Can the Report of the 'Five Presidents' Save the Euro?

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Abstract: The international financial crisis of 2007/2008 and the 'great recession' that followed have highlighted a range of problems with the 'euro project', but these problems and difficulties are related to some fundamental weaknesses of the euro. There are well-known difficulties of macroeconomic policies under the Stability and Growth Pact, and the more recent Fiscal Compact, including their deflationary nature and the 'one size fits all problem' of imposing common deficit requirements on all European Economic and Monetary Union countries. There are also problems with monetary policy in view of the fact that the European Central Bank does not possess the functions of a central bank properly, especially that of lender of last resort. We discuss the reforms that are needed, most important of which is the requirement for a substantial Economic and Monetary Union-level fiscal policy as part of political integration, along with a banking union. In this context the recent proposals of the 'Five President's Report' (European Commission, 2015b; see, also, European Council, 2012) are relevant and the question is whether they will save the euro. It is concluded that the deep-seated problems are unlikely to be resolved, casting a dark shadow over the future of the euro.

1. Introduction

The 'great recession' has highlighted a range of problems with the 'euro project', but these problems and difficulties are related to some fundamental weaknesses of the euro. There are well-known difficulties of macroeconomic policies under the Stability and Growth Pact (SGP), and the more recent Fiscal Compact (FC), including its deflationary nature and the 'one size fits all problem' of imposing common deficit requirements on all countries. There are also problems with monetary policy in view of the fact that the European Central Bank (ECB) does not possess the functions of a proper central bank especially that of lender of last resort. Reforms are important and urgent. The nature of the reforms and their impact on the operations of the euro area are examined. We discuss the reforms that are needed from which the general conclusion is that they are extremely urgent, but unfortunately they might not be carried through. This discussion also includes the requirement for a substantial European Economic and Monetary Union (EMU)-level fiscal policy as part of political integration, along with a banking union. It is concluded that the deep-seated problems are unlikely to be resolved, casting a dark shadow over the future of the euro. In this context the recent proposals of the 'Five President's Report' (European Commission, 2015b; see, also, European Council, 2012) are relevant and the question is whether they will save the euro.

The ECB launched the single currency (euro) in 1999 alongside with the foundation of the EMU. The euro replaced the national currencies for all transactions at the beginning of 2002 for twelve countries, namely Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain. Another seven countries joined the EMU subsequently, Cyprus, Estonia, Latvia, Lithuania, Malta, Slovakia and Slovenia. In addition, there are countries, which use the euro as their official currency but are not members of the EMU; these are Andorra, Kosovo, Monaco, Montenegro, San Marino and Vatican City. All in all 336 million Europeans use the euro. It should be noted that Kosovo and Montenegro adopted the euro unilaterally; the rest, Andorra, Monaco, San Marino and the Vatican City, and in agreement with the EMU, use the euro as their official currency and issue their own coins. So the euro has been operating since 2002 (and since 1999 if the period as a virtual currency is included), when its introduction was technically accomplished. Although there have been occasional rumblings against it, there has not until very recently been any concerted effort for a country to withdraw from the euro and revert to a national

currency. However, the international financial crisis of 2007/2008, the subsequent 'great recession' and the euro area crisis, produced financial and budgetary problems in a number of EMU countries, which have brought withdrawal of some from the euro, especially Greece, as a seriously considered option.[1]

In terms of the economic performance of the euro area countries since the introduction of the euro, it has not been all that promising. Economic growth has been sluggish, inflation has remained low though often breaking the 'below but near' 2 percent inflation target,[2] and unemployment has remained high.[3] There have been continuing disparities in economic performance among the EMU countries in terms of unemployment and standards of living, and the framework of the euro area has little to address them. Many of the euro area countries have been exposed to these problems in view of the 'great recession' that emerged following the international financial crisis of 2007/2008. In fact, "Economic performance since 2008 has been outright dismal. By the end of 2014 domestic demand was still some five percent below its 2008 level and HICP inflation entered negative territory" (Bibow, 2015, p. 108).[4] The sharp increases in budget deficits as the economies slowed and tax revenues plummeted meant that the limits of the SGP were breached. Fortunately, the immediate response was generally to accept those breaches but it was not long before the calls for concerted action in terms of reduction of budget deficits and fiscal consolidation started. The 'Greek tragedy' and the crises in Ireland and Portugal, though, have exposed very obviously a number of these problems, which have also led to the question of the euro's survival.

What could save the euro is an interesting and topical question. History teaches us that monetary unions require economic integration to survive. In its absence, as the case is now with the EMU, then political integration is paramount (see, for example, Arestis et al., 2003; see also Arestis and Sawyer, 2006a, 2006b, 2006c). The requirements for effective political union are: EMU-level of expenditure programmes and taxation; and a common social security system, which would enhance labour mobility and would involve elements of redistribution. Fiscal policy would likewise aid economic integration and would involve significant fiscal transfers between countries and regions. It is clear then that political integration is very important for it provides fiscal union that enables coordination of taxation and spending throughout the EMU. Such union would allow the EMU to spread risk across

[1] Greece is an interesting case. After marathon debates, supposedly aiming to keep Greece in the euro area and lead the country to a path of sustainable recovery, a 'tentative deal' was reached. Whether such a deal would succeed is extremely debatable. But above all the lesson from the 'Greek Crisis' is that 'when push comes to shove' international creditors are the winners, not euro area democracy. Even worse the euro area has fragmented into different groups sticking to their national politics. Even worse, fiscal contraction of the magnitude imposed on Greece led to depression, especially so in the absence of domestic monetary policy and ability to devalue its currency. This experience raises issues about the functionality of the euro area; it is indeed not healthy at all for the future of the euro, Greece and other member countries.

[2] Actually the euro area's inflation target breaks have been persistent target misses in the upward direction prior to the international financial crisis 2007/2008 and an undershooting since then and especially in more recent times.

[3] Unemployment in the euro area, and in 2010, was around 10% of the labour force. The latest figures (as in the Economist 03 October, 2015) suggest that it is 11.0% (as in August 2015). In the USA it was also 10% in 2010, but the latest figure is 5.1% (as in August 2015). It is also the case that euro area youth unemployment (people unemployed who are between 15 and 25 years of age) is high at 21.9% (July 2015; available at: http://www.tradingeconomics.com/euro-area/youth-unemployment-rate) – 11.0% in the USA (as in August 2015; available at: http://www.tradingeconomics.com/united-states/youth-unemployment-rate). This raises issues about the future longer-term euro area growth potential.

[4] Harmonised Index of Consumer Prices, HICP, is a consumer price index, which is compiled according to a methodology that has been harmonised across the EU countries. The euro area HICP is a weighted average of price indices of member states who have adopted the euro; a geometric mean is used. HICP excludes mortgage interest payments, council taxes and other housing costs.

the EMU area and eliminate uneven booms and busts in different regions. Under such arrangements the ECB single interest rate would never be inappropriate for any one country; clearly this is not the case under current arrangements. Banking union is another relevant aspect to which attention should be paid. In this sense the European Monetary Union is incomplete without banking union, but more incomplete without fiscal union. The interesting question is the extent to which the 'Five Presidents' Report (European Commission, 2015b) tackles these aspects efficiently and satisfactorily.

We address these issues in this contribution where we first visit, in section 2, the convergence Maastricht criteria, which were built into the euro project. This is undertaken to illustrate the nature of the 'euro project' and also to indicate how some problems were left unaddressed at the start of the project and have now come to undermine the edifice of the EMU. Section 3 briefly visits the issues of the EMU fiscal and monetary policies, and highlights some of the policy faults, which lie at the heart of the euro. The question is also raised in this section of whether the euro can be saved, which requires political integration in the absence of economic integration. Section 4 considers the possibility of political integration, which would enable the euro to function effectively. We discuss in this sense the 'Five Presidents' Report that aims to achieve gradually an 'Economic, Financial and Fiscal Union'. We summarise and conclude in section 5.

2. The Convergence Criteria

The Maastricht Treaty, which was signed in February 1992 and entered into force on 1 November 1993, laid down criteria that should be met by those seeking to join the euro. The purpose of setting the criteria was to achieve price stability within the euro area and ensure that it would be maintained after new members accede. The convergence criteria applied to each country for membership of the EMU under the Maastricht Treaty are: (1) The 12-month average of yearly rates of the HICP should not exceed the unweighted average rate of inflation of the three community nations with the lowest HICP inflation rate by 1.5 percent; (2) the ratio of the annual general government deficit relative to Gross Domestic Product (GDP) at market prices should not exceed 3 percent at the end of the preceding fiscal year; (3) the ratio of gross government debt relative to GDP at market prices should not exceed 60 percent at the end of the proceeding year; (4) applicant countries should not have devalued their currencies during the last two years prior to membership, meaning that countries' average exchange rates should not deviate by more than 2.25 percent from its central rate (as agreed between the euro and the country's currency); (5) long-term interest rates (average yields for the 10-year government bonds in the year prior to membership) not to exceed the average interest rate by 2 percent of the three countries with the lowest HICP inflation rate (having qualified as benchmark countries for the calculation of the HICP reference value). The 'convergence criteria' were set in nominal terms (relating to inflation, interest rates and exchange rate) with no mention of real convergence (in terms of, for example, output per head or unemployment rates) or even of the convergence of business cycles across countries. These 'convergence criteria' are relevant for those EU countries, which may seek to join the euro in the future.

In terms of countries meeting the Maastricht criteria discussed above, it must be said that with the exception of the inflation rate and the interest rate, they were not met as comfortably as it might have appeared initially. In fact a great deal of 'fudging' took place (see, for example, Arestis et al., 2001). The experience with the budget deficit below 3 percent of GDP and public debt below 60 percent is interesting. In practice the 60 percent limit was not attained by many who joined and the 3 percent limit reached in a number of cases only through the use of creative accounting (Arestis et al., op. cit.). There are further problems with the same

constraints on budget deficit and debt for all EMU countries. There is no theoretical underpinning on these numbers whatsoever; why should they be 3% and 60% is an interesting and relevant question without a satisfactory answer, if any at all. It is also the case that ever since the introduction of the Maastricht criteria, a number of countries breached these rules without any penalties being imposed. The requirements for the interest rate and inflation rate in a country to be close to the average achieved in the three countries with lowest inflation had an inherent rationale. It was that after the formation of EMU, a single interest rate regime would apply and a common inflationary experience would be required for the successful continuation of the euro. The stability of a country's exchange rate relative to the other countries of the EMU had a similar intuitive appeal since the exchange rates of the EMU countries were about to be locked together.

Price stability to be achieved by the independent ECB is also an important aspect of the criteria discussed above. The independence of the ECB is in fact thought of as conducive to maintaining price stability. Neither the ECB nor the national central banks (NCBs), nor any member of their decision-making bodies, are allowed to seek or take instructions from EMU institutions or bodies, from any government of an EMU Member State or from any other body. The adoption of a national 'independent' Central Bank, as a forerunner for inclusion into the European System of Central Banks with the European Central Bank at its apex, signalled the adoption of a neo-liberal agenda (Arestis and Sawyer, 2006a, 2006c; Lucarelli, 2004). The question is whether independence of central banks, including the ECB, has worked as intended. Angeriz et al. (2008) demonstrate that there has been only a marginal effect of such independence; this is evident in terms of its impact on inflation, inflation persistence and containment of inflationary expectations. Angeriz and Arestis (2007, 2008) also show that low inflation and price stability do not always lead to macroeconomic stability. The international financial crisis of 2007/2008 and the 'great recession' that emerged, provide ample evidence of this conclusion. But even prior to the international financial crisis of 2007/2008 and the 'great recession', steady output growth and stable inflation were associated with growing imbalances, essentially in the balance sheets of households, firms and financial institutions. There were, in addition, growing misalignments of asset prices. All these imbalances proved to have been very costly indeed (Arestis and Karakitsos, 2011). More concretely for the ECB, in terms of recent experience and in terms of the euro crisis, the ECB independence seems to have been undermined. The Outright Monetary Transaction (OMT) programme, see below for further details, was opposed successfully for a while by some EMU member governments. Similarly for the Quantitative Easing (QE), see below for more details, which was never introduced before March 2015. Not to mention the ECB involvement in the Greek crisis in terms of the Emergency Liquidity Assistance (ELA) whereby the ECB suddenly froze its emergency funding to the Greek banking sector. There is the argument that the ECB acted illegally on this occasion as a result of pressures by the politicians.[5] All these incidents seriously undermine the ECB independence.

[5] The ECB, however, extended the ELA lifeline after Greece signed up to a new bailout package (July, 2015). The President of the ECB also indicated at the time that Greece could soon benefit from being included in the QE scheme.

3. Fiscal and Monetary Policy in the EMU[6]

3.1 EMU Fiscal Policy

In terms of the EMU fiscal policy, this is dictated by the SGP. The core elements of SGP are three: to pursue the medium-term objectives of budgetary positions close to balance or in small surplus over the course of a business cycle and not to have a deficit of more than 0.2 percent of GDP but not to exceed 3 percent of GDP in any given year (and debt to GDP ratio not to exceed 60%); the submission of annual stability and convergence programmes by the member states; and the monitoring of the implementation of the stability and convergence programmes. The official rationale for the SGP is twofold. The first is that a medium-term balanced budget rule secures the scope for automatic stabilisers without breaching the limits set by the SGP. Second, since a balanced budget explicitly sets the debt ratio on a declining trend, it reduces the interest burden and improves the overall position of the government budget. Underlying the approach to SGP, though, is the notion of sound public finances (see, also European Commission, 2000). The SGP seeks to impose a 'one size fits all' fiscal policy, namely that over the course of the cycle national government budgets should be in balance or in slight surplus with a maximum deficit of 3 percent of GDP. However, it has *never* been shown (or even argued) that fiscal policy should be uniform across countries. There is no reason that what is in effect a single fiscal policy is appropriate for all. Even if it is accepted that the budget should be balanced over the cycle, there is little reason to suggest that the extent of the swings in the budget position will be similar across countries. Also, there is no reason that a swing in the deficit to a maximum of 3 percent of GDP is relevant for all countries. It is also the case that countries differ in the extent to which their GDP varies in the course of a business cycle and to which the budget position is sensitive to the business cycle. There is, thus, no economic theory or empirical evidence to justify the SGP (see the references as in footnote 6).

There were problems with a number of EMU countries, which broke the SGP rules. That led to proposals endorsed by the European Council in March 2005. The main points of that endorsement were: more budgetary consolidation in good times; more flexibility in reducing deficits in bad times; more focus on cutting the debt to GDP ratio; more room for manoeuvre for countries carrying out structural reforms; countries with sound finances allowed to run small deficits to invest. Although the cosmetic changes, introduced in March 2005, entailed some flexibility, they did not address the underlying issue, namely the imposition of arbitrary arithmetic limits on budget deficits with the pursuit of balanced budgets over the business cycle.

The European Leaders agreed in principle at their meeting in Brussels on the 8th/9th of December 2011 to adopt tougher sanctions on the euro-area countries that break the 'new' rules of the revised SGP, the Treaty on Stability, Cooperation and Governance, what is now called the 'fiscal compact' (FC). This is an inter-government treaty, not a change to the EU treaties, whereby tax and spending plans will be checked by the European officials before national governments intervene. Its main ingredients are the following: a firm commitment to 'balanced budgets' for the euro area countries, defined as a structural deficit of no greater than 0.5% of gross domestic product, which should be written into the national constitutions; automatic sanctions for any euro area country whose deficit exceeds 3% of GDP; and a requirement to submit their national budgets to the European Commission, which will have the power to request that they be revised. In effect the FC retains the principles of the

[6] For extensive discussion on fiscal and monetary policy in the EMU see Arestis and Sawyer (2006a, 2006b, 2006c, 2012).

previous SGP version but with the added one that countries that break the deficit rules may actually be punished in some way. The limits of the revised and old SGP are in effect to balance the overall budget over the cycle and limit the national budget deficit in any year to a maximum of 3 percent of GDP. It is also the case that the rule of the old SGP of 60 percent debt to GDP ratio is retained. Any excess should be eliminated at an average rate of a 20th of the excess each year. For example, a country with debt at 80 percent of GDP would be required to reduce this ratio at 1 percent of GDP each year. FC entered into force on 1 January 2013. It is clear that the problems discussed above in relation to the SGP remain the same for the 'fiscal compact' as well.

3.2 EMU Monetary Policy

The ECB and the national central banks of the EMU countries comprise the European System of Central Banks (ESCB). The ECB is endowed with the responsibility of the single monetary policy and being "independent from political influence" (ECB, 2004, p. 12). The ESCB Treaty, Article 105 (1), states that "the primary objective of the ESCB shall be to maintain price stability" and that "without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2". The differences in inflation rates among the EMU countries have been a serious problem for the euro area. This has meant that a country with a relatively low (high) inflation rate has a relatively high (low) real interest rate since there is a common nominal interest rate anchor as set by the ECB applying across the EMU. Thus, monetary policy has operated in a perverse manner with low real rates applying where inflation is relatively high, running counter to the presumptions of inflation targeting that high inflation is met by high real rates of interest to dampen demand (see Arestis and Sawyer, 2012, for more details on these issues).[7]

The ECB may appear to have been rigid, especially when compared with the Bank of England and the USA Federal Reserve System (Fed). It is also the case that, unlike the Bank of England and the Fed, the ECB accepted the function of the lender of last resort in the secondary government bond market only in September 2012 under a great deal of opposition.[8] However, a number of changes have been taken or proposed as a result of the

[7] It should also be mentioned that price stability does not guarantee financial stability as this became clear after the international financial crisis of 2007/2008. Macroprudential instruments thereby become vitally necessary (Goodhart, 2014; see, also, Arestis, 2016). In terms of financial stability in the euro area, Article 127 of the Treaty on the Functioning of the European Union (TFEU) states that "the ESCB shall contribute to the smooth conduct of policies pursued by the competent authorities relating to the prudential supervision of credit institutions and the stability of the financial system"; it, nonetheless, goes on to suggest "the Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions with the exception of insurance undertakings". However, in view of the financial liberalisation era whereby financial regulation and supervision were absent, financial stability was ignored. As a result the euro area was ill-prepared when the international financial crisis of 2007/2008 emerged.

[8] The lender of last resort, especially in the government bond market, is important for the ECB for it is an essential tool for maintaining financial stability. De Grauwe (2013) provides relevant arguments that support this proposition; the ECB should be allowed to be lender of last resort in the EMU primary government bond markets. According to the OMT programme, introduced in September 2012, the ECB could provide unlimited liquidity support (but conditional on the European Stability Mechanism, ESM, see further below on the ESM, accepting to support the country concerned) in the secondary government bond markets of the euro area. This is so the argument goes, since buying debt instruments directly from the government in the primary markets is equivalent to monetary financing of the government budget deficit. Despite the regime change that the introduction of the OMT programme constituted in the euro area, and as shown below, there was a great deal of opposition to giving the ECB the OMT mandate.

international financial crisis of August 2007, the 'great recession' and the euro crisis that are worth discussing in this respect. The most important ones are the following.

The ECB pumped limited liquidity into commercial banks after the 2007/2008 emergence of the international financial crisis. Nonetheless, the ECB raised its rate of interest twice before it started reducing it from 4.25 percent in September 2008 (after the Lehman Brothers collapse on 15 September 2008) to an all-time low of 0.25 percent in November 2013. In May 2009 the ECB enhanced credit support to euro area banks at very low interest rates through the introduction of the Long-Term Refinancing Operations (LTROs). Sovereign debt is used through this scheme as collateral on the loans provided. LTRO is designed to provide longer-term liquidity than the standard Main Refinancing Operations (MROs), whose maturity is one week – liquidity could also be accessed through the Emergency Liquidity Assistance (ELA) scheme, which is a very temporary measure designed to help banks during periods of crisis. Initially LTROs were offered monthly and typically repaid in three months, six months or one year. In December 2011, however, the ECB offered a three-year type of LTROs, which had a significantly immediate higher demand than previous operations. From December 2011 to February 2012 the ECB provided €1trillion to the euro area banks.

The European Council decided in December 2010 the creation of the European Stability Mechanism (ESM), the euro area's permanent bailout fund. The euro area Member States signed an intergovernmental treaty establishing the ESM on 2 February 2012. The ESM was inaugurated on 8 October 2012. It was also established as a permanent firewall for the euro area. It was designed as the permanent crisis resolution mechanism for the countries of the euro area, to thereby safeguard and provide instant access to financial assistance programmes for member states of the euro area in financial difficulty, with a maximum lending capacity of €500 billion. The ESM issues debt instruments in order to finance loans and other forms of financial assistance to euro area Member States. The then existing European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM) remained active until mid-2013, when they were replaced by the ESM. They continued until then to handle money transfers and program monitoring for the previously approved bailout loans to the relevant euro are countries.

The European Union (EU) summit meeting, 28/29 June 2012, took a number of decisions: banking licence for the European Stability Mechanism (ESM) that would give access to the ECB funding and thus greatly increase its firepower; banking supervision by the ECB; a 'growth pact', which would involve issuing project bonds to finance infrastructure; two long-term solutions were proposed: one was a move towards a Banking Union and a single euro area bank deposit guarantee scheme; another was the introduction of euro bonds and euro bills. Germany resisted the latter, arguing that it would only contemplate such action under a full-blown fiscal union.

The ECB announced in July 2012 that it would do 'whatever it takes' to save the euro, as the President of the ECB promised then. That statement by the ECB President was considered as a turning point in the euro area sovereign debt crisis. The July 2012 statement was also confirmed by the ECB President after the ECB's first meeting in 2014 (Thursday 9th of January) of its rate-setting governing council: the ECB was willing and able to act quickly and decisively if inflation or money market rates got out of line. Indeed the President reiterated that monetary policy would remain ultra loose and accommodative 'for as long as necessary', with the key ECB interest rates to be kept as they were then, or even at lower levels, for an extended period of time. The key ECB lending rate was left unchanged at the meeting of its Governing Council on the 9th of January 2014, even though euro-zone inflation

rate was well below the ECB's 2% target, at just 0.8%, and unemployment was near record highs at 12.1 percent (November 2013).[9] Since September 2012, further details have emerged: the programme that might help those countries that were regaining market access shifted into a strict condition that they would have complete market access, so that a relevant candidate could be allowed access. Also, instead of publishing OMT's legal documentation 'soon' after September 2012, the ECB shifted stance to 'only publish when a country applies'.

Unlike the Federal Reserve and Bank of England, the ECB does not provide 'forward guidance' in the same way. It has its own version of 'forward guidance' (adopted in July 2012), which is the promise to keep interest rates at their current levels for an extended period, with the adamant statement that the ECB stands ready to maintain the high degree of monetary accommodation and even undertake more decisive action if conditions worsen. This, however, needs reinforcing along the lines of the Federal Reserve and the Bank of England, which pledge to explicit 'forward guidance'.[10] However, the ECB developed the OMT bond-buying tool, only in secondary markets though, to back up that pledge, which was unveiled in September 2012. The OMT was never tested. There was also the problem of unknown finer details of the programme. In addition, there was the condition that under OMT the ECB could buy unlimited amounts of short-maturity bonds in the secondary market of any country that signed up to fiscal conditions; it was also conditional on a government signing up for austerity-and-reform programmes.

Another proposal was the EU Bank Resolution agreed by the EU finance ministers at their meeting on the 18th of December 2013 – the Single Resolution Mechanism (SRM) as it is called. This agreement proposes a new system that will centralise control of failing euro area lenders. It will be responsible for restructuring the 130 biggest euro area banks if and when they are faced with problems, as well as 200 or so cross-border banks. It is also given the right to intervene in any of the 6000 euro area lenders if necessary. An important development on this score was the ECB President's promise to 'clean' the euro area banks, made on the 9th of January 2014 after the relevant rate setting of the ECB governing council. This was under the Comprehensive Assessment of 130 euro area banks across the 19 member states. This would cover 85 percent of the region's bank assets. A regulatory check of the banks' key risks and vulnerabilities followed by an in-depth asset quality review of their loans and bad debts, collateral valuations and trading book exposures.

The SRM was proposed to be a single resolution board, made up of representatives from euro area governments plus five permanent officials, and would be responsible for any decisions reached. However, relevant recommendations would have to be approved by the EU finance ministers. This procedure, however, could hold up controversial decisions. National governments could form national resolution funds by imposing levies on banks, which over

[9] Source is Eurostat, available at: http://epp.eurostat.ec.europa.eu/portal/page/portal/eurostat/home/

[10] The Federal Reserve and the Bank of England in their explicit 'forward guidance' pledged not to increase the rate of interest under their control before the unemployment rate fell to 6.5 percent and 7.0 percent respectively, unless the inflation rate exceeded their implicit and explicit targets respectively. The unemployment targets, however, were not to be treated as 'automatic triggers'. However, when by February 2014 the unemployment rates in both countries reached the 6.5 percent and 7.0 percent, that commitment was dropped by both central banks, with no longer explicit link to the rate of unemployment. The Fed considered more variables since, it was argued, it was important to account for more of them than simply unemployment when the interest-rate setting Federal Open Market Committee evaluated the conditions of the USA labour market. The Bank of England would no longer link its policy to a particular economic indicator. The rate of interest would not change unless significant rise in medium-term inflation expectations emerged and if the Financial Policy Committee saw risks, which needed to be addressed by an interest rate rise.

10 years would be merged into a single European pot, estimated to be around €55 billion. All this intended to stop expensive banking crises from ruining the finances of the relevant countries. It would bring to an end the use of the European taxpayer's money as a last resort, thereby ending the era of massive bailouts. But there are problems. The proposal may be too complex and its financial buffer is too small to safeguard against a major crisis. Furthermore, the SRM could face further problems, even a legal challenge, at the European Court of Justice (ECJ). The European Parliament and the European Commission have already expressed concerns that the SRM agreement does not follow the 'community method'.

In June 2014 the ECB introduced new steps to counter deflation. Reduced its benchmark interest rate from 0.25 percent to 0.15 percent (reduced further to 0.05 percent in September 2014); introduced a negative deposit rate, whereby the ECB would be charging commercial banks 0.1 percent (increased to 0.20 percent in September 2014) on their deposits with it. As from September 2014, the 'Targeted Long-Term Refinancing Operation' (TLTRO) was introduced whereby the ECB would support bank lending to the euro area non-financial sector. Banks could borrow up to 7 percent of their loans to companies and individuals (exclusive of mortgages) in two tranches in September and December 2014 initially; additional operations would be carried out in March, June, September and December 2015 and in March and June 2016. Banks could borrow for up to four years so long as they used the funds to lend to households and companies. This meant that banks would be able to borrow roughly 400 billion euros, cumulatively over four months.

Germany's Central Bank, the Bundesbank, opposed OMT on the ground that it was close to monetary financing, namely direct borrowing by governments from their central banks, which was banned by the Maastricht treaty; although the treaty did permit the ECB to buy public debt in the secondary markets.[11] The Bundesbank actually never warmed to the OMT. In fact the matter was referred to the German constitutional court, which in its turn referred the ECB OMT scheme to the European Court of Justice (ECJ), the highest legal court in the EU, on 7 February 2014. The view of the German constitutional court was still that the OMT programme was not covered by the mandate of the ECB; it was, therefore, 'incompatible with primary law' (as reported in the Financial Times, 8 February 2014), and it violated the German constitution. It would deprive the German government of its fiscal sovereignty for it would force it to accept any generated losses. The court considered OMT as 'monetary financing' or 'debt monetisation', whereby the Central Bank prints money to finance sovereign debt; this in this view was outlawed under European treaties. This incident raised questions over the OMT's legality thereby providing ammunition to the ECB's critics and prolonging legal uncertainty over the OMT. The German constitutional court concluded that only the EJC could decide on the matter. It is clear that both the Bundesbank and the

[11] The opposition to OMT in the government bond markets relies on the argument that by buying government bonds the ECB increases the money supply thereby leading to inflation (this is not necessarily the case, though). Also that such action can have undesirable fiscal implications in the sense that if governments failed to service their debt, the ECB would suffer losses, which would have to be borne by taxpayers. Such losses, though, may be necessary to guarantee financial stability. Moral hazard is, of course, another argument in that OMT would encourage governments to issue too much debt. In the case of the ECB, OMT is conditional on countries applying through the ECM, which would impose conditions on the country applying for support. In times of crises, though, the central bank should provide unlimited support at a price, which would take care of the moral hazard problem, without conditions. De Grauwe (2013), provides further details on all the issues covered in this footnote. In addition De Grauwe (op. cit.) provides clear evidence that the relevant Treaty does not forbid the ECB to buy government bonds in the secondary markets.

Germany's constitutional court registered their strong objection to monetary policies underpinning the euro.

It is worth noting that another problem emerged, which was related to objections to the proposed Banking Union. The Banking Union is set to face a challenge in Germany's constitutional court. Five German academics filed a case, and claimed that Banking Union was illegal and contrary to the German constitution because it was created without the necessary treaty changes. This case could take months winding its way through court hearings but will force officials from the European Commission and the ECB to defend the Banking Union.

On the 14th of January 2015, the ECJ released an Advocate General opinion on the legality of the ECB's OMT. The ECJ found OMT in line with EU law, with a final ruling issued on the 16th of June 2015, declaring the ECB bond-buying plan legal. The ECB at its meeting on the 22nd of January 2015 decided to undertake QE. Under this scheme the ECB would purchase €60 billion of euro area bonds and other safe financial assets, every month between March (2015) and September (2016), or until inflation is back to the ECB's inflation target. This implies total purchases worth around €1.1 trillion, equal to around 10% of the EMU's GDP. The ECB started the QE on 9 March 2015. One of the chief aims of the ECB QE was to stimulate bank lending and in turn encourage expansion of investment in the EMU countries. QE requires the ECB to buy sovereign or high quality bonds. This is undertaken with the objectives of, in addition to enabling the banking sector to prevent a contraction in credit from lending, also stimulating the 'portfolio channel'. The latter by suppressing the free-risk interest rate of government bonds and other relevant high-quality assets should enhance the price of all other assets, which include credit, equities and other. Whether it would be successful is an interesting and relevant question.

Investment is undertaken on the basis of healthy growth prospects and potential profits rather than lower interest rates. But investment prospects have been modest to say the least. Investment collapsed in the EMU following the 2007/2008 international financial crisis. It picked up briefly in 2010-2011 but it has stagnated more recently. In any case, EMU banks, insurance groups and pension funds need the relevant QE assets to meet their capital requirements. This could imply that the ECB would have to pay higher price to encourage institutions to sell their bonds, which would imply lower if not negative yields. So banks and other relevant financial institutions may not be persuaded to buy riskier assets, such as equities, to boost the economy. ECB may thus not be successful (see, also, Financial Times, 'European QE may not be live up to Draghi's hopes', 9 March, 2015). As it is also reported in the Financial Times (10 August, 2015), and referring to data from the EU statistical office (the Eurostat), investment in equipment and infrastructure in 2008 accounted for 23 percent of the euro area GDP; in 2014 it was 19.5 percent. It is suggested that the business sector has been using profits to repay debt, fund share repurchases or build up cash piles, instead of investing, a process that continues. More recent Eurostat data reveal that industrial production in the euro area fell by 0.2 percent, on month to month calculations, in May 2015 (while in April 2015 there was no growth); still worse it was reduced by 0.4 percent in June 2015. Further Eurostat data, released in August 2015, show that the fragility of the euro area recovery continued despite the massive QE bond-buying by the ECB. The euro area is struggling to recover from the economic crisis: the year to July 2015 figures show inflation at 0.2 percent, much lower than the 'below but close to 2 percent' ECB target, and GDP growth increased by only 0.3 percent (undershooting analysts' estimates). Under such circumstances the ECB QE is being held back from stimulating investment and growth in the euro area, and also from pulling back inflation to its target.

In any case, it is equity finance that is needed to promote growth; but it is lacking. This is so since the equity basis of the EMU banking system has not been handled properly. The banks have had to raise their equity ratio thereby reducing their leverage ratio. The reduction in their leverage ratio has not helped them to recover from the financial crisis, thereby weakening their ability to provide equity finance.[12] As reported in the Financial Times (12 July, 2015), euro area banks have actually reduced their balance sheets in view of deleveraging. Bank-credit growth is not large. This looks set to continue despite the early optimism that QE would boost bank lending.[13]

It is clear from the analysis in this section that there are serious problems with both the EMU fiscal and monetary policy. It is the case that the EMU's SGP, and the subsequent FC, as well as the common monetary policy have not acted as stabilising forces as had been argued by the proponents in the early 2000s. These problems have been shown to be serious, especially so by the emergence of the international 2007/2008 financial crisis and the 'great recession'. More seriously, though, these problems are rooted in the absence of economic integration, and as such, and as argued above, without a political union the EMU cannot have a good record of long-term survival. The section that follows examines the extent to which political integration might emerge in the EMU as required.

4. Would political integration emerge?

Our analysis so far has clearly shown that the need for a significant EMU fiscal policy is urgent, along with the question of whether political integration will emerge. The implementation of such a policy does require that the levels of tax revenues and of public expenditure, which come within the scope of EMU fiscal policy, and the balance between them (i.e. the budget deficit/surplus) is settled at the EMU level. It is though also remarkable how little attention has been paid by the EMU to the promotion of economic integration, which would produce convergence of economic conditions between the member countries, whether with respect to unemployment, positions in the business cycle or common inflationary and changes in competitiveness experience.

We try to answer the question in this section whether political integration would emerge under these circumstances. But in no way should one underestimate the political, legal and ideological barriers, which are raised against policy changes along the lines indicated. But it is clear that the EMU cannot proceed with its current policy arrangements, and for those who strive for economic integration in the EU and political integration must realise that changes are urgently required 'to save the euro'. Will political integration emerge? We attempt to answer this question in what follows.

A recent report of the European Commission (2015b; the 'Five Presidents' Report) on 'Completing Europe's Economic and Monetary Union' by the year 2025, updates relevant plans that were proposed in the European Commission Report (2012; the 'Four Presidents'

[12] Goodhart (2014) suggests that regulators should target Core Tier 1 capital, which is the numerator of the Capital Adequacy ratio (bank's capital as percentage of its risk weighted credit exposure), rather than the leverage ratio itself.

[13] More recently, since the introduction of the QE in the euro area, the question has arisen as to whether the ECB would have to undertake more QE in view of disappointing euro area growth and inflation (see footnote 13). In fact the President of the ECB is expected to announce further QE stimulus (see, for example, Financial Times, 'Focus shifts to further ECB stimulus', 23 September 2015), although he stated at his appearance before the committee on economic and monetary affairs at the Brussels European parliament (23 September 2015) that "We will … monitor closely all relevant incoming information and its impact on the outlook for price stability" before taking further QE (as reported in the Financial Times, 'Draghi wary over need for further dose of easing', 24 September, 2015).

Report). The aim is to gradually achieve 'a genuine economic and monetary union', which would gradually evolve towards 'Economic, Financial and Fiscal Union'.[14]

The 2012 report proposed closer integration in four main areas: Banking Union; closer integration of budgetary policies; better coordination of economic policies *other* than fiscal policy; and a strengthening of democratic legitimation and accountability. With the exception of the Banking Union objective, not much else was achieved. But even within the Banking Union driver not much has emerged. The only changes in the latter respect were the agreement on a new structure for prudential supervision of banks under the ECB pinnacle of national central banks and a common approach to resolving failing banks (the single resolution mechanism). Banking Union, along with common deposits insurance, is an important ingredient of the EMU. In the absence of political integration, a single currency within diverse states needs a Banking Union (Goodhart, 2014).[15] Such a union would greatly help to eliminate divergences among the euro area states and thereby help in the creation of EMU political integration.

The same broad headings remain in the new report (European Commission, 2015b), although some of the more contentious components have been dropped or toned-down in scope. The 2015 proposals contain two consecutive stages: the first stage (1 July 2015 – 30 June 2017), "would build on existing instruments and make the best possible use of the existing Treaties" (European Commission, 2015b, p. 5). In the second stage (mid-2017 to 2025), "concrete measures of a more far-reaching nature would be agreed to complete EMU's economic and institutional architecture" (European Commission, 2015b, p. 5).

Banking Union is probably the most important item of the report. The aim of the banking union is to achieve financial stability. This is to be achieved through improving bank regulation (involving rules in terms of what banks must, or may not do); introducing a single supervisory mechanism (reinforcing the regulatory rules along with discretionary powers to control undue risk-taking and ensure adequate capitalisation; introduced in November 2014); also by introducing a single resolution mechanism (to enforce regulations and facilitate consistently the approach to supervision across the banking union; introduced as from January 2016); and deposit guarantees (the European Commission will review the current country ones by 2019 and decide on whether a single pan-European Deposit Guarantee Scheme should be set up). The objectives of the Banking Union are to reduce financial risk

[14] The Five Presidents of the 2015 report were as follows: the Presidents of the European Commission, the European Council, the ECB, the EU Parliament and the Eurogroup. The Four Presidents of the 2012 report were the same with the exception of the EU Parliament one, who was not included in the latter report.

[15] Goodhart and Lee (2013) compare the euro area and the USA in terms of their "similar housing and financial shock in 2007/8" (p. 626) to conclude that unlike the USA badly-hit states (such as Arizona), which never needed a special bailout support, such concerns were prevalent in the euro area (such as Spain). Their suggestion of this difference is that this is entirely due to the USA having a banking union while the euro area is totally lacking it. The 'out-of-state' banks helped the adjustment of the banks in the troubled states. It should also be noted that fiscal transfers are also significant as in the case of the USA – but not in the euro area, where fiscal transfers do not exist. Eichngreen et al. (2014) compare another two USA badly-hit states, Nevada and Florida, with Ireland and Spain, another two badly-hit euro area states, and suggest that in the US, but not in the euro area, "The federal tax and transfer system provides a degree of automatic insulation from state-specific shocks. And the existence of a single bank resolution mechanism, the Federal Deposit Insurance Corporation, offers a degree of risk sharing when dealing with state-entered banking problems." (p. 233). Eichngreen et al. (op. cit.) also suggest that the absence of an EMU banking union is a problem. Goodhart and Lee (2014) reinforce this argument when they argue that the euro area "needs a banking union even more urgently than it needs a fiscal union" (Goodhart and Lee, 2013, p. 641).

and improve access to liquidity. Such a scheme is expected to improve confidence in banks and support growth in the EMU.[16]

Once the Banking Union is completed, a Capital Markets Union is to be launched for all the EU members. Strengthening macroprudential supervision at the EU level is also recommended. The Capital Markets Union was proposed initially in February 2015 (see European Commission, 2015a). The latter publication, the Green paper, "marks the beginning of a three month consultation. We want to hear from parliamentarians, member states, those who work in capital markets and from all groups concerned about jobs, growth and the interests of European citizens. That feed-back will help us to develop an action plan to put in place the building blocks for a fully functioning Capital Markets Union by 2019" (p. 3). In any case, "Compared to other parts of the world, European businesses remain heavily reliant on banks for funding and relatively less on capital markets. Stronger capital markets would complement banks as a source of financing and would: unlock more investment for all companies, especially Small and Medium-Sized Enterprises (SMEs), and for infrastructure projects; attract more investment into the EU from the rest of the world; and make the financial system more stable by opening up a wider range of funding sources" (European Commission, 2015a, p. 2).[17] It is true actually that Europe has traditionally been more dependent on bank lending, which makes the European economy, especially SMEs, more vulnerable when bank lending tightens, as the case was with the emergence of the international financial crisis of 2007/2008.[18]

In terms of fiscal policy the new report (European Commission, 2015b) emphasises the importance of fiscal discipline, referring to 'responsible budgetary policies'. In this sense the report proposes the creation of a fiscal stabilisation function for the euro area. However, such function "should be developed within the framework of the European Union" (European Commission, 2015b, p. 15). It is also suggested that the creation of a European Fiscal Board to conduct independent checks on the conduct of fiscal policy is important. However, this proposal "should not be conceived as a way to equalise incomes between Member States" (European Commission, 2015b, p. 15).

It is thereby recommended that "Responsible national fiscal policies are therefore essential. They must perform a double function: guaranteeing that public debt is sustainable and ensuring that fiscal automatic stabilisers can operate to cushion country-specific economic shocks" (European Commission, 2015b, p. 15); and that "The Stability and Growth Pact remains the anchor for fiscal stability and confidence in the respect of our fiscal rules" (European Commission, 2015b, p. 18). Clearly, this is not very different from the current

[16] This would be an important development in that it is the case that the current slow growth in the euro area (see footnote 13) is due to the inadequate strength of the banking system and the insufficient progress in writing down non-performing loans (see footnote 17).

[17] Another relevant development is that the ECB has been buying Asset-Backed Securities (ASB) since November 2014. The European Commission unveiled regulatory proposals on 30 September 2015 designed to enhance the securitisation industry. This, it is thought, should form part of a 'capital markets union' in the sense that ABS can offer the opportunity to increase the flow of credit without necessarily over-increasing the banking sector leverage (as reported in the Financial Times, 'Europe faces challenges in bid to revive ABS', 01 October, 2015). The danger is that banks may use ABS to deleverage instead of increasing credit. A further danger is that such initiative could lead to another financial crisis of the type of the 2007/2008 international financial crisis (see, for example, Arestis, 2016).

[18] A further relevant problem is the non-performing loans. A non-performing loan is that on which the borrower is not making interest payments or repaying any of the principal. When a loan is classified as non-performing by the bank, and when it becomes bad debt, depends on local regulations. And as the IMF (2015) reports, "The financial crisis and deep recession have left many euro area countries with high levels of non-performing loans (NPLs) and corporate debt. For the euro area as a whole, NPLs stood at €932 billion (or 9.2 percent of GDP) at end-2014, more than double the level in 2009" (p. 57).

EMU arrangements, as explained and criticised above. It is, therefore, the case that the EMU is far from a political integration scenario.

5. Summary and Conclusions

We have argued in this contribution that the economic problems within the euro area have been building since its inception, and have become acute with the 'great recession'. The faults lie in the design of the euro project, which requires significant and urgent changes, both basic and fundamental ones. Without such changes the euro area countries face a bleak economic future. Under these circumstances the future of the euro is surely not bright to say the least. Changes within the euro area are thereby desperately needed. Most important of which is banking union and fiscal integration. Indeed, the history of monetary unions around the world is very telling. In the absence of economic integration, a monetary union without a political integration simply cannot survive (Arestis et al., 2001; Arestis and Sawyer, 2006a, 2006b, 2006c).

We have discussed relevant proposals, the latest of which is the 'Five Presidents' Report on 'Completing Europe's Economic and Monetary Union'. Whether the latter and the relevant promised and forthcoming changes would produce satisfactory outcomes it is unfortunately a very sad expectation as argued above. Although the Five Presidents' Report on the economic governance of the EMU with the focus on the need to promote real convergence, it is far from achieving economic or indeed political integration. As such the proposed changes are rather cosmetic ones. It is also the case that obsession with rules rather than with sensible discretion does not help. Especially so under the current arrangements whereby the euro area's closest federal institution, the ECB and in the absence of political integration, is exposed to each of the 19 member countries of the EMU political pressures. Clearly then the measures as currently proposed will not save the euro. It is undoubtedly the case that the euro experiment is going through a severe test. Indeed the recent experience with the 'Greek crisis' has demonstrated the importance of the EMU moving towards political integration. At the same time, however, such an idea has not found much support. EMU leaders are not yet ready for a proper political union; on the contrary, recent experience may have taken the EMU to its 'slow-motion disintegration'.[19]

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[19] There are exceptions, however. The French President in his piece on the 19th of July 2015, in France's Sunday paper, Le Journal Du Dimanche, put forward his vision for the future of Europe: a government and a new parliament for the euro area countries to ensure its democratic control, and a shared budget. Also, and as reported in the Financial Times (27 July, 2015), the Italian Finance Minister suggested that a political union, along with an urgent completion of banking union, would be the only way for the euro to survive. The finance minister conceded, however, that the trend is not quite towards this kind of development. Even more recently, the French Minister of Economy, Industry and Digital Affairs is reported in the Financial Times (25 September 2015) to have stated that the current set up of the EMU cannot survive. An EMU Parliament and a Treasury with a single finance minister are desperately needed for its survival, he argued; and the Treasury should be overseen by the EMU Parliament.

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