The Eurozone economy is stalling. Growth forecasts have been revised down. Inflation is falling, well below the level consistent with the definition of price stability (two percent). Unemployment remains high. Divergences between the members of the monetary union have not shrunk, with northern countries recording large and increasing surpluses in their current accounts, while the deficits in the south have largely been cut through sharp contractions in domestic demand and imports.

What needs to be done to put the Eurozone on a more sustainable growth path is clear. Mario Draghi, the president of the European Central Bank (ECB), restated it recently in Jackson Hole at the yearly conference organized by the Federal Reserve. It concerns three main policy areas.

First, Europe needs structural reforms to increase its growth potential and raise productivity growth. These reforms are particularly important in countries like France and Italy, which have lost competitiveness over the past few years. Second, aggregate demand needs to be boosted through concerted action at the European level to reduce the slack in the economy. Third, monetary policy needs to become more expansionary to counter the risks of deflation, which have emerged over the recent past.

The implementation of these policies is much more complicated and faces a series of political and institutional difficulties, some of which are common to the advanced economies, others that are specific to the Eurozone. This explains why Europe lags behind and may continue to muddle through in the near future.

Let us start with structural reforms. The European difficulties are not that different from those experienced in other parts of the world, notably Japan. Reforms are hard to implement because they lead to a redistribution of rights and income across different groups in society. Those that are affected negatively by the reforms tend to oppose them very strongly, given their vested interests. When these interest groups are well organized, for instance in unions and corporative interests, they are able to get the support of the public, making it hard for governments to implement the reform.

Reforms tend to be implemented when the economic situation is so dire that a growing majority of citizens understands that there is no alternative to change. Germany started implementing its structural reforms in the early 2000s, in the face of a record unemployment rate since World War II. Germany was considered “the sick man of Europe.” Reforms could get approved since people finally realized that the future of the German social and economic system was at stake. Nevertheless, it required harsh political fights and ultimately cost Gerhard Schroeder, the German chancellor, reelection.

More recently, Spain adopted wide-ranging labor market reforms as the rate of unemployment reached 25 percent,
Countries that have not experienced such dramatic deteriorations, like France and Italy, face even greater difficulties when implementing reforms. Citizens do not seem to understand how grave the situation is and may still live under the illusion that the economy can recover without major changes. Italy nevertheless adopted one of the most far-reaching pension reforms in 2012, but this was only possible because financial stability was at risk. This suggests that in order for reforms to be implemented throughout the Eurozone, the economy may have to get worse.

This raises an additional problem: it takes time before people can actually see the effects of structural reforms on economic growth. Some of these reforms may even produce negative effects in the short term, especially on employment and budget accounts. It is therefore politically difficult to implement reforms while pursuing other restrictive policies, particularly fiscal consolidation. The paradox is that in principle, it is better to pursue structural reforms during “good times,” but the political incentive to do so arises only during “bad times.”

This brings us to the second policy area, fiscal policy. Given the slowdown of aggregate demand in the Eurozone, fiscal policy should be somewhat relaxed. However, there is no single fiscal policy in the union, as the member states retain responsibility for their own budgets. Furthermore, member states have limited room to maneuver, given the high debt levels recorded in some countries. The financial market instability experienced in 2010 to 2012 has shown that countries with high deficits and debts have very little margin for loosening policies and need to continue their consolidation efforts.

Many observers tend to blame the European institutional framework, in particular the Stability and Growth Pact which limits deficits to three percent of GDP, for the austerity policies implemented over the past few years. However, the major restraints on the ability to relax budget policies ultimately came from financial markets. The debt sustainability of Italy, Spain, and Ireland—not to talk about Greece—requires that they continue to pursue medium term consolidation.

A key question is whether the pace of consolidation can be relaxed, at least in the short term. This requires that financial markets agree to finance a slower pace of adjustment, which ultimately depends on the credibility of the adjustment itself. This raises the issue of the complementarity between structural reforms and fiscal consolidation. The more a country embarks on structural reforms, the stronger its growth potential will be, and thus the sustainability of its public debt. Therefore, a country implementing structural reforms should in principle be able to afford a more gradual—and more effective—pace of fiscal adjustment. This is precisely what the European policy authorities would like to achieve, given the difficulty to implement structural reforms and fiscal consolidation at the same time.

In fact, the trade-off between structural reforms and fiscal consolidation is consistent with the way in which the Stability and Growth Pact has been applied over time. In 2003, while Germany experienced a budget deficit higher than three percent, the fiscal correction was diluted over several years in order to allow the country to implement a series of important reforms that would over time transform the “sick man of Europe” into one of the best performing economies in the world. Recently, Spain and France have also been given more time to reduce their deficits below the three percent benchmark in light of the reforms that they were implementing.

The problem with such a trade-off is time consistency. It takes time for reforms to be fully implemented and affect growth and employment, while budgetary measures have a much more direct impact. Ideally, the fiscal policy leeway should be granted before, or at the same time when structural reforms are being implemented, so as to create a favorable political environment for the latter. However, there is a risk that once the fiscal space is created, and used, policy makers will have little incentive to complete the part of the package related to the reforms. This would lead to a loss of credibility and a deterioration of the mutual trust between European policymakers.

The policy debate in Europe has been stuck on this issue, about whether the room to maneuver for fiscal policy adjustment—the so-called flexibility—should be provided before or after the implementation of structural reforms, and about which reforms are needed in order to use the required flexibility. This is clearly an issue of coordination failure, which needs to be addressed by a common institution, ideally the European Commission.

The mandate of the previous European Commission just expired in October 2014, and the new commission, chaired by Jean-Claude Juncker started immediately after. In his July speech to the European Parliament, Juncker recognized the need to re-launch demand in Europe. He proposed a plan for public investments in the order of 300 billion euro over several years. While Europe certainly needs large infrastruc-
tured that banks' failures end up raising the national public debt. An increase in banks' credit risks raises sovereign risk, given that European banks are heavily invested in domestic government bonds, a increase in sovereign debt immediately translates into higher banking risk. Vice versa, an increase in banks' credit risks raises sovereign risk, given that banks' failures end up raising the national public debt.

An additional complication comes from the full separation between monetary and fiscal policy in the Eurozone. De facto, monetary policy is outside the control of the member states, and the central bank pursues the primary objective of price stability in the Eurozone as a whole. Such a separation is beneficial in good times because it prohibits governments from interfering with the conduct of monetary policy and from using inflation as a tax to finance public expenditure. In the midst of financial turmoil, however, the full separation between the central bank and the treasury may make it more difficult for financial markets to price the government bonds of the different countries in an efficient way. European governments de facto issue debt that is denominated in a “foreign” currency. When the debt is denominated in the national currency, a default is much more difficult to occur. For instance, a country that is hit by a negative shock, which raises its budget deficit and debt, may reduce the interest rate and depreciate the currency to ease the adjustment and make the debt sustainable. In a monetary union instead, the interest rate and exchange rate are determined on the basis of the area as a whole. As a result, an asymmetric shock hitting one or a few countries does not necessarily lead to an interest and exchange rate change, which makes the adjustment more painful and potentially destabilizing. The risk of multiple equilibrium in the price of government bonds may arise, leading to self-fulfilling expectations, including the potential exit of the country.

The Eurozone experienced these perverse dynamics during the crisis, until the ECB made it clear that it would do “whatever it takes” to avoid countries leaving the euro, provided that they adopted an adjustment program that the European Union approved. The ECB would thus stand ready to buy unlimited amounts of any country’s assets that would be sold for fear that that country would leave the euro. Such an announcement helped to calm the markets in the summer of 2012.

This brings us to monetary policy. In a monetary union there can be only one monetary policy, which means a single representative interest rate. For monetary policy to operate efficiently, however, money has to be able to flow easily from one part of the union to the other, without major impediments. It should not really matter how and where the central bank intervenes to inject or withdraw liquidity in the markets, because the free flow of funds within the system should evenly distribute the liquidity across the union.

The financial crisis has put an end to these ideal conditions, as financial markets partly renationalize. Credit spreads started to be charged again for cross-border flows, in fear of sovereign or bank risks, which became increasingly correlated. Given that European banks are heavily invested in domestic government bonds, an increase in sovereign debt immediately translates into higher banking risk. Vice versa, an increase in banks’ credit risks raises sovereign risk, given that banks’ failures end up raising the national public debt.

The fragmentation of the financial market reduced the effectiveness and homogeneity of monetary policy throughout the union. Monetary conditions became relatively tighter in the part of the union that needed more accommodative conditions, and vice versa. The ECB tried to intervene to correct the differential in the transmission mechanism of monetary policy, but as a consequence raised fundamental questions about the role of monetary policy. In particular, the ECB intervened by purchasing government bonds from Greece, Portugal, and Ireland and subsequently from Italy and Spain, to try to avoid the spiraling of banks’ funding costs that...

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was unduly tightening monetary conditions. However, such interventions led to the direct assumption of sovereign risk by the ECB, which could lead to a redistribution of income in case the sovereign risk would effectively materialize and lead to capital losses for the ECB.

An additional problem is that the ECB’s interventions reduced countries’ incentives to adopt appropriate fiscal and structural policies. Given that political authorities have the incentive to act only when they feel the pressure of the markets, they tend to relax the intensity of their policy efforts as soon as market tensions appease. By intervening in financial markets, the central bank thus risks taking away the pressure on the other policymakers to implement their part of the adjustment. This is not unique to the Eurozone, but has been quite evident in several European countries over the last few years.

The debate about the role of monetary policy has become more acute as inflation gradually fell below the level consistent with the definition of price stability, which is “less than but close to two percent.” The traditional instrument through which the central bank injects liquidity in the markets has become ineffective. The ECB provides liquidity mainly through refinancing operations with the banking system, against collateral. The conditions have been gradually relaxed, in particular through close to zero interest rates and unlimited supply. The problem with such a procedure is that the quantity of liquidity injected in the markets ultimately depends on the demand from the banking system. If the demand for credit is weak and banks are concerned for their capital adequacy, the demand for central bank liquidity tends to drop. This results in a decrease in the size of the balance sheet—and thus a tightening of monetary conditions—at a time when the economy slows down.

Consequently, the ECB had to change its policy instrument. Instead of standing ready to lend money to banks, the central bank decided that it would purchase assets directly into the markets in exchange for liquidity. Financial institutions would then use that liquidity to purchase other—more risky—assets or to lend to the private sector. This is broadly the same instrument that has been implemented by the Federal Reserve, the Bank of Japan, and the Bank of England, under the name of quantitative easing.

The key question about such a policy is what type of assets the central bank should buy. The risk associated with such a policy is that it interferes with the market pricing system and it absorbs risks from the private sector, which, if they materialize, would lead—as mentioned previously—to a redistribution of income across ECB shareholders, the taxpayers of the different countries. For instance, if the ECB buys government bonds from a country whose debt is later restructured, with a capital loss for the central bank, the loss will be shared by all the ECB’s shareholders, and thus all countries. This is the reason why there are strong reservations within the ECB to purchase government bonds. On the other hand, government bonds are the most widespread and liquid assets in European financial markets. If the central bank wants to intervene in a quantitatively meaningful way it cannot rely only on private paper.

This problem would not arise if there was a single treasury in the Eurozone, or a single debt instrument like a Eurobond, issued under a joint guarantee by the member states. However, this would require shifting to a fiscal union, with the transfer of powers in the budgetary field from the national parliaments and governments to the European Union. We are not there yet, and unlikely to make such a move in the near future.

The ECB is nevertheless bound by its mandate, which sets price stability as its primary objective. If inflation does not move back to the two percent level, the central bank will have to step up its interventions, adding even more liquidity eventually through government bond purchases. If the ECB systematically fails to meet its objective, it risks losing its independence, as it happened to the Bank of Japan when it allowed deflation to become entrenched in the Japanese economy.

Monetary policy can achieve price stability, which is a necessary pre-condition for growth and job creation, but it cannot replace other policies, in particular structural reforms, in strengthening the economy’s potential. Without structural reforms, the Eurozone will continue to underperform compared to the other major economic areas. There is even the danger, as pointed out above, that monetary policy takes away the incentive for politicians to implement reforms.

To sum up, Europe needs a package of policies to tackle the cyclical and structural components of its economic slowdown. But each of the policies faces specific institutional constraints and may create disincentives for other policymakers to do their part. Although this issue is not unique to Europe, Europe’s incomplete institutional setup makes it more difficult for the continent to overcome the dilemma.