



Eurozone: The High Cost of Complacency

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As the Eurozone is celebrating its first decade of existence this January 2009, a paradox strikes the observer. Caught by the “Ice-landic fever,” Eastern and even Northern small open EU economies are rushing to adopt the Euro. Yet, the region finds itself in deep recession for the first time since its creation. So the Euro is attractive, but the Eurozone is inert. How to make sense of this seeming contradiction? It is tempting to blame America for Europe’s recession, but the slowness of European action is also at fault. Actually, if we view the last decade as a whole, we

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see that European passivity has cost it dearly and there lies the key to the Eurozone’s still unfulfilled promise.

By any reasonable economic standard, the ten years between 1999 and 2008 have been a golden era. There probably was not a better time in contemporary history to launch a monetary union and, learning by doing, to build efficient and resilient economic policy institutions to ensure its prosperity and sustainability. Yet, the decade was largely lost by Europeans in vain doctrinal debates and sterile blame game sessions. Jean-Paul Fitoussi has convincingly argued that economic doctrine (e.g. determining the number of “pillars” a central bank monetary strategy should comprise) plays a central role in the Eurozone, as it does more generally in the European

Union. The reason it absorbs so much time and energy is that, absent a true democracy, economic doctrine has become over the years the justification of political power in Europe. Blame games also serve a purpose, which is essentially to cover up collective indecision and divergence among national governments as to what their collective growth strategy in globalization should be.

But arguing instead of acting has its cost. With virtually the whole planet booming over the past decade, the Eurozone has, since its creation in 1999, displayed the worse performance in terms of growth and unemployment of the developed world, barely ahead of a depressed Japan. Not to mention the growing divergence among its members with regards to inflation and long-term interest rates.

A PERSISTING DEFICIT OF GROWTH AND CONFIDENCE

In a report released last year, which received too little attention, the European Commission compiled striking data comparing EU 15 countries that became part of the Eurozone with those that decided against it a decade ago. Since 1999, the non-members have exhibited comparable or better nominal indicators (inflation, interest rates, fiscal balance) and far better real ones (GDP per capita growth, unemployment, labour productivity).

GDP per capita growth has actually decreased in Eurozone countries between 1989–1998 and 1999–2008, while it has accelerated over the same period of time in Sweden, Denmark and the U.K. In the meantime, the confidence of Eurozone citizens in their common currency has plummeted. According to the Eurobarometer, while 59% in the Eurozone thought the Euro was advantageous in September 2002, only 48% had this opinion in September 2006 (with negative opinions climbing from 29% to 38%).

One might conclude from these unflattering numbers that the value added of the Euro is so far, at best, dubious and wonder

why. But the European Commission did not, and recommended instead more of the same economic policies, stressing the importance of “budgetary surveillance” for the future and dismissing calls for improving economic cooperation and coordination among member states. Driving the same road, chances are Eurozone countries will enjoy more of the same economic performance.

In fact, the latest by-product of the European irresolution stands before our eyes. The European Central Bank (ECB) made in 2008 the exact same mistake as in 2001 by resisting a necessary cut in interest rates (actually, it *increased* interest rates in July 2008), waiting for the worst to be certain instead of trying to prevent it. In the meantime, the Fed acted boldly on both occasions to keep the U.S. economy growing. After the 2001 recession, it took a year for the U.S. to go from negative to vigorous growth. In the Eurozone, it took five years to fully recover. As for fiscal policy, despite the European labelling by the Commission of diverging national plans in December, a true European stimulus is still nowhere in sight, even as the economic outcome worsens by the day.

A LARGE ECONOMY OR A COLLECTION OF SMALL COMPETING COUNTRIES?

In the face of so much evidence, the European passivity is hardly understandable. Who can seriously argue that monetary accountability exists in the Eurozone, when ECB statutes are *de jure* untouchable? As for the Eurogroup, the informal gathering of Economic and Finance ministers of the Eurozone, its most important contribution to policy-making seems to be the choice of the adjective with which it characterizes its “concern” about the various aspects of the economic context. Actually doing something about it is apparently not in its repertoire.

Facts speak for themselves in this regard: the financial and banking crisis started to receive an adequate response after an improvised meeting of head of states and governments of the Eurozone last October, a standing body that does not even exist in European treaties. As Fitoussi observed: “the structure of power is such in Europe that those institutions who have the instruments to react have not the legitimacy to do so while those which have the legitimacy no longer have the instruments. Hence the

passivity of European policy reaction.” This inconsistency must be remedied and the current crisis must not be wasted.

The Eurozone is a single large economy, and, as such, needs proactive and cooperative macroeconomic policy of both the fiscal and monetary variety if it is to avoid disintegration in the medium term and to actually prosper in the long run. Stability without prosperity is not a viable option. Member states already rationally behave like small economies, pursuing competitiveness at the expense of one another, and monetary union runs the risk of being turned into a zero, or even a negative-sum game. The recent evolution of tax competition on corporate taxation is a salient illustration of how not only small countries compete against large ones in the Eurozone, but also large ones among themselves, with Germany as the front-runner. If the Eurozone continues to be run like a collection of competing small economies, the result will not only be slow regional growth and persistent unemployment, but also growing divergence among member states and rising political tensions.

Eurozone officials cannot go on pretending for another decade that they have consistently

built the right economic institutions but end up systematically with the wrong economic policies, which amounts to saying that the region is endowed with perfect rules but flawed rulers. This can not be true. As James Buchanan and Geoffrey Brennan put it, “good games depend on good rules more than they depend on good players.” The question is thus: isn’t it time to change the rules of the game in the Eurozone?

WHERE TO START?

But how to avoid the colossal cost of renegotiating European treaties? A good place to start would be to apply European law on exchange rate policy. The interpretation whereby the ECB reigns supreme on the Euro exchange rate is indeed highly debatable. The ECB is *de facto* in control of the exchange rate policy of the Eurozone through the exclusive control it has over the interest rate. But, legally, the Council can formulate general orientations for the exchange rate policy (Article 111 of the European Union Treaty) and the ECB must support those orientations when they are formulated, in accordance with its mandate.

As the ECB itself put it, the “ultimate responsibility” for the exchange rate policy thus

lies with the member states. Another way to understand this balance of power is to stress the distinction between independence of means and independence of objectives. The ECB is legally independent in terms of the means chosen to achieve the general exchange rate objective set by the Council. But this objective has to be discussed between the Council and the ECB. Hence, because the exchange rate policy is unambiguously a legally shared competence between the Council and the ECB, it could become the embryo of a true European economic policy, put under the authority of the newly created gathering of Eurozone’s heads of states and governments. By growing it into a full economic sovereignty, the Eurozone could be able to escape premature death by disintegration and reach maturity.

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