments forced to comply with the 3 per cent rule, the large and unfilled deflationary gaps between private-sector savings and public sector borrowings triggered deflationary spirals. That effectively pushed these countries off the fiscal cliff, with devastating consequences for their economies and their peoples (Koo 2016).

The amount of time the peripheral private sectors are taking to repair their balance sheets has been far beyond anything that was anticipated by the Maastricht Treaty. According to 2015 flow of funds data, private-sector savings amounted to 10.8 per cent of GDP in Ireland, 7 per cent for Spain, 6.8 per cent for Portugal and 6.3 per cent for Italy (Koo 2016). This means that there are sufficient levels of excess (i.e., unborrowed) savings to support a fiscal expansion in the order of 6-8 per cent of GDP in most periphery countries.

It is often argued that German taxpayers would never sanction a fiscal stimulus in periphery countries, but the existence of huge pools of private savings in those countries means that if those savings were to return to the domestic government bond markets, the ultimate cost to the German taxpayers would be zero. That said, periphery countries need to ensure that idle savings in these nations do not flow abroad – we are already witnessing the return of intra-EMU capital flight – but are invested in local government bonds. As argued by Richard Koo, this can be achieved by ‘re-internalising’ fiscal policy in the EMU: i.e., prohibiting member states from selling government bonds to investors from other countries (Koo 2012). In other

words, only German citizens would be allowed to purchase *bunds*, only Spanish citizens would be able to buy Spanish government bonds, and so on. The new rule would also resolve the capital flight problem by preventing Spanish savings from flowing into German *bunds*. As Koo writes:

This rule would also ensure fiscal sovereignty for individual countries instead of subjugating them to bureaucrats in Brussels or politicians in Berlin. With large cultural and economic differences existing even between Germany and France, eurozone governments – which effectively gave up monetary sovereignty – actually need enhanced fiscal freedom if they are to remain accountable as democratic representatives of the people. Indeed the challenge for democracy in the eurozone is how to make citizens feel they are empowered to decide their own destiny without jeopardizing the credibility of the euro as a common currency. A rule limiting the issuance of government bonds to citizens of the issuing nation would address this challenge (Koo 2012).

A softer version of this plan would involve the introduction of different risk weights for local and foreign bonds (Koo 2016). The proposed new rule would allow individual governments to pursue autonomous fiscal policies within its constraint. In effect, governments could run larger deficits as long as they could persuade citizens to hold their debt. It goes without saying that this proposal is diametrically opposed to the German proposal to cap banks' sovereign bond holdings.

One might retort that Koo's proposal violates one of the cardinal rules of the European Single Market, that of the free movement of capital. But this rule has already been violated, first by Cyprus in 2013 and then by Greece in 2015. Both countries were forced to introduce capital controls to stem capital flight and guarantee their permanence in the eurozone. Yet, most economists and commentators (even those favourable to capital controls on a general basis) would argue that capital controls are fundamentally incompatible with a currency union (see, for example, Yglesias 2013). But is that really the case? After all, even the IMF acknowledges that capital controls are particularly useful for countries that have little room for economic manoeuvre, such as those that are part of a fixed exchange-rate system, because they are less equipped to deal with economic shocks (Ayhan Kose and Prasad 2012). And what is a currency union if not an extreme form of a fixed exchange-rate regime?

In this light, it would appear that capital controls in a currency union such as the eurozone – especially if focused on inflows rather than outflows – are not only possible, but necessary (at least in the absence of policies aimed at a true economic convergence). They would arguably have prevented many of the booms-gone-bust that are the root of the economic imbalances tearing the single currency apart. As EU analyst Ulrich Machold wrote in 2002, warning against the risks that unfettered financial liberalisation posed for the emerging EMU, 'limited capital controls in times of crisis would not necessarily violate the spirit of the European project and should not constitute an ideological taboo as the integration project continues and in the run-up to enlargement' (Machold 2002). Thanks to the Cypriot and Greek crises, it would appear that the 'ideological taboo' on capital controls has been broken.

A decentralised fiscal stimulus

Having established the criteria with which to determine the optimal fiscal stance for each member state (the private-sector savings level), we can now turn our attention to the optimal composition of the fiscal stimulus. Firstly, we have to consider that the public debt of EU member states has increased significantly since the onset of the financial crisis in 2007. In many instances, it has increased dramatically, reaching or exceeding 100 per cent of GDP. As a result, interest payments tend to absorb a high and sometimes increasing share of GDP, and to account for a large share of the public deficit, despite the extremely low

level of interest rates. In the event of future interest rate increases this will mean a further futile austerity drive.

Further, in many countries a large share of the deficit is accounted for by the effects of the automatic stabilisers (unemployment benefits and other transfers), which simply reflect the worsening social and occupational conditions of those countries. For this reason, we believe that a strict implementation of a golden investment rule, as some have proposed (see, for example, Truger 2015b), which would likely lead to further cutbacks in social spending in those countries worst hit by the crisis, would not be an optimal solution. In this transitory phase, deficit spending by governments should be used to cover current expenditure as well.

However, we believe that the fiscal expansion (i.e., the percentage increase in the budget deficit vis-à-vis the current fiscal stance) pursued in the context of Koo's proposal should be entirely devoted to the financing of government investment. The reason for favouring government investment over social transfers is twofold: first, the former is associated with higher fiscal multiplier levels, to the point that 'investment may be self-financing for some economies', in the sense that the debt-to-GDP ratio may not rise as a result of investment (and may even decrease) (IMF 2014b); second, government investment doesn't simply increase demand, but can also have positive supply-side effects. The IMF's findings are quite conclusive in this respect. According to the October 2014 *World Economic Outlook* report, 'the effects of public investment on output and debt tend to be stronger when there is economic slack, when public investment efficiency is high, and when public investment is debt financed' (IMF 2014b). The analysis shows that during periods of low growth a 1-percentage point increase in investment spending increases the level of output by about 1.5 per cent in the same year and by 3 per cent in the medium term. Further, public investment boosts during periods of low growth also bring about a significant reduction in the debt-to-GDP ratio (IMF 2014b).

Furthermore, it is interesting to note that Koo's criterion, precisely because it mobilises *idle savings*, does not run the risk of crowding out private investment but, on the contrary, has the potential to generate an opposite *crowding in* effect, by stimulating private investment, as even the IMF acknowledges:

An increase in public infrastructure investment affects the economy in two ways. In the short term it boosts aggregate demand through the short-term fiscal multiplier, similar to other government spending, and also by potentially crowding in private investment, given the highly complementary nature of infrastructure services... There is no statistically significant effect on private investment as a share of GDP. The latter finding suggests the crowding in of private investment, as the level of private investment rises in tandem with the higher GDP as a result of the increase in public investment (IMF 2014b).

As for the supply-side effects of government investment, the IMF writes:

Transport networks connect producers and consumers to markets, utilities provide essential inputs such as power and water for both production and consumption, and communications networks facilitate the exchange and dissemination of information and knowledge. As such, infrastructure is an indispensable input in an economy's production, one that is highly complementary to other, more conventional inputs such as labor and non-infrastructure capital. Indeed, it is hard to imagine any production process in any sector of the economy that does not rely on infrastructure. Conversely, inadequacies in infrastructure are quickly felt – in some countries, power outages, insufficient water supply, and decrepit or non-existent roads adversely affect people's quality of life and present significant barriers to the operation of firms (IMF 2014b).

Another channel through which public investment can improve a country's economic performance is the reduction of the external deficit through a strategy of import substitution. Even though the European Single Market's rules forbid discriminatory and protectionist practices, countries still have ample margins to pursue discretionary policies without damaging their partners in the EU and/or EMU. For example, investment in renewable energy can help reduce a country's energy dependence, while investment in open-source software can reduce its technological dependence, by promoting the development of a local software industry. These supply-side effects have the crucial advantage of helping countries improve their external balance without resorting to destructive fiscal consolidation policies. Conversely, a fiscal stimulus aimed primarily at boosting private consumption is likely to lead to a worsening external balance, with little effects on national output, as Italy's case demonstrates (Daveri 2015).

As mentioned, the banking union raises serious doubt as to its capability to contain banking crises. The protracted economic crisis has taken a heavy toll on the banking systems of a number of European countries. As the ECB's recent stress tests have revealed, the banks with the largest capital shortfalls are all located in periphery countries: Italy, Greece, Portugal, Ireland and Cyprus (EBA). This is not surprising: various studies have shown that there is a clear pro-cyclical link between a country's negative macroeconomic performance and the capital adequacy of its banks (see, for example, Quagliariello 2008). This is evident from the rapidly-growing volume of non-performing loans (NPLs) in these countries. According to a recent study, for the EU as a whole, NPLs stood at over 9 per cent of GDP at the end of 2014 – equivalent to 1.2 trillion euros, more than double the level in 2009 (Aiyar et al. 2015). NPLs are particularly elevated in some southern countries, such as Italy, Greece, Portugal and Cyprus. And they are generally concentrated in the corporate sector, most notably among small and medium-sized enterprises (SMEs), which contribute almost two-thirds of Europe's output and employment, and tend to be more reliant on bank financing than large firms. This has worrying implications not only for the financial stability of the euro area but also for the prospects of economic recovery, given that 'higher NPLs tend to reduce the credit-to-GDP ratio and GDP growth, while increasing unemployment', the study found (Aiyar et al. 2015). This is also attributable to the austerity policies, which have exacerbated the recession in a number of countries, further deteriorating the balance sheets of families and corporates and, in turn, those of banks. In this sense, an investment-led recovery will also improve the financial stability of these countries, and of the EU and EMU as a whole, by allowing corporates to reduce their debt exposure.

The role of the ECB: the need for a new 'whatever it takes'

As is well known, in 2010, following the eruption of the Greek sovereign debt crisis, the interest rate differential (the so-called 'spread') between Germany and the periphery countries of the EMU started growing dramatically. Interest rates had, in fact, started to diverge already in 2008, in the immediate aftermath of the financial crisis, but became an existential threat to the survival of the eurozone only in 2010. With the eruption of a periphery-wide sovereign debt crisis, capital started fleeing periphery countries, causing a sharp sell-off of periphery government bonds, even in countries that hadn't experienced a banking crisis, like Italy. Banking crises were not limited to periphery countries, of course:

Germany has provided 240 billion euros to its banks, and another 20 billion euros were bestowed in the form of state guarantees (so-called contingent-liabilities); France also has granted government guarantees to its troubled banks and at times the government has even nationalized some credit institutions (as in the case of BNP) (Merler and Minenna 2016).

Further, it has been noted that the ESM/EFSSF bailout of periphery countries amounted effectively to 'a back-door bailout' of reckless German and French lending (Gareth and Roy 2012). This begs the question:

why has the eurozone *not* collapsed? Marc Lavoie explains the EMU's resilience with the fact that in a monetary union such as the EMU no country will ever find itself short of reserves, due to the functioning of the TARGET2 interbank payment system (which calculates debts between the EMU's central banks):

There is no limit to the debit position that a national central bank can incur on the books of the ECB; that is, its liabilities with respect to the rest of the Eurosystem are not limited. They can be carried indefinitely. There is no time prescribed for the settlement of the TARGET2 balances. Additionally, national central banks in debit are charged the main official rate, which is also the rate gained by those with claims on the Eurosystem. Thus these imbalances could go on forever (Lavoie 2015).

In other words, the TARGET2 system acted as an automatic stabiliser that prevented the implosion of the eurozone. Yet, it did not – and could not – prevent the divergence in bond yields witnessed between 2011 and 2012. This is why, in mid-2012, the ECB announced its Outright Monetary Transactions (OMT) programme. Mario Draghi unveiled the programme in his famous London speech, where he stated:

Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough (Draghi 2012).

By pledging to purchase government bonds on an unlimited basis, though under strong conditionality, effectively transforming the ECB into a quasi-lender of last resort, Draghi caused core/periphery bond yields to converge once again. Furthermore, following the activation of the ECB's quantitative easing (QE) program, peripheral government bonds, such as those issued by Italy and Spain, have been trading at record low yields. In another speech, held at the University of Helsinki in 2014, Draghi stated:

[I]f there are parts of the euro area that are worse off inside the union, doubts may grow about whether they might ultimately have to leave. And if one country can potentially leave the monetary union, then this creates a replicable precedent for all countries. This in turn would undermine the fungibility of money, as bank deposits and other financial contracts in any country would bear a redenomination risk. This is not theory: we all have seen first-hand, and at considerable costs in terms of welfare and employment, how fears about euro exit and redenomination have fragmented our economies. So it should be clear that the success of monetary union anywhere depends on its success everywhere. The euro is – and has to be – irrevocable in all its member states, not just because the treaties say so, but because without this there cannot be a truly single money (Draghi 2014).

In other words, the financial integrity of a monetary union rests on the equivalence of bank deposits in all member states. If a euro deposited in a Greek bank is judged less safe than that of a euro deposited in a German bank account, then monetary union ceases to exist in the eyes of the public. There is a significant exception to the (relative) calm on sovereign debt markets: Greece. Excluded from the QE program and subject to a structural adjustment program that is likely to fail (even on its own terms), the country is still judged by financial markets to be at risk of exiting the euro. This raises the doubt that the OMT and QE programmes, precisely because they are conceived as *emergency programmes*, may not be sufficient to guarantee the integrity of the EMU in case of a new shock.

Thus, what is needed is an instrument that will conclusively and permanently reassure markets about the 'fungibility' of the euro. Government bonds play a crucial role in the EMU (as in any other monetary system): they are both the 'raw material' through which the ECB issues the currency, as well as safe assets that banks need to function smoothly. Therefore, to ensure the stability of the financial system, *the government bonds of the euro area require the backing of the ECB*. Such backing is crucial also for the success of the

decentralised fiscal stimulus proposed in this article, because member states need to be insulated from any doubts that financial markets may have concerning their solvency or euro membership. Ultimately, guaranteeing the sovereign debt of the euro area member states means guaranteeing the irrevocability of the euro itself.

In practical terms, the ECB would simply have to pledge to do ‘whatever it takes’ to keep the interest rate differential between member states below, say, 30 basis points. This would ensure that member states would be able to finance themselves at reasonable costs even after the tapering of the ECB’s QE programme. The ‘fiscal effect’ of such a decision would be no different from that of the QE programme, and thus should not raise concerns of ‘monetary financing’ of government deficits. It could be argued that the ECB would be taking on a big risk – and mutualising it – by buying the bonds of potentially insolvent governments. This is irrelevant for two reasons. First, as with the OMT programme, it is likely that the ECB will not have to directly intervene in secondary bond markets to keep the spread within the predetermined boundary. Second, the ECB, quite simply, *cannot default*; as noted in a recent ECB paper:

Central banks are protected from insolvency due to their ability to create money and can therefore operate with negative equity (Bunea et al. 2016).

Jaime Caruana, general manager of the Bank for International Settlements, was even more explicit:

Central banks are not commercial banks. They do not seek profits. Nor do they face the same financial constraints as private institutions. In practical terms, this means that most central banks could lose enough money to drive their equity negative, and still continue to function completely successfully (Caruana 2013).

Ultimately, there is only one scenario in which the ECB could go broke: a collapse of the monetary union. On the contrary, a decentralised fiscal stimulus would have a number of economic and political benefits: not only would it have an immediate macroeconomic impact (thus leading to increased debt sustainability), it would also engender a more positive attitude towards European institutions (which would no longer be seen simply as enforcers of watertight fiscal rules), thus slowly re-creating the conditions – in the longer run – for moving towards a true solidarity-based and democratic fiscal and political union.

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