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Editorial to the special forum

Making the euro area work: proposals for monetary and fiscal reform

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Seven years after the Great Recession, the crisis of the European Monetary Union (EMU) is far from over. In many countries unemployment remains intolerably high. The improvement of unemployment rates has slowed down in recent months. In some countries aggregate demand is still too weak to stop the decline in wages and prices, while dwindling oil and food prices threaten to take the whole euro area to the brink of a deflation. Private and public investment is below precrisis levels, and consumption expenditures suffer from low incomes and high inequality.

Economic policy has contributed little to stabilize the EMU so far. After a brief phase of supporting demand by means of public expenditures during the crisis, fiscal policy has been forced into austerity in all EMU countries simultaneously. In particular, the so-called 'crisis countries' in the South and Ireland were coerced into a drastic reduction of their public expenditures and welfare states. The cutbacks in budgets have been less severe in most countries during the past 2 years, but fiscal policy still fails to foster aggregate demand in most EMU countries. The only serious attempt to increase investment expenditures, the so-called 'Juncker Plan' or 'European Fund for Strategic Investment' (EFSI), was flawed from the very beginning and has not had any effects so far.

Monetary policy, on the other hand, has been extraordinarily expansionary. The European Central Bank (ECB) promised to do 'whatever it takes' to save the euro and embarked on a large-scale purchasing programme of public debt of EMU countries last year, which is going to be continued until 2017. However, without the support of fiscal policy, this programme will have only limited effects. Pumping more and more money into the financial system does not automatically increase aggregate demand in the EMU. Relying on monetary policy alone will not lead the EMU out of the crisis.

The abovementioned developments highlight some of the fundamental weaknesses of the EMU which this Special Forum aims to address. Notably, all four articles focus on the importance of fiscal policy and its interactions with monetary policy. In the first contribution to the Special Forum, Philip Arestis assesses the question of whether the 'Five Presidents' Report,' which was published last year, has the potential to eradicate the fundamental deficiencies of the EMU. He argues that, given the experience of past years, the monetary union will not be able to survive without further political integration in the long run. Political integration, on the other hand, requires certain changes in the field of fiscal policy, such as EMU-level taxation and expenditure programmes and a common social security system, which would entail significant fiscal transfers between member states and regions. In Arestis's view, these policy instruments should be handled by a common fiscal authority, which should furthermore be enabled to issue debt in a currency under its control – that is, debt that is backed by the ECB. Arestis then argues that the reforms proposed by the Five Presidents'

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Report fall short of these deep reforms and are therefore not suited to achieving political integration. He concludes that the Report is not very different from current EMU arrangements and that it will therefore fail to save the euro. Instead, the EMU is doomed to follow the path of a 'slow-motion disintegration' accompanied by a continuing economic crisis.

Andrea Terzi takes a similar line and argues that in a monetary economy all financial savings are stored in the form of a financial claim and therefore require other economic agents to issue the corresponding debt. He develops a simple ('T-shirt') model to show that when savings exceed the intended amount, the private sector dissaves, spends money, and creates jobs. When savings are short of the intended amount, private entities destroy jobs. This also means that differences in the financial balances of economic sectors are absolutely normal in a monetary economy and should not be treated as 'imbalances.' Assuming intended savings as given, any policy that restricts the formation of debt also inhibits the formation of financial savings and thus the creation of jobs. A cap on public debt, as required under the EMU rules, therefore constrains one major source of savings. It leaves the euro area with two alternatives, both unsustainable: building up more private debt or counting on a permanently high trade surplus.

Both Achim Truger and Jörg Bibow highlight the lack of public investment as a major source of weak demand in the EMU. Truger calls for the implementation of a 'golden rule' of public investment into national and EMU fiscal frameworks. The golden rule would exempt public (net) investment from the deficit targets of both the preventive and the corrective arms of the Stability and Growth Pact as well as the Fiscal Compact. That way, fiscal policy would receive more room for maneuver and public investment, as a particularly growth-enhancing public expenditure category, would be strengthened. Furthermore, debt financing of public investment would strengthen the 'pay-as-you-use principle' since future generations of taxpayers would share the burden of financing the capital stock. Truger argues that the golden rule was an important element in the original plan for the German debt brake, as proposed by the Council of Economic Advisers in Germany, and that it was unfortunately left out of the European Fiscal Compact – a fact that led to a significant decrease in public investment after the Great Recession.

Jörg Bibow goes one step further and proposes a Euro Treasury to boost public investment in the euro area. The core idea is to establish a new fiscal entity to pool future euro area public investment spending. It would be funded by euro area treasury securities. The Euro Treasury would give investment grants to EMU member states in line with their GDP shares. Such a Euro Treasury plan would establish a 'minimalistic' fiscal union without entailing fiscal transfers between member states and regions. Furthermore, no mutualization of existing national debt would take place and the no-bail-out clause would remain in place. Member states would still need to adhere to the existing fiscal rules and balance their budgets. The difference with respect to the current framework is that since public investment is undertaken by the Euro Treasury, it is excluded from fiscal rules. The golden rule of public investment would therefore automatically be implemented. The Euro Treasury plan would furthermore eliminate all national debts within a generation and thereby create a monetary union that actually functions, as in the USA. Bibow acknowledges (as does Arestis) that a full-fledged political union is still a long way off, and that German fears of a 'transfer union' are hard to appease. The Euro Treasury Plan therefore focuses on what may be feasible in the near future.

The four contributions to the Special Forum all share the aim of making the EMU governance framework function properly. Their proposals reach from a full political union with an enormous transfer of fiscal competences at the EMU level to more pragmatic proposals with a more realistic chance of being implemented in the near future, such as the 'golden rule' or a Euro Treasury. What they have in common however is the view that, without any changes in the fiscal policy framework, the EMU is doomed to fail.