'None of the above' is no longer an option for the Eurozone

Covid-19 has reignited concerns about the future of the Eurozone. **Mark Copelovitch** *explains that there is no sound economic reason why the Eurozone and its member states should find themselves in such a dire position. The problem is entirely political and can be solved only if European leaders finally step up and address the core problems threatening the Eurozone's long-term survival.*

The Covid-19 pandemic once again has left the Eurozone teetering on the brink of collapse. After an initial stumble, the European Central Bank has responded aggressively. President Christine Lagarde has fully embraced the "Draghi doctrine," noting in her announcement of the ECB's $750 billion bond purchasing initiative, the Pandemic Emergency Purchase Programme (PEPP), that "there are no limits to our commitment to the euro."

The ECB's aggressive intervention has been welcome news. But the crisis also requires a joint European fiscal response. This is why I joined more than 300 other scholars in signing an open letter to the Financial Times urging Eurozone leaders to "mutualize the fiscal costs of fighting this crisis" by issuing common debt. Unfortunately, the "frugal four" countries, led by the Netherlands and Germany, have sharply opposed Eurobonds, claiming predictably that this would create moral hazard and punish countries that saved responsibly for rainy days. Instead, the Eurogroup cobbled together yet another underwhelming compromise that fails to resolve the Eurozone's enduring problems and reflects the stubbornly persistent narrative of "northern saints" and "southern sinners," in which debt is equated solely with deficit countries' "fiscal sins" and never ascribed to structural problems of monetary union.

But monetary union is not a morality play, and the Eurozone's core problems and fundamental imbalances remain the same as they did two decades ago. These persist because of two key policy errors that have been left to fester for years: the "original sin" of admitting countries into the EMU that clearly failed to meet the Maastricht criteria, and the failure to fully resolve the last euro crisis. As with the recent Eurogroup package, politics drove these decisions. Monetary union simply could not exclude one of the "original six" countries of the European Community and the European Coal and Steel Community. Likewise, the Eurozone's crisis policies since 2010 have delicately balanced political interests – most importantly, the domestic political preferences of Germany and Angela Merkel.

German Chancellor, Angela Merkel, speaking with Dutch Prime Minister, Mark Rutte, at a European Council meeting, Credit: European Union

Unfortunately, "kicking the can down the road" has left these problems to fester, particularly in Italy and Greece. This legacy debt problem is most clearly visible in Italy. Measured by its primary budget surplus, Italy has been as fiscally prudent as Germany and the Netherlands since the establishment of the euro in 1999. Yet two decades of austerity and primary surpluses have not reduced Italy's debt level, leaving it saddled with a decades-old overhang and lacking fiscal space to address the Covid-19 crisis. In Greece, the economic devastation remains truly staggering. The country is now mired in a depression longer and deeper than the Great one, with GDP stuck more than 20% below 2007 levels and a full recovery still years, if not decades, away.

These festering problems have now transformed another serious shock into an existential crisis, again raising the spectre of the Eurozone's collapse and the EU's uncertain future. Economically, this makes no sense. The ECB issues the world's number two reserve currency and inflation is negligible. Most of the Euro-19 can borrow at negative real interest rates in essentially unlimited quantities. The Eurogroup, as a whole, faces no real resource constraint, and there is no sound economic reason why it should find itself in such dire straits.

The problem, of course, is politics, most notably sharp cross-national disputes about the distributional costs of adjustment policies. But what is politically expedient today for surplus countries like Germany and the Netherlands is almost certainly unsustainable in the long run for deficit countries like Italy and Greece. As French President Emmanuel Macron noted in his interview with the *Financial Times* earlier this month, the Eurozone faces a "moment of truth" requiring both greater North-South "solidarity" and major reform if it is to survive.

What might a sustainable Eurozone look like? There are at least three options. The first involves deeper fiscal union, with some form of shared debt. The second involves little or no fiscal integration, leaving crisis policy primarily to individual governments. But in order for all states to have the fiscal "breathing space" to deal with crises unilaterally, this option requires comprehensive debt relief to finally eliminate the debt overhangs and permanent austerity plaguing southern countries. The third version involves neither fiscal union nor debt relief but requires periodic large fiscal transfers from surplus to deficit countries during crises, along with the gradual "monetisation" of debt through an ECB that targets and delivers higher inflation.

Eurozone leaders have categorically ruled out the first and second options for a decade, on the grounds that they are politically infeasible, while pretending that they have chosen option three. In reality, they have not: the fiscal transfers have been far too small, and the ECB has undershot its inflation target for nearly a decade, making it all but impossible for Greece and Italy to adjust through internal devaluation and austerity alone. In reality, Eurozone leaders have repeatedly chosen "none of the above," opting only for half-measures that prevent the euro's collapse but fix none of its fundamental problems. This "failing forward" has severely weakened political support for the Eurozone (and the EU) in the south.

In short, a sustainable Eurozone requires Germany, the Netherlands, and others to decide if they were truly serious when they signed up for a monetary union. If so, they must finally choose some combination of economically feasible but politically unpopular policies: deeper fiscal union, comprehensive debt relief, larger and permanent north-south transfers, or permanently higher inflation. This involves wrestling with difficult tradeoffs and being honest with voters about the Eurozone's real problems, rather than falling back again on unhelpful, moralising narratives.

However, choosing "none of the above" is unsustainable. The status quo – with its half-hearted fiscal solidarity and permanent austerity for southern countries – will eventually lead to the Eurozone's demise. The euro has survived for two decades by kicking the can down the road. Yet as Herb Stein famously noted, "If something cannot go on forever, it will stop." European leaders should seize the momentum provided by the pandemic crisis to finally, at long last, address the core problems threatening the Eurozone's long-term survival.

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Note: This article gives the views of the author, not the position of EUROPP – European Politics and Policy or the London School of Economics.

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