European Failures: Democracy on a Slippery Slope?

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It cannot be denied that Europe has performed particularly badly over the major part of the past decade. We have suffered many years of economic stagnation, including a 'double dip' recession from which the economy even at this moment still has a long way to go before having completely recovered. Unemployment has risen to record high levels, precarious work practices are spreading, and inequalities are on the rise. And while the events that initially triggered the start of this long period of crisis were outside of our remit (the bursting of the US subprime bubble), policy in Europe has made a series of mistakes that worked to deepen and prolong the crisis.

A series of mistakes

A first major mistake was made in 2010 when, reassured by the so-called "green shoots" of recovery, Europe as a whole switched from a supportive fiscal policy stance into a restrictive one. At that time, this was called an "expansionary fiscal consolidation". What we got however was not an expansion but a new recession adding an even higher number of unemployed to the dole queue.

A second mistake concerns monetary policy making. Standard macroeconomic theory tells us to offset fiscal tightening by monetary easing and that, given the different time lags, monetary policy should take care to anticipate and act in a timely manner. On at least two occasions however, the ECB did the opposite by raising interest rates at a moment the economy was already staring in the face of a serious downturn. Moreover, other central banks in the world were not only faster in cutting policy interest rates to the zero number, they also quickly adopted so called unconventional monetary policies by 'monetizing' debt and printing money to relaunch aggregate demand in all sorts of ways. In the euro area, we had to wait until just recently before this form of quantitative easing arrived.

Add to this the breakdown of the so called monetary transmission channel in the Euro Area, with the euro area periphery being hit by an especially vicious feedback loop between the sovereign and its banking sector and the picture is complete. With fiscal policy in austerity mode, with monetary policy staying too long in doubt on the sidelines and with a banking system that is broken across major parts of the euro area, no wonder the economy went down and we ended up with so many unemployed.

A Monetary Union that is incomplete

History cannot be turned back. History however does exist to learn from it so that the same mistakes are not to be repeated in future. So what explains the policy errors described above? Was it a case of mistaken analysis on the side of policy deciders? Was it the factor of "tradition" that occupied the mindset of policy makers, thereby inducing them to apply the old policy model of "competitive disinflation" on an entirely different and new set of economic problems (bursting of debt financed asset bubbles)? Or was there a structural reason that was pushing policy makers into a certain but dangerous direction leaving them little choice but to publicly deny the risks, take the plunge and hope for the best?

Arguments can be made for each of these three reasons. However, the latter is the most relevant one. Indeed, the way monetary union is designed contains structural flaws. Seen against this background it becomes easier to understand what has happened and why policy makers reacted in the way they did.

The key problem here is that sovereign debt of individual euro area member states is no longer backed by a central bank of their own. Indeed, when adopting the single currency, member states do not only become member of European monetary union, they are also divorcing in some way from their national central bank. The *Banca d'España* (just to name one) does continue to exist but with the competence on monetary policy transferred to Frankfurt, the government in Madrid can no longer call upon the assistance of a money creation institution in case of emergency.

This peculiar combination of one supranational central bank together with 19 different sovereign debt stocks has made euro area member states extremely vulnerable in case of a run on the bond market for their sovereign debt. No longer able to resort to the their own national central bank as a lender of last resort, governments in European monetary union have no other choice but to adopt brutal austerity –or else default– in the face of a liquidity crisis.

Until 2010, this gap in the construction of monetary union in Europe went completely unnoticed. However, when the crisis of Greek public finances erupted back in 2009 and with central bankers openly declaring their increasing unwillingness to accept Greek debt as collateral, the fault - line in monetary union became painfully clear. Financial markets reacted in a **predictable** way, by panicking and staging a self- fulfilling prophecy: Realising that, in the absence of the ECB backing up Spanish, Italian, French, or Belgium sovereign debt, a run on these bonds could trigger default, markets started running for the exit by massively dumping these bonds.

The rest of the story is the one described at the beginning. Euro Area Member states, trying to calm down markets, embarked on the experiment of highly pro-cyclical austerity, thereby topped this further up with wage devaluation. Their hopes soon turned out to be vain as austerity and internal devaluation triggered the double dip recession, thus on the contrary stoking (instead of appeasing) markets' worst fears about default and/or break up of monetary union. This vicious circle was only broken some years later when the ECB's president, Mario Draghi, finally addressed market concerns about the lack of a lender of last resort by orally promising to do 'anything it takes' to save the single currency.

Democracy on a slippery slope

By then however, the damage had already been done. The price however does not simply come in the form of economic stagnation, record high unemployment and rising inequalities. An even more worrying issue is that these events have also been accompanied by a certain hollowing out of the principle of democracy. Euro area elected governments have repeatedly found themselves to be confronted with little other choice but to abide by what the markets seem to be demanding or, alternatively, to obey the detailed "diktats" prescribed in –not so– secret letters written by monetary policy makers. At its most extreme, the interventions of the "troika" entering the crisis counties and intervening in the social and economic fabric of these countries with the single aim of guarding the 'sanctity of debt' should raise deep concerns.

Moving forward

If the single currency is to be made to work, then this basic flaw of national sovereign debt existing on its own and without a structural backing of a central bank needs to be addressed. And, if we want to avoid new financial market "accidents" from flaring up again, we cannot wait for another 20 years (or even more) during which the Fiscal Compact is supposed to bring public debts back down to the 60% of GDP threshold. What the euro area needs to do instead is to set up its own Treasury, a euro area Treasury issuing its own bonds. Bonds whose proceeds are used to finance investment across the euro area, bonds that replace national sovereign debt at an accelerated pace and bonds of which markets know they are, if necessary, backed by the ECB (see here for a detailed description of this idea).

The mantra of structural reforms