Divergence of the European Monetary Union's Monetary Policy from Member-States' Fiscal Policies as a Structural Deficiency in the Eurozone Crisis

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The European Monetary Union's (EMU) reforms, following the 2009 Eurozone crisis, proved to have mixed results on the future stability of European economic integration. For example, the stabilization of the European economies through macroeconomic fiscal consolidation policies, and the subsequent polarization of political parties across EU member-states, has proven that the EMU's response to the crisis has been inadequate. This paper will show that the Eurozone crisis was perpetuated by the structural deficiencies present within the EMU since its establishment by the Treaty of the European Union (TEU). The principal structural deficiency within the EMU was the divergence of perspectives between EU supranational institutions and member-states involvement in monetary and fiscal policy. It is argued that the EMU mistakenly made the assumption that a singular monetary policy would inevitably lead to systematic fiscal policy coordination between member-states through "spillover" effects. On the other hand, member-states assumed that the EMU would inevitably bail them out in times of economic difficulties. The inevitability of the EMU as a "lender-of-last-resort" is due to the intergovernmental dependence of each member-state on one another under a singular monetary policy. This paper will firstly introduce the structure and organization of the EMU followed by an analysis of the main structural deficiencies within the EMU, which perpetuated the Eurozone crisis. Next, the paper will highlight three EMU reforms, and the implications of those reforms within the EU, in response to the Eurozone crisis. Lastly, there will be a short discussion of the EMU's trade-off between supranational and intergovernmental policy coordination when it comes to ensuring the EMU's democratic governance.

STRUCTURE OF THE EUROPEAN MONETARY UNION (EMU)

The European Monetary Union (EMU) is responsible for establishing sustainable economic development balanced on growth and price stability (Art. 3, TEU). The European Monetary Union (EMU) consists of the "Eurosystem" and the European System of Central Banks (ESCB). The Eurosystem is comprised of the European Central Bank (ECB) and the member-states' National Central Banks (NCBs). The Eurosystem member-states also hold the euro as their official currency making them part of the Eurozone (ECB, 2011, 13). The European System of Central Banks (ESCB) is comprised of the ECB and NCBs of all member-states not in the Eurozone, in which they do not participate in European monetary policy (ECB, 2011, 13). Other than balanced economic growth and price stability, at the heart of the "institutional set-up" of the EMU, is the idea that it is possible to have "one monetary policy and many fiscal policies" by having a strong coordination amongst fiscal policies to achieve a sort of "fiscal federalism." Fiscal federalism refers to how fiscal responsibilities of taxation and expenditure are divided up between different levels of government (Baldwin & Wyplosz, 2015, 427). In the case of the European Union, fiscal federalism is referring to how fiscal competencies should be allocated between national governments and supranational (EU) institutions. Along with establishing monetary policy, and (indirectly) coordinating sound fiscal policy, the EMU is responsible for a flexible exchange rate regime, converging long-term interest rates, maintaining independence from political influence, and European Supervisory Authorities (ESAs) in areas of banking, insurance, and securities to secure adequate intervention when economic difficulties arise (ECB, 2011, 18).

In accordance to Article 130 in the Treaty on the Functioning of the European Union (TFEU) the central bank shall remain politically independent from "Union institutions, bodies, offices or agencies and the governments of the Member States... and not to seek to influence the members of the decision-making bodies of the European Central Bank or of the national central banks" (Art. 130, TFEU). The strong principle of monetary independence, where there was a lack of coordination with member-states' fiscal policies, resulted in macroeconomic divergence between the EU's monetary and fiscal policies. Macroeconomic divergence in the EMU was a prominent contributing factor to the Eurozone crisis. However, it was not only the deficiencies within the EMU structure that lead to the Eurozone crisis, but the fact that such challenges are inevitable in being part of the European integration process. As Mario Draghi, the President of the ECB, stated in 2014 this was the "Achilles Heel" of European integration (Jones, Keleman, Meunier, 2016, 1011).

CORE STRUCTURAL DEFIENCIES OF THE EUROPEAN MONETARY UNION (EMU)

At the heart of the deficiencies of the EMU (which perpetuated the Eurozone crisis) was consistent conflation between an intergovernmentalist fiscal policy and a supranationalist monetary policy, whereas EU bureaucrats were promoting a supranational "fiscal federalism" even though fiscal policy was primarily intergovernmental in nature. Instead, the ECB assumed that neo-functionalist integration in the EU's monetary policy would create a "spillover" effect into a seamless coordinated "intergovernmental" fiscal policy between member-states, however, this did not come to fruition (Jones, Kelemen, Meunier, 2016, 1016). On the other hand, member-states assumed that the ECB would inevitably have to offer a bailout package if a member-state did not maintain sound fiscal policy. Although the promise of a bailout package was not the case in the TFEU, the implicit assumption of bailout remained true as the failure of one member-state would mean the failure of the EMU. Therefore, the ECB would be "forced" to bailout the member-states to serve their own interest of achieving macroeconomic stability. At the creation of the EMU in 1999 these two perspectives of implicit coordination of fiscal policy, as a form of "fiscal federalism," and the assumption by member-states that the ECB would inevitably bail them out in times of extreme economic difficulty created a lack of coordination between fiscal and monetary policy which exacerbated the Eurozone debt crisis.

In economics, coordination of fiscal and monetary policy is critical in an optimum currency area because monetary policy affects the ability for governments to finance budget deficits while fiscal policy coordinates taxation and expenditure (Laurens & Piedra, 1998, 3). Therefore, if a state decides to have a large fiscal deficit but does not adjust the interest rate this can result in asymmetric currency shocks. Due to asymmetric currency shocks the state would have to devalue its currency or become fiscally insolvent (Laurens & Piedra, 1998, 5). Since all "Eurosystem" member-states share the euro it would be difficult to devalue the euro currency accordingly. Similarly, the EU as an optimum currency area (OCA) is subject to asymmetric shocks because the Mundell-Fleming model predicts that when capital markets are open EU member-states must choose between exchange rate stability or domestic policy autonomy (Copelovitch, Frieden, Walter, 2016, 824). The "Mundell-Fleming trilemma," or the "impossible trinity principle," implied that member-states of the European Union had to reluctantly give up domestic monetary policy autonomy to achieve exchange rate stability (Copelovitch, Frieden, Walter, 2016, 824).

Member-states of the Eurozone that gave up their monetary autonomy reflected the EU historic trend of moving from an intergovernmentalist to a supranationalist approach of EU policy-making (Tommel, 2018, 90). However, policy-makers during the formation of the EMU did take the difficulties of monetary and fiscal policy coordination into consideration; although, individual member-states were too reluctant to give up fiscal policy competencies to a supranational institution (i.e. ECB). For example, at the time of formation, the EMU knew of the risks associated with discoordinated monetary and fiscal policy, but they did not establish an effective method for regulating fiscal policy because the costs of giving up fiscal policy were too high for member-states wishing to maintain national sovereignty (Copelovitch, Frieden, Walter, 2016, 825). As a result of the endogenous constraints from the member-states' reluctance to give up fiscal competencies, in favour of an intergovernmentalist approach to European integration, a revision of the EMU was inevitable since its establishment in 1999. As on the eve of the launch of the euro currency European Commission President, Romano Prodi, stated that "I am sure the euro will oblige us to introduce a new set of economic policy instruments. It is politically impossible to propose that now. But someday there will be a crisis and new instruments will be created." (Jones, Kelemen, Meunier, 2016, 1018).

The Eurozone crisis had to be dealt with separately from the United States' subprime mortgage crisis, even though the catalyst for the Eurozone crisis was the collapse of Lehman Brothers in 2008. The United States' subprime mortgage crisis and the Eurozone crisis must be dealt with separately because there were structural problems within the EMU that perpetuated moral hazards in fiscally adverse EU states, such as the PIIGS countries (i.e. Portugal, Ireland, Italy, Greece, and Spain) (Shure & Verdun, 2018, 137). The principal structural deficiencies in the EMU that perpetuated the Eurozone crisis were: 1) a lack of a "mutual-recognition" approach that facilitated macroeconomic divergence; 2) a lack of fiscal policy coordination between member-states, and with the ECB's monetary policy; 3) weak financial regulation, most notably the Stability and Growth Pact (SGP); and, 4) the lack of credibility behind the no bail-out commitment (Art. 125, TFEU) meant that sovereign default risk was not taken into consideration when financial market risk increased in 2008 (Bernoth & Erdogan, 2012, 651). These four factors contributed to a divergence of expectations between EU institutions and member-states. The core structural deficiency being the ECB's assumption of "spillover convergence" of fiscal policies and the member-states assumption that the ECB would have to bail out insolvent member-states. Next, I will provide an assessment of how the four deficiencies developed within the EMU. This will be followed by an assessment of the key reforms and their implications since the start of the Eurozone crisis.

There was a lack of "mutual recognition" of the structural trade relationships between northern and southern European countries leading up to the Eurozone crisis. For example, between 1998 and 2007 German inflation averaged 1.5 percent per year while in Spain inflation averaged 3.5 percent per year (EuroStat, 2018). As a result of the differences in inflation, labour costs increased by 30.4 percent in Spain while in Germany labour costs fell by 3.9 percent between 1998 and 2007 (Copelovitch, Frieden, Walter, 2016, 818). Irrespective of the differences in inflation rates between Spain and Germany the EMU followed the optimum currency area (OCA) theory. Following OCA theory, the ECB targeted the interest rate between EU member-states inflation differentials to best serve all EMU member-states at around 3 percent inflation (Copelovitch, Frieden, Walter, 2016, 818). However, this implied negative real interest rates for southern European member-states, after factoring in high inflation, and slightly positive interest rates for low-inflation northern member-states. As a result, negative real interest rates in high-inflation member-states induced large amounts of private borrowing (Johnston, Hacke, Pant, 2014, 1772). With the exception of Greece, a "wage price-level effect" induced domestic inflation that eroded export competitiveness, which led to a surge in the current account deficit (i.e. net import surplus) (Johnston, Hacke, Pant, 2014, 1794). Therefore, Portugal, Italy, Ireland, and Spain's involvement in the optimum currency area (Eurozone) resulted in an overvaluation of the euro relative to the domestic strength of their economies. The overvaluation of the euro induced heavy private sector borrowing in high-inflation member-states (e.g. Spain) and heavy private sector lending in low-inflation member-states (e.g. Germany). This meant that capital was following north to south in the EMU because of interest rate arbitrage in the financial/private sector. Interest rate arbitrage in the financial sector implied that the sovereign debt crisis was not the result of reckless fiscal spending but was the result of private sector mismanagement, which turned into a sovereign debt crisis once the financial institutions were "bailed-out" (Johnston, Hacke, Pant, 2014, 1794). Failure of the EMU to adequately consider the effects of asymmetric supply shocks in an optimum currency union, which would increase the inflation rate under a targeted exchange rate, has been a core structural deficiency within the EMU (Roisland & Torvik, 2003, 113).

There was also a lack of effective fiscal policy coordination due to structural deficiencies within the EMU's Stability and Growth Pact (SGP). The Stability and Growth Pact (SGP) was established in 1999 to "speed up and to clarify the excessive deficit procedure set out (Art. 126, TFEU) in order to deter excessive general government deficits" (Council Regulation, 1997, No. 1467/97). The main role of the Stability and Growth Pact (SGP) was to ensure responsible fiscal policy coordination amongst EU member-states. However, a 2010 European Commission paper from the Directorate General of Economic and Financial Affairs found out that there were two "critical elements" overlooked in the SGP.

Firstly, it was found that rules and procedures for national fiscal policy making were "entrusted" to the member-states to decide on what was in common EU interests, which was an inevitable result of a "lowest common denominator solution" (Copelovitch, Frieden, Walter, 2016, 831). The key failure of this mechanism was that there was no institutional framework to enforce the SGP mechanism other than "peer pressure" from the no bailout clause in the ECB and "moral persuasion" from other EU member-states (Jonung, Noord, Larch, 2010, 5).

Secondly, the original SGP did not implement a proper escape clause because they did not factor in that even the most complicated SGP system would be unable to account for all potential financial situations or "contingencies" in the EU (Jonung, Noord, Larch, 2010, 5). A lack of foresight by SGP policy-makers and the fact that fiscal deficits did not show up on the public deficit figures, because they were private deficits, increased the financial risk of the EMU leading up the Eurozone crisis (Copelovitch, Frieden, Walter, 2016, 820).

Lastly, there was a lack of commitment behind the no bailout clause (Art. 125 TFEU) because EU member-states' self-interest appealed to intergovernmentalist thinking in which integration efforts only "intermittently spilled over into related sectors and policies." (Moravcsik, 1993, 476). For example, Article 105 (6) within the TEU (Maastricht Treaty) contained a provision that allowed member-states to "confer on the ECB a leading role in financial supervision" (Jones, Kelemen, Meunier, 2016, 1019). However, the Council of the European Union rejected the idea of a regulatory authority as "a step too far towards regulatory integration" (Jones, Kelemen, Meunier, 2016, 1019). Similarly, in response to the no bailout clause ECB President Mario Draghi stated he promised to do "whatever it takes" to protect the euro in 2014. The Outright Monetary Transactions (OMT) was his solution to the constitutional limitation of the ECB to act as a "lender-of-last-resort" when faced with the no bailout clause in Article 125 of the TFEU. The Outright Monetary Transactions (OMT) was a secondary bond market outside of the ECB placed under sovereign bond prices. The OMT made "unlimited purchases of obligations" with short-term maturities with governments that participated in fiscal consolidation (Jones, Kelemen, Meunier, 2016, 1025). Although the OMT saved the euro it implied strict "fiscal consolidation" policies that had stringent conditionalities similar to the IMF's structural adjustment programs.

In Greece, the OMT conditionalities under the European Stability Mechanism (ESM) implemented "austerity programs" which had strong contractionary effects on the Greek economy from 2010 to 2014. For example, the Greek GDP (Purchasing Power Parity 2009 adjusted) declined by 22 percent in less four years, unemployment rate increased from 7 percent in 2008 to more than 28 percent in 2014, final consumption expenditure decreased by 30 billion euros, and monthly minimum wages saw a real decline of 23.2 percent before income tax and social security contributions between 2008 and 2014 (Panagiotis, 2017, 43). As a result of "austerity reforms" the Greek economy's debt-to-GDP ratio still remains high at 179 percent in 2016 (Shure & Verdun, 2018, 141). The Greek's debt-to-GDP ratio is quite high considering Canada's debt-to-GDP ratio was only 92.3 percent in 2016 (Trading Economics, 2018). Despite the stabilization of the major European economies after 2014 the implications of "austerity" policies have created an environment for political polarization, with the rise of political parties such as SYRIZA in Greece, PODEMOS in Spain, and the Five Star Movement in Italy (Mavrozacharakis, Kotroyannos, and Stylianos, 2017, 39). In Greece SYRIZA led by Alexis Tsipras came to power in 2015 after George Papandreou of PASKO implemented austerity policies to manage the economic crisis (Mavrozacharakis, Kotroyannos, and Stylianos, 2017, 41). However, SYRIZA both wanted to leave the EU and stay within the Eurozone. Since Greece could not have it both ways the Tsipras government was forced to implemented further austerity policies in return for the chance to stay in power (Mavrozacharakis, Kotroyannos, Tzagkarakis, 2017, 40). SYRIZA presents an interesting case where decades of "spillover" integration of the Greek economy with the European Union limited Greece's sovereign ability to engage in intergovernmental bargaining with the EMU. The EMU's supranationalist authority over the Greek economy stands in direct contrast to the predominantly intergovernmental SGP program, where a lack of an effective enforcement mechanism gave rise to discoordinated fiscal policies. However, the success of Mario Draghi's OMT policy is debatable, as on the one hand it protected the euro and possibly the EU from disintegration; but, on the other hand it established strict austerity policies which has presented a challenge towards the democratic-sovereignty of EMU member-states.

THE EUROPEAN MONETARY UNION'S (EMU) REFORMS AND IMPACT

As a result of the Eurozone crisis there have been a number of EU programs established to manage the economic fall-out and potential recurrence of the Eurozone crisis. These policy programs can be characterized under fiscal policy reform, financial sector reform, and crisis resolution reform (Buti & Carnot, 2012, 906). In response to the lack of coordinated "macro-prudential" approach in the management of fiscal and monetary policy, it was critical that the Stability and Growth Pact (SGP) be revised to implement more stringent enforcement mechanisms. The European Commission revised the SGP into the 2011 "Six Pack" reforms that established quantitative fiscal rules for member-states to meet including an "operationalization of debt criterion" (Buti & Carnot, 2012, 907). The operationalization of debt criterion stated where public debt exceeded 60 percent of GDP member-states would have to reduce the excess debt by 5 percent per year over an average of three years (Buti & Carnot, 2012, 907). Otherwise, member-states would have to implement an excessive deficit procedure (EDP). The EDP is an action by the European Commission that would follow a set of financial procedures resulting in the imposition of strong financial sanctions against a EU member-state (EuroStat, 2016). Thus, the "Six Pack" reforms would enforce responsible fiscal policies amongst Eurozone member-states by increasing the severity of repercussions against states facing a sovereign debt crisis.

In the financial sector, the Basel III agreement increased capital requirements for credit institutions and investment firms. Increasing the capital reserve requirement for national and commercial banks reduced the risk of financial insolvency, which also improved transparency, accountability, and regulation of the banking system. These EU regulations and directives were based of the Basel Committee on Banking Supervision (BCBS) regulation (Regulation EU, No. 575/2013). Alongside the Basel reforms, the EU reformed the European financial supervision framework into the European Systemic Risk Board (ESRB) that monitored excessive risk-taking and deficit leveraging (Buti & Carnot, 2012, 908). However, the reforms in the financial sector have proved difficult to enforce because of the close relationship between governments and national banks (Buti & Carnot, 2012, 909).

Lastly, the EMU's crisis resolution reform established the European Financial Stability Facility (EFSF), later superseded by the European Stability Mechanism (ESM), which restructured monetary policy in Greece, Portugal, Ireland, Spain, and Cyprus through intervention in secondary bond markets (Buti & Carnot, 2012, 909). As proposed by the ECB President, Mario Draghi, the EFSF did stabilize the insolvent EU member-states. However, the imposition of harsh fiscal consolidation "austerity" policies on insolvent member-states contracted recipient countries' economies (Mavrozacharakis, Kotroyannos, and Stylianos, 2017, 39). In fact, it has been found that merely belong to the EMU would "increase the vulnerability of sovereign issuers relative to non-Eurozone countries" as private financial markets can "force" default on a state despite sound fiscal policies (Buti & Carnot, 2012, 909). Although the ESM system provided an effective curtailment of the Eurozone crisis the contractionary effects on recipient economies, and the political fallout (e.g. Greece), has hindered ESM policies as a politically attractive stabilization mechanism.

TRADE-OFF BETWEEN SUPRANATIONALISM AND INTERGOVERNMENTALISM?

Given the complexity of the EMU structure, and Eurozone crisis, establishing viable policy solutions to aid the structural deficiencies present has proven difficult. However, the approach taken to aid the Eurozone debt crisis has presented new challenges that question the democratic nature of the EMU. Questions revolving around the democratic legitimacy of the EMU's policies can be attributed to the macroeconomic divergence of monetary and fiscal policies in the EMU. Furthermore, the discoordination of monetary and fiscal policies can be attributed to the divergence of perspectives between member-states that assumed the ECB would act as a "lender-of-last-resort," and the ECB's assumption under a centralized monetary policy fiscal policy coordination would be inevitable.

Dani Rodrik's trilemma between deep economic integration, national sovereignty, and mass politics implies that only two out of the three components can be maintained at a single point in time. For example, due to the separation between monetary and fiscal policy in the currency union mass politics was sacrificed to maintain national sovereignty of the member-states and EMU price stability (Snell, 2016, 178). The transfer of mass politics to EU institutions, at the expense of national sovereignty, can prove to be a viable solution in establishing a democratic and stable EMU. However, the complete transfer of democratic politics to EU institutions is unlikely given the reluctance of member-states to give up fiscal policy autonomy (Snell, 2016, 179). Rodrik's trilemma shows that the EMU's response to the Eurozone financial (and sovereign debt) crisis has proven to be an ad-hoc arrangement with mixed implications for EMU member-states. Overall, divergence of expectations between supranationalist institutions (e.g. EMU) and intergovernmentalist member-states has proven to be a fundamental deficiency within the EMU's architecture regardless of the EMU's reforms.

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