The Euro @20: How Economic and Financial "Asymmetries" Marred the Promise of the Single Currency

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The dream of building a unified Europe traces its roots back to the signing of the Treaty of Rome in 1957. France, Germany, Italy, the Netherlands, Belgium, and Luxembourg established a common market known as the European Community, or EC, which meant abolishing intra-trade barriers and erecting common external tariff barriers. To facilitate the functioning of the common market and encourage intra-EC trade and investment, exchange rate stability was deemed an integral part of deeper economic, financial, and political integration among EC member states. In the heyday of the Bretton Woods system (1944–1971), pegged exchange rates provided the necessary currency stability that made a monetary union a less urgent goal for the European project.

The breakdown of the Bretton Woods system in 1971 and the ensuing chaotic experiment of generalized floating exchange rates revived the goal of a European Monetary Union. The ill-fated European Monetary System (1979-99) re-enacted on a European scale a mini-Bretton Woods system of pegged exchange rates that was designed to limit exchange rate volatility. Undermining this quest for exchange rate stability were structural disparities, or "asymmetries," between "core" and "periphery" countries. More specifically, the source of failure was the significant differences between member countries' key macro-economic aggregates such as GDP per capita, unemployment, inflation, current account balances, interest rates, nominal and real exchange rates, fiscal balances, and government debt—differences that the European Monetary System proved unable either to eliminate, or to deal with effectively.

The launch of the single currency in 1999 rekindled the European Union's momentum for deeper integration. But a first decade of low interest rates was marred by bulging budgetary and current account deficits in several eurozone sovereigns that brought them to the brink of default in 2010. A second decade of sluggish and lopsided recovery since then has deeply scarred Europe's social fabric and widened the divide between the single currency's winners—Northern European countries—and losers—chiefly, the Mediterranean countries. Can a retrospective of the EU's long quest for monetary union explain how the euro crisis was seeded? What is in store for the euro in its 20th year? Will the corona virus pandemic prove to be a game-changer by enabling the eurozone to recapture its momentum—or is it fated to languish and fade away?

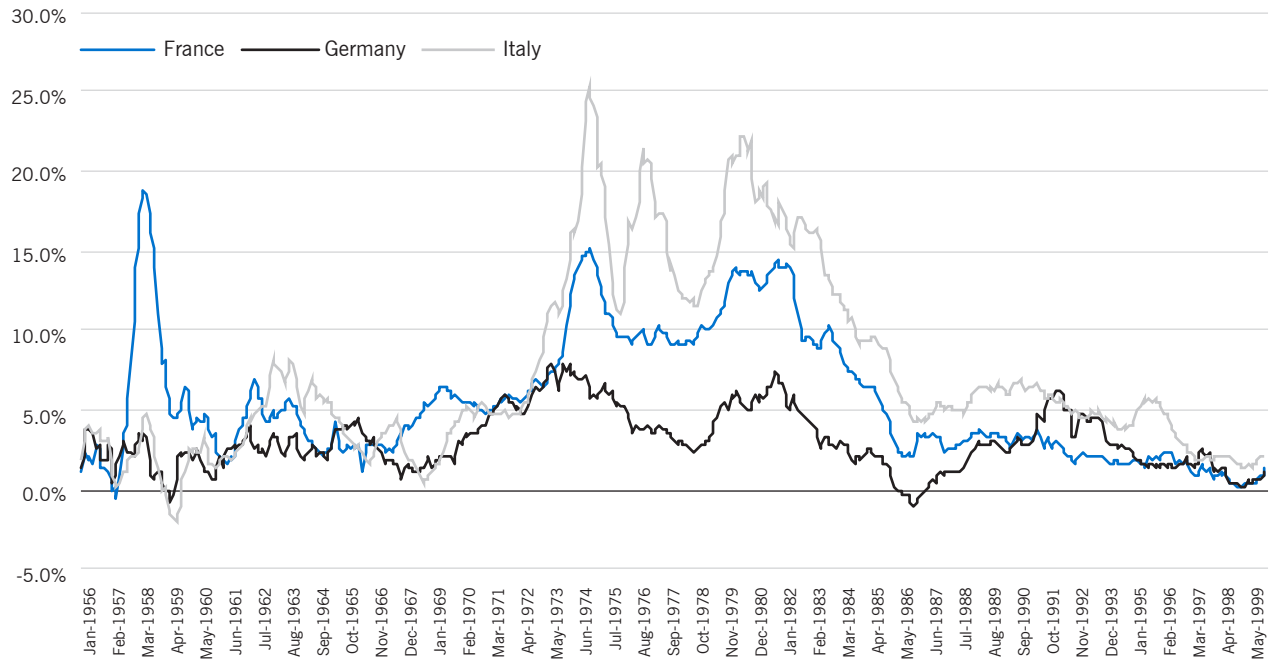
In what we have cast as a drama in five acts, Act I recounts the quest for a European Monetary Union and documents the gradual deepening of monetary cooperation among member states. The promise of how the single currency held first with the launch of the euro in 1999 (Act II) but was later broken by the euro crisis (Act III) is explained through the lens of the construct of an optimal currency area. Is the euro @ 20 (Act IV) likely to limp along by "muddling through"? or, will the corona pandemic (Act V) usher the euro area into bold reforms to deepen the European monetary union by laying the foundations of a fiscal union? or will it simply splinter with one of the crisis countries exiting the euro area?

Act I: The Quest for Monetary Union

Launched on March 13, 1979 by the EC, the European Monetary System (EMS) had three principal objectives: to reduce exchange rate variability, limit macroeconomic asymmetries and foster monetary stability through economic convergence

Figure 1

Inflation Rates in France, Italy and Germany (1957-1999)



among its constituent members.[1] In effect it resurrected on a Europe-wide basis the old Bretton Woods system of pegged exchange rates. The EMS called for closer monetary cooperation among EC countries, leading eventually to full monetary union—admittedly a lofty goal for Europe. A zone of European quasi-exchange rate fixity was to be achieved by establishing a two-pronged pegging system around a newly created artificial currency unit called the ECU, or European Currency Unit.

Grid of Bilateral Par Values à la Bretton Woods. First, a parity grid, based initially on the definition of bilateral par values among the seven core EMS currencies, created a matrix of 21 tightly managed rates. Fluctuations were limited to plus or minus 2.25 percent of central rates (Italy was allowed a wider band of 6 percent). Once a currency reached its bilateral limit against another member currency, the two national central banks involved were required to intervene to prevent the exchange rate from escaping from the scheduled band of fluctuations. This was also known as the *exchange rate mechanism* (ERM).

In addition to lower and upper intervention points, the EMS introduced an early warning system in the form of a divergence indicator for each currency from a fixed "central rate" against the European Currency Unit (ECU). This system of divergence indicators acted as an *early warning* signal. Once a currency ECU rate diverged by three-quarters of its allowable band, there was a presumption that its government would take remedial action, such as raising interest rates or tightening fiscal policy if the currency was weak.

The EMS Straitjacket Comes Unglued. In spite of the EMS's lofty ambition of providing a zone of monetary stability to the European Community, most member nations currencies' (with the exception of the Dutch guilder) devalued by at least 20% against the Deutsche mark between 1979 and 1987. The French franc alone devalued by more than 50% against the Deutsche mark, and the Italian lira did not fare any better. The severe currency crisis in the summer of 1992 hastened the loosening of the EMS. The catalyst seemed to have been Germany's decision to tighten its monetary policy. Germany used higher interest rates to rein in inflationary pressures brought about by the massive expansionary fiscal policy that had been necessary to meet the cost of German reunification. This restrictive monetary policy of Germany is reflected in the rates of German, French, and Italian inflation shown in Figure 1.

1 The Treaty of Rome had already acknowledged that the exchange rate of member countries was a matter of "common interest." Even before the collapse of the Bretton Woods and in view of the incipient instability of the dollar in the late 1960s, the European Council had authorized the Werner report on moving ahead with economic and monetary union (EMU). See Pierre Werner, Baron Hubert Ansiaux, G. Brouwers, B. Clappier, U. Mosca, J. Schollhorn, and G. Stammati, *Report to the Council and the Commission on the Realisation by Stages of Economic and Monetary Union in the Community*, EC Commission, Brussels, October 8, 1970.

Even before the demise of the Bretton Woods system of fixed exchange rates in 1973, French and Italian inflation were higher than German inflation. After 1973, French and Italian inflation shot up, as both countries loosened their monetary policy, whereas German inflation went down as Germany tightened its own monetary policy. The inflation differentials remained high until the early 1980s. Because of collective decisions about realignments, exchange rate devaluations in countries with more expansionary monetary policies and higher inflation than Germany were never allowed to offset completely the cumulative inflation differential between these economies and Germany. This was especially true for Italy. As a consequence, inflation rate differentials/asymmetries were never fully corrected in Purchasing Power Parity terms and therefore, through the EMS years, Germany became more and more competitive vis-a-vis Italy and other EC economies with higher inflation while the Deutsche mark remained consistently undervalued.

Higher German interest rates also forced other EC countries to raise their interest rates significantly to defend their currencies against the German mark. Britain and Italy hiked their interest rates to 15% and France to 13% at a time when these countries were confronted with sluggish economic growth and high unemployment. Speculators increasingly reckoned that exchange rate parities would become unsustainable and that weak economies would eventually resort to devaluation to prop up their economies.

On September 14, 1992, after having lost an estimated $4 to $6 billion in a futile intervention in the currency market, EC central banks finally surrendered to market pressures. Britain and Italy abandoned the EMS ship, whereas Ireland, Portugal, and Spain devalued their currencies. Indeed, in 1993, with most countries no longer willing or able to mimic Germany's high interest rate policy, the EMS widened its allowable band of fluctuations around cross par values to plus or minus 15%, in effect aborting its pegged exchange rates policy in all but name. The original EMS limped along until August 1993, when it finally came unglued. For all practical purposes, the European Monetary System morphed into more of a floating rate system, although the wider fluctuation margins were not fully utilized.[2]

Why Did the EMS Fail? The short answer is that the EMS simply resurrected on a regional scale the architecture of the Bretton Woods system, which had been proven unstable and had collapsed 20 years earlier. The loosening of exchange rate controls in the 1980s as well and the pursuit of national policies—rather than a coordinated single European monetary and fiscal policy—largely explain the inherent instability of the EMS. No amount of central bank intervention in the currency markets could keep the edifice standing, as the punishing crisis of 1992–1993 painfully demonstrated. In spite of higher than anticipated exchange rate volatility, national interest rates and inflation rates did start to converge in the 1990s, paving the way for the launch of the euro in 1999. The gapping asymmetries between the core and periphery countries had been only partly reduced, and the lessons of the EMS crisis of the early 1990s were ignored!

Act II: The Auspicious Launch of the Single Currency and the Seeds of its Demise

The Maastricht treaty, which was signed in 1992, set the European Union on the path toward monetary union by setting convergence objectives (later known as the Growth and Stabilization Pact) that would serve as prerequisites for a country to join the euro:

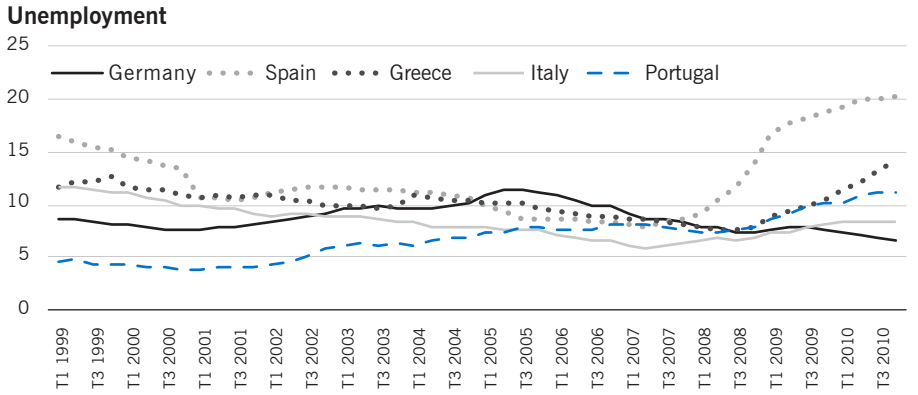
- reducing budget deficits below 3% of GDP;
- reducing public debt below 60% of GDP;
- keeping inflation sufficiently close to the average of the three countries with the lowest inflation rates;
- reducing short term nominal interest rates sufficiently close to the average of the three countries with the lowest nominal interest rates; and
- participation in the ERM of the EMS for at least two years without realignments.

On January 1, 1999, member countries abandoned their national currencies and adopted a common currency dubbed the euro. On the launch day, each country locked in its exchange rate against the euro, which took over from the ECU. A European Central Bank (ECB) was established to issue the new currency, conduct the common monetary policy for the newly formed euro area (EA), and set a common interest rate for all its members. Each member country retained an independent albeit constrained fiscal policy, but surrendered its monetary autonomy. To join the euro club, countries would have to satisfy the Maastricht criteria, later codified into the Stability and Growth Pact and listed above. The objective was to impose fiscal discipline on member countries so that fiscal policy independence would not undermine the stability of the euro. However, there was no master plan to build a European fiscal union to complement the monetary union.

2 For a historical account of the operation of the EMS within the context of the international monetary system, see Barry Eichengreen, *Globalizing Capital: A History of the International Monetary System*, Princeton University Press, Princeton, N.J, 2008. For a detailed analytical treatment of the EMS, see Francesco Giavazziand Alberto Giovannini, *Limiting Exchange Rate Flexibility: The European Monetary System*, MIT Press, Cambridge, MA, 1989. For a history of monetary cooperation in Europe in the post-war period until the creation of the Euro, see Harold James, *Making the European Monetary Union*, Harvard University Press, Cambridge, MA, 2012.

Figure 2

Unemployment in Germany and Greece, Italy, Spain (1999-2010)



Having been officially approved by the European Parliament on May 2, 1998, the euro was formally launched on January 1, 1999, with 11 founding members: Austria, Belgium, Finland, France, Germany, Holland, Italy, Ireland, Luxembourg, Portugal, and Spain. Greece joined on January 1, 2001, just in time for the launch of the euro in physical form. Slovenia joined in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014 and Lithuania in 2015. The European Central Bank was also formally established on January 1, 1999 and headquartered in Frankfurt (Germany); its prime mission is to conduct monetary policy with the overarching goal of keeping inflation at 2% or below. Three other countries known as the euro-skeptics—United Kingdom, Sweden, and Denmark—met the Maastricht criteria but decided to opt out. The remaining 10 countries failed to meet admission criteria and were encouraged to put their financial houses in order to satisfy the Maastricht Treaty criteria before applying to become members of the euro club.

Macroeconomic Euphoria (1999-2008). The first nine years of the euro constituted a period of relative macroeconomic euphoria throughout the euro area (EA). In most respects, the creation of the euro area appeared an unmitigated economic success.[3] Growth rates remained healthy, with countries in the periphery growing faster than Germany, France and the smaller economies of the core. Inflation rates in the periphery, though still higher, continued to converge towards the low inflation rates of the core and unemployment rates were on a downward path, especially in the periphery. Between 1999 and 2007, real GDP per capita was growing at an average annual rate of about 1.7% , the same as in the U.S. and higher than the average growth rate of 1.4% in Japan. GDP per capita in the economies of the periphery was rising faster than the EA-12 average of about 2.6% per year. The same applied to the small economies of the core, which also experienced higher than average growth rates at 2.0% per year. However, the average annual growth rates in the three largest economies were lower than the EA-12, with Germany at 1.7%, France at1.4%, and Italy at 1.1%.

Unemployment rates also fell significantly. For the EA-12, the average unemployment rate fell from 9.8% in the 1990s to 8.5% in 2000-2007. Average unemployment rates in the periphery fell even further, from 14.6% in the 1990s to 9.3% during 2000-2007. In the smaller economies of the core, average unemployment rates fell from 7.1% in the 1990s to 5.9% in 2000-2007. The periphery also experienced the steepest reductions in inflation with average annual rates falling from 5.3% in the 1990s to 3.3% in 2000-2007. The proximate cause of the economic boom in the countries of the periphery of the euro area was the precipitous fall in their real interest rates that resulted from the elimination of the devaluation premium; their interest rates converged with those of Germany and the smaller core economies.

However, these first nine years of the euro also saw new debilitating asymmetries develop as a result of the introduction of the single currency and the divergence of inflation rates and real interest rates. The new asymmetries took the form of significant current account imbalances between the core economies—especially Germany—and the periphery.

3 According to the President of the ECB Jean-Claude Trichet in 2009: "When we look back over the first ten years of the euro, then we can do this with satisfaction. The skeptical forecasts before its birth have not materialized. The euro is a historic achievement. Its first ten years have been a success. ... We have many challenges to cope with in the years to come. Some are shared with the other important central banks in the world, like responding to the present economic and financial global situation and drawing all the lessons from the present turmoil." See Jean-Claude Trichet: "Ten years of the euro – successes and challenges," (Speech); Osnabrück, 12 February 2009.

Figure 3

Sovereign Debt as a percentage of GDP for Germany, Greece, Italy and Spain (1999-2010)

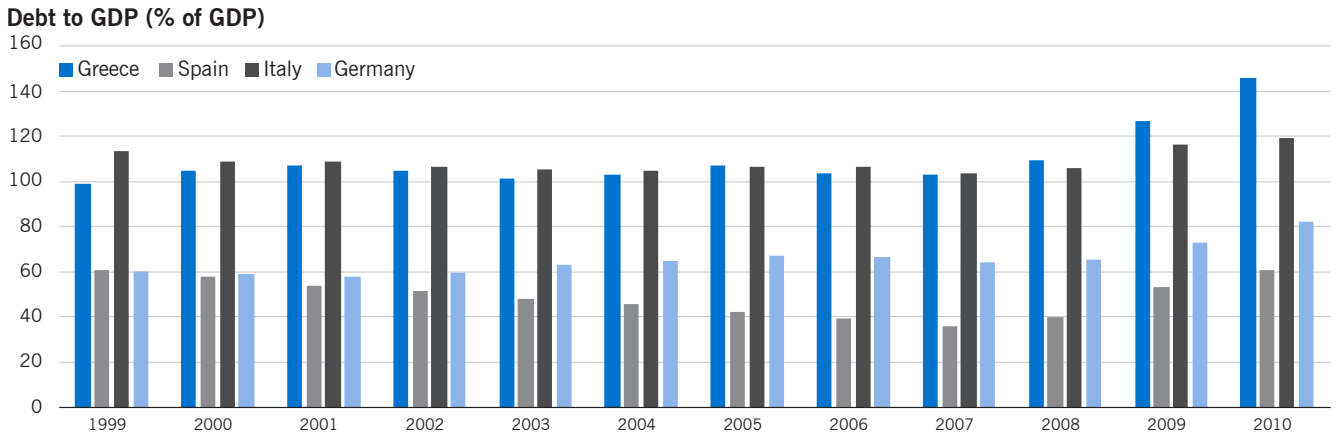
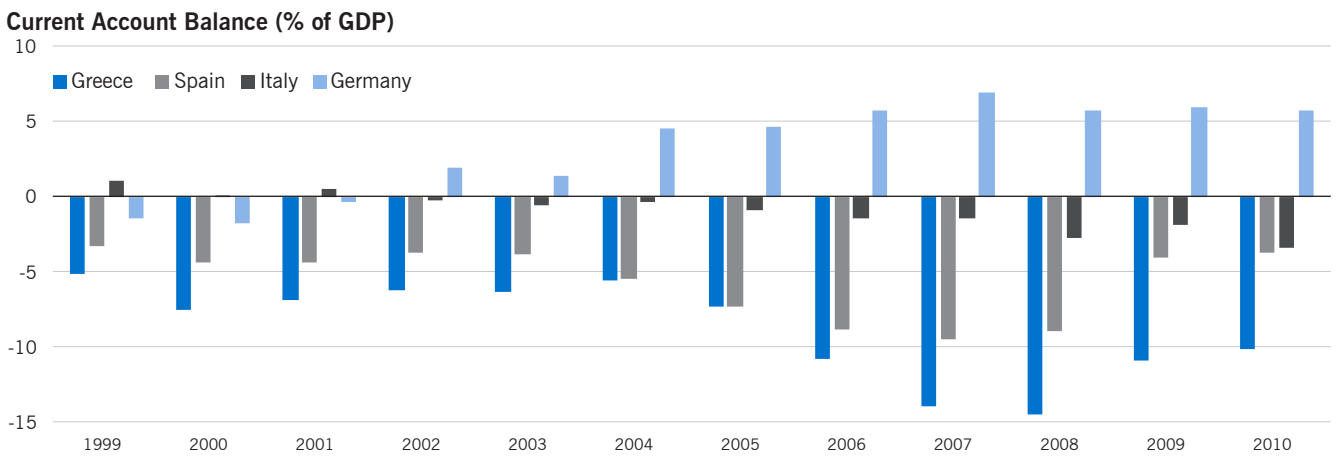


Figure 4

Current Account Balances for Germany, Greece, Italy and Spain (1999-2010)

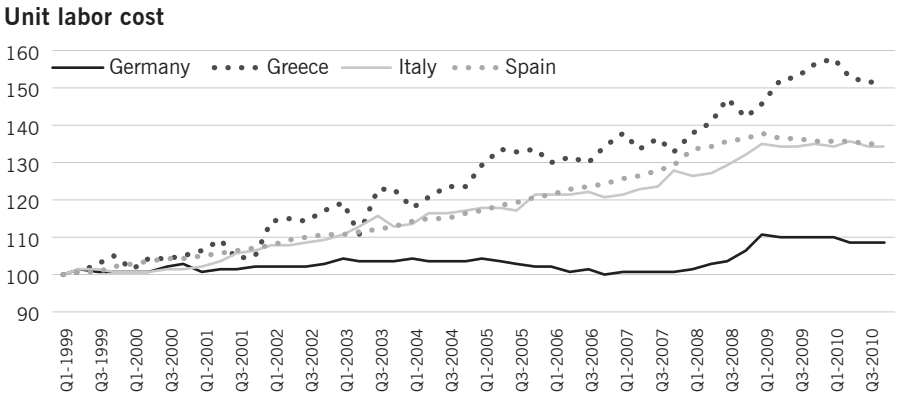


Current Account Imbalances and the Seeds of the Euro Crisis. Indeed, not all was well. One of the main characteristics of the 1999-2007 period was the development of significant external imbalances between the economies of the periphery and the core member countries. These external imbalances led to the rapid and excessive rise in international indebtedness of the countries of the periphery, which made them extremely vulnerable in the aftermath of the international sub-prime crisis (see Figure 3) that was about to start.

On average, following the creation of the euro area, the current account of the EA-12 remained in a small surplus. The surplus rose from 0.1% of GDP in the 1990s to 0.4% of GDP in 2000-2007. However, the economies of the periphery saw their average current account deficit rise from 2.5% of GDP in the 1990s to 6.8% of GDP in 2000-2007. Furthermore, the rise was almost continuous throughout the first nine years after the creation of the euro and reached almost 10% of their GDP in 2007. These rising deficits were associated with current account surpluses in the rest of the euro area. The average current account surplus of the small core economies of the north rose from 2.4% of GDP in the 1990s to 4.8% of GDP in 2000-2007. Germany moved from a small current account deficit of 0.6% of GDP in the 1990s to a surplus of 2.9% of GDP in 2000-2007. Thus, the first nine years of the euro area were characterized by widening current account deficits in the periphery and significant and rising current account surpluses in Germany and the smaller economies of the core (see Figure 4).

Figure 5

Unit labor costs in Germany, Greece, Italy and Spain (1999-2010)



The proximate cause of the external imbalances was the same as the cause of the stronger post-euro boom in the periphery: the precipitous fall of real interest rates in the countries of the periphery. Such a sharp drop in real interest rates would be expected to lead to an increase in international borrowing, as private savings fall and investment rises. This is exactly what happened in the euro area. In addition, governments found it more attractive and easier to borrow at the lower interest rates that they faced. For a long time, the risks of low interest rates and the consequent widening of external imbalances were underestimated. Many even considered the fall in interest rates as highly beneficial and an indication of a successful financial integration between the periphery and the core.

Furthermore, a significant problem was that much of the additional investment in the periphery was directed to non-tradable sectors, such as public investment and real estate, including housing. Hence, the increase in external indebtedness was not associated with an increase in the export capacity of the economies of the periphery. Worse still, capital flows contributed to house price bubbles that would inevitably burst, leading to losses for lenders, chiefly domestic banks, which had extended the loans. Due to the "doom-loop" between domestic banks and governments, which made governments responsible for bailing out banks, the bursting of these house price bubbles eventually led to a rise in government deficits and debts in countries such as Ireland and Spain. Hence, the economies of the periphery were not investing sufficiently in sectors that in the longer run would help service their growing external debt. Lastly, these economies were continuously losing international competitiveness, which undermined further their existing export capacity.

How Diverging National Rates of Wage Inflation Undermine the Stability of the Euro. Unfortunately, the combination of centralized monetary policy and decentralized fiscal policy resulted in localized differences in wage and labor cost inflation, which in turn led to a national *over- or undervaluation* of the euro in terms of its purchasing power in each euro-area country. Under national exchange rate policy, this can in principle be corrected through monetary policy and competitive depreciation or appreciation of the national currency. However, such corrections are no longer possible since the creation of the euro eliminated the exchange rate policy instrument and imposed a common monetary policy for all euro-area member states. Because of this inability to respond flexibly to inflation, the purchasing power of the euro in several countries rapidly eroded compared to the "German" and "euro-area wide" euros. Indeed, on the basis of labor cost indexes in Italy and Germany between January 1, 1999, and September 30, 2008, the euro in Italy was overvalued by 41 percent against the euro in Germany; Spain and Greece were not far behind (see Figure 5).

Unless countries suffering from overvaluation can correct the problem through larger gains in productivity or increases in downward wage and price flexibility, the problem is not reversible. More importantly, overvaluation is a cumulative process that becomes increasingly difficult to correct over time. In this vein, the latest round of EU expansion (to include Eastern European countries) did bring about a modicum of downward price and wage flexibility to the euro area. Indeed, it gives euro area–based firms the ability to make increasingly credible threats to outsource or relocate manufacturing operations to Eastern Europe (part of the EU but not of the euro area) in order to take advantage of the cheaper labor.

To make matters worse, the European electoral calendar continues to be asynchronous, with each country holding elections at the presidential, parliamentary, or municipal level on its own schedule. This, in turn, has the effect of exacerbating cyclical discrepancies across the euro area because the run-ups to election tend to be accompanied by expansionary fiscal policy.

Is the Euro-area an Optimum Currency Area? The politically motivated launch of the euro in 1999 never met the acid test of what economists call an "optimal currency area." The concept of an optimal currency area is a helpful construct for answering the difficult question of when a group of geographically contiguous countries should adopt a single currency.[4] The benefits of adopting a common currency derive mainly from increased economic integration and lower transaction costs; for example, a single currency eliminates the cost of forex trading and hedging currency risk while increasing the price transparency of goods and services that makes prices in different countries readily comparable. Chief among the costs, however, are those associated with a nation's forgoing the option to exercise monetary autonomy and use an independent foreign exchange rate policy to tackle the adverse consequences of shocks that impact the various economies in different ways.

A group of countries (or regions) is deemed an optimal currency area when their economies are characterized by similar economic structures, are closely intertwined through trade in goods and services, exhibit significant mobility of capital and labor, and are linked through a significant federal budget that could act as a shock absorber in the presence of significant asymmetries. The United States is the longest-surviving and most successful example of a well-functioning currency area.

Is the European Union anything like an optimal currency area? For starters, there are significant differences among the EU economies, especially between the core economies of central and northern Europe, and the economies of the periphery, in southern Europe. In addition, intra-EU trade hovers around 17% of the euro area's gross national product, which is significant, but lower than in the United States where inter-state trade amounts to 66% of GNP. If free capital mobility is increasingly the EU norm, labor mobility across Europe is only a small fraction of what it is in the United States and it remains very low even within each of its national economies. Finally, the EU is not a federation, and the EU budget is limited to 1% of the EU GDP, as compared to a U.S. Federal budget that now exceeds 20% of the U.S. GDP.

Ignoring these quintessential problems, the euro created a single monetary policy with the establishment of a European Central Bank, thereby depriving each country of two (of the three) critical economic policy instruments: (1) an independent monetary policy to tame inflation or spur growth through interest rate adjustments and (2) a flexible exchange rate to help keep its economy competitive. Furthermore, fiscal policy, the third critical instrument, is sharply constrained by the small size of the EU budget and the Stability and Growth Pact, which caps the budget deficit for each country at 3% of GDP. Additionally, national debt is not supposed to exceed 60% of a country's GDP (with notable exceptions such as Italy and Greece, which breached the ceiling at 104% and 95% of their GDPs, respectively). Given the obvious structural and cyclical differences between individual EU members, the much-reduced flexibility of macroeconomic policy is of particular concern should a given member country suffer an economic shock that does not have similar effects on the rest of the euro area.

If the euro area were indeed an optimal currency area, a country facing an "idiosyncratic" recession, with high unemployment and no growth while the rest of the euro area remains unaffected) would be able to adjust in three ways: (1) its workers could find employment in other parts of the euro area; (2) its wages and prices could adjust downward to restore competitiveness; and (3) wealth transfers through the EU budget would help the crisis country finance part of the increase in spending on unemployment and social protection, and so make up part of the reduction in its tax revenues. But, as already noted, the EU budget is too small to function as an automatic stabilizer at the EU level.[5]

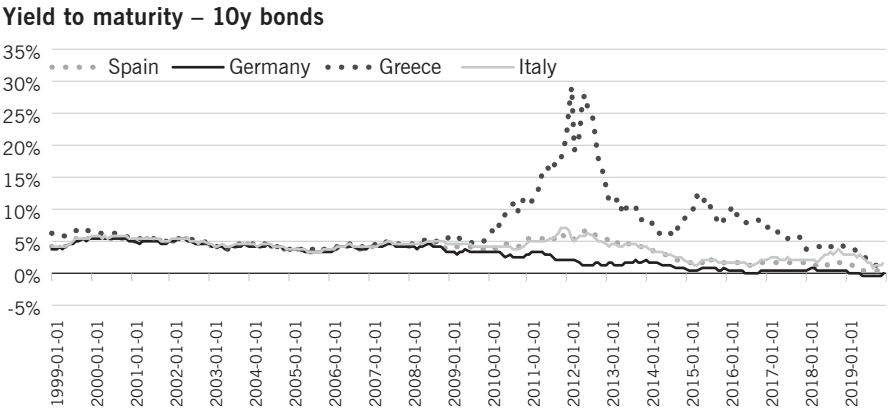
And, in fact, none of these three conditions was met when the euro was first launched in 1999, nor is there any sign that member countries are putting in motion structural reforms to bring the euro area significantly closer to becoming an optimal currency area. The third condition—which happens to be most difficult to meet—calls for a hefty dose of fiscal union

4 This question was first posed, and partially answered, in 1961 by Robert Mundell, who is rightly considered as the father of this literature. See Robert Mundell, "A Theory of Optimum Currency Areas," *American Economic Review* 51(4): 657–665, 1961. Other early contributors were Ronald I. McKinnon, "Optimum Currency Areas," *American Economic Review* 53(4): 717–725, 1963 and Peter B. Kenen, "The Theory of Optimum Currency Areas: An Eclectic View," in R. Mundell and A. Swoboda (eds), *Monetary Problems of the International Economy*, University of Chicago Press, Chicago, Ill., chapter 2, pp. 41–60, 1969. A survey of the so called "new" theory of optimum currency areas can be found in George S. Tavlas, "The 'New' Theory of Optimum Currency Areas," *The World Economy*, Volume 16, Issue 6, Pages 663-685, November 1993.

5 On prima facie grounds, admitting the countries of the periphery into the Euro-area may have been premature, as they did not satisfy some of the important optimal currency area criteria. In any case, the United States is much closer to the optimal currency area criteria than the euro area, according to Kevin H. O'Rourke and Alan M. Taylor, "Cross of Euros," *Journal of Economic Perspectives* 27(3): 167–192, 2013.

Figure 6

Yield-to-maturity for 10 year sovereign bonds of Germany, Greece, Italy and Spain



Source: Federal Reserve bank of Saint Louis

and would transfer significant taxing and spending power from national governments to the EU in Brussels. For fear of further diluting national sovereignty, such a transfer remained unthinkable—until the Covid 19 pandemic of 2020 triggered a mammoth European fiscal rescue very much akin to what is expected from a fiscal union—a subject we return to in Act V.

Indeed, the European Union, which itself has very limited taxing power (no more than 1% of GDP in principle), does not have the wherewithal for making stabilizing fiscal transfers to smooth out national shocks.[6,7] The brunt of the responsibility of fiscal policy remains in the hands of national governments, with Brussels, as already noted, accounting for less than 3% of euro-area government expenditures. This stands in stark contrast to the United States, where more than 60% of government expenditures occur at the federal level. The United States also enjoys a significantly larger degree of labor mobility and greater wage flexibility than Europe. Even Germany's reunification, which fused the East and West German marks into a single German mark in 1991, hardly created an optimal D-mark zone. Instead, it faced a stubbornly high rate of unemployment (close to 20%) in East Germany despite massive fiscal transfers in excess of €200 billion over a 10-year period and freedom of movement between East and West Germany!

Act III: The Euro Crisis

In early 2010 the Euro area was shaken by its most severe confidence crisis to date. Greece faced an exploding budget and current account deficit, triggered largely by the 2008-9 recession, but also partly attributable to the early elections of 2009, and came close to defaulting on its external debt. The worldwide subprime crisis that had already resulted in negative growth was driving the Greek economy into an even deeper recession, reducing government tax revenues while increasing fiscal expenditures. Financial markets punished Greece: a massive sell-off of its sovereign bonds pushed up interest rates to an all-time high. Credit bureaus downgraded Greece's sovereign debt to "junk" status, pushing the price of its outstanding bonds to an all-time low, a yield to maturity close to 15% on 10-year bonds (as shown in Figure 6). The panic quickly spread to other peripheral countries—most notably Spain, Portugal and Ireland which, like Greece, had experienced massive housing booms fueled by unprecedently low nominal (and even negative real) interest rates.

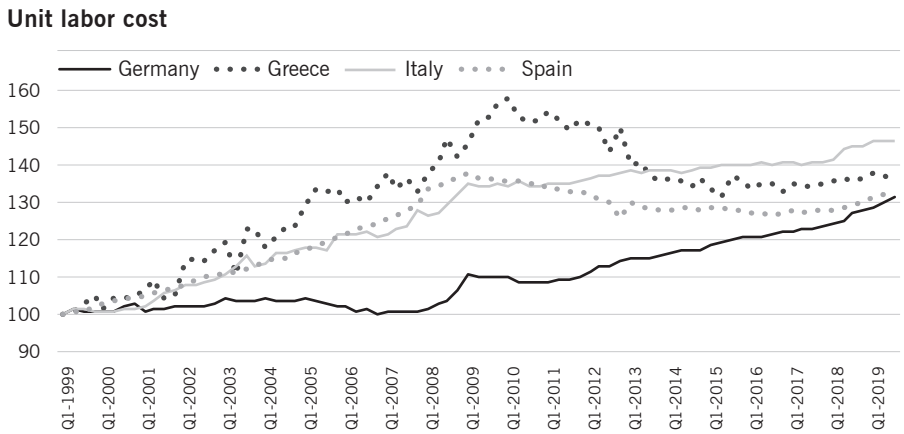
In May 2010, the European Commission, the European Central Bank, and the International Monetary Fund hammered out a rescue package amounting to €115 billion, which gave Greece significant breathing room. Greece was forced into a drastic austerity budgetary plan in which its budget deficit would be reined in from 13% to less than 8% of GDP in three years—still far exceeding the 3% of GDP guidelines of the Stability and Growth Pact. But this European rescue plan, however impressive a display of European solidar-

6 The swift EU integrated fiscal response to the pandemic may set a precedent to the contrary (see Act V).

7 This so-called fiscal federalism criterion was investigated by Sala-i Martin, X. and Sachs, J. D. (1991). "Fiscal Federalism and Optimum Currency Areas: Evidence for Europe From the United States; in M. Canzoneri, V. Grilli and P. Masson (eds), *Establishing a Central Bank: Issues in Europe and Lessons from the US*, Cambridge University Press. Bargain, O., Dolls, M., Fuest, C., Neumann, D., Peichi, A., Pestel, N. and Siegloch, S. (2013). "Fiscal union in Europe? Redistributive and stabilizing effects of a European tax-benefit system and fiscal equalization mechanism," *Economic Policy* 28(75): 375–422. demonstrate that a bigger EU federal budget would have mitigated the adverse effects of the euro area crisis for the economies of the periphery, by absorbing about 10-15% of the shock.

Figure 7

Labor costs in Germany, Greece, Italy and Spain (1999-2019)



Source: EUROSTAT

ity, failed to address the fundamental challenges faced by Greece: a sclerotic economy with a bloated public sector hampered by a grossly overvalued "Greek" euro that made it impossible for Greek companies to compete in traditionally labor-intensive industries such as textiles, garments, agribusiness, shipbuilding/repairing, and tourism. Forcing down government expenditures when government revenues were decreasing even faster because of the recession did not do much to remedy the national budget deficit either. Greece needed to find some way of restoring economic growth while avoiding the recessionary spiral set in motion by fiscal austerity. The Stability and Growth Pact, for all its good intentions, functioned as a straitjacket that could not and would not allow, much less contribute to, the desired recovery of the Greek economy!

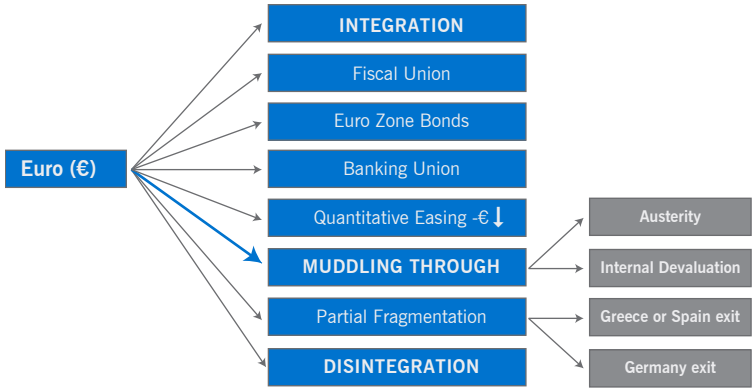
Act IV: Finding a Way Forward: Re-balancing Economic and Financial Asymmetries

As the euro area is closing down on a full decade of crisis management, its toll remains excruciatingly heavy, with stubbornly high unemployment rates: 20.2% in Greece, 15.2% in Spain, 10.9% in Italy for the active population (with an EU average of 6.9%), but significantly higher for 18-25 years old at 43.2% in Greece, 33.8% in Spain and 31.9% in Italy (and an EU average of 15.1%). Yet in spite of all the vicissitudes inflicted on and endured by the members of the single currency, the euro has remained intact, thanks almost entirely to the deft tactical initiatives of the European Central Bank.

Muddling through. In August 2012, Mario Draghi, the newly appointed president of the European Central Bank, defused the looming euro crisis when he declared that, *"within our mandate, the ECB is willing to do whatever it takes to preserve the euro and, believe me it will be enough."* The bond prices of Greece, Italy, Ireland, Portugal and Spain (GIIPS), which had been under extreme pressure, rebounded, giving crisis countries a new lease on life as the cost of deficit financing returned to more manageable levels. And indeed since 2012, the prospect of massive bond purchase by the ECB has brought stability to the euro-denominated sovereign bond market.

At the same time, the euro area seems committed to continuing its policy of "muddling through" (see middle of figure 8) by enforcing a policy of fiscal austerity on the GIIPS, and so hampering their recovery. Indeed, it was fiscal austerity in the form of higher taxes and cuts in government expenditures that initially led to the deeper economic recession and higher unemployment, and which brought about lower wages in the Mediterranean economies most affected by the euro crisis. Labor-intensive industries such as export-oriented tourism services clearly benefited and rebounded. However, this did not prove enough to bring about a general recovery. Unlike a classical or "external devaluation" that at once makes exports cheaper and imports more expensive, such a policy is tantamount to a devaluation of its "national" euro, which would end up affecting only the exports of goods and services while leaving the price of imports unchanged. This is why it is often dubbed an "internal devaluation"; as shown in Figure 7, its principal effect is to reduce the gap in unit labor cost. With similar intent and effect, the quantitative easing ECB-style ushered in 2014 by Mario Draghi led to a significant depreciation of the euro, which increased

Figure 8
The Way(s) Forward



the export competitivenessof the entire euro area, including member economies, like Germany, that did not need it.[8]

The Way Forward towards Fragmentation. The Cassandras of the Single Currency prophesy that the euro area may splinter or dissolve entirely. It may be a limited fragmentation in which one of the GIIPS country exits the euro, or it may be a massive dislocation should Italy or Germany decide to break away from the single currency (as depicted in the lower part of Figure 8). Clearly this is a low probability scenario but not an impossible one, given the gathering political strength of Europhobia. A proper cost-benefit analysis of such a scenario remains to be carried out and could go a long way towards assessing if it is indeed an option for resolving the lingering euro crisis. Clearly, depending upon national idiosyncrasies, the drama of exiting the euro would unfold differently. We shall consider the diametrically opposite cases of an exit by one of the GIIPS countries and an exit by Germany.

Will one of the GIIPS countries exit the euro? To varying degree, all of the GIIPS countries are facing a stark choice: they can choose the agony of snail-pace growth, endless rounds of budget austerity, violent strikes, and missed fiscal targets—or they can "bite the bullet" and drop out of the euro area, however traumatic an abrupt exit would undoubtedly be. The detractors of an exit scenario paint a grim picture of chaos engulfing the "deserter" as it revives a national currency prone to inflation and devaluations. Let us not forget, however, that in the 20 years preceding their euro membership, GIIPS countries enjoyed steadier growth and lower unemployment, albeit at the cost of higher inflation. Unfortunately, the euro playbook does not include the possibility of members taking a leave—only new members joining!

Let us sketch what exiting the euro area would entail. To have any chance of success, the divorce would have to be an amicable one, with the ECB and European Commissions acting as good faith partners of the exiting country's government. The departing country would have to resurrect its national currency of yesteryear, imposing first exchange controls to prevent a capital flight and freezing all outstanding debt or bonds at the old exchange rate against the ECU, at least initially.[9] The exiting country would also have to print new banknotes. How would the exiting country weather this shock therapy?

On the positive side, the resurrected national currency would be allowed to float, and it would then presumably immediately lose a significant part of its value. The extent of the currency devaluation would be dictated by the overvaluation of the "national euro" and the prospects of the new currency as assessed by the markets. The currency devaluation would initially restore the competitiveness of its economy as domestically manufactured products and services would no longer be priced out of international and domestic markets. The domestic currency price of imports would rise signifi-

8 According to the former IMF chief economist Olivier Blanchard "Without the power to devalue their currencies, peripheral economies would forever be forced to endure 'tough adjustment,' such as slashing their wages, to keep up with stronger member states." In this vein, Mr. Blanchard dismissed any talk of a growth "miracle" in Spain, which has been held up as the poster child of austerity programs. He added that he was "surprised" that sluggish Euro-area economies were not doing better in the face of a cocktail of favorable economic conditions. "When people talk about the Spanish miracle, I react: when you have 23% unemployment and 3% growth, I don't call this a miracle." *The Telegraph*, October 10, 2015

9 Exchange controls imposed by the exiting country should be short-lived allowing for an orderly transition to the new currency and be lifted as soon as the situation returns to normalcy. The risk of capital flight would likely happen in the days leading up to the exit from the euro area.

cantly, rapidly shrinking its imports bill while triggering import substitution.[10] The capital account of the exiting country's balance of payments would also improve to the extent the devaluation makes foreign direct and portfolio investment more attractive. The real economy would probably rebound, bringing about a decline in unemployment, while tax revenues would likely rise and the budget deficit would thus be in check.

But on the minus side, devaluation will unleash domestic inflation unless there are draconian restrictions on wage increases and a tight monetary policy is adopted. If wages increases are not allowed, living standards will fall even for the employed. It is uncertain whether they will be reduced more or less than under the current policy of "internal devaluation." Employment nevertheless would be bolstered, benefiting unemployed "outsiders." If wage increases do take place, inflation will increase, triggering a cascade of wage and price increases and further currency depreciation, thereby offsetting the initial benefits of depreciation for international competitiveness. Admittedly the specter of an unraveling vicious cycle of wage increases, fueling inflation and devaluations has given governments, and their citizenry, reason to hesitate—at least up til now!

The option of exiting the Euro zone is not necessarily limited to weak economies. How would Germany leaving the euro play out? If GIIPS' euros are "overvalued," the German euro is clearly "undervalued," which partly explains its mammoth current account surplus. By breaking away from the single currency, Germany would immediately see its re-kindled Deutsche mark appreciate markedly against the euro, thereby curbing its current account surplus and allowing the *euro minus Germany* to depreciate. The debtor countries of the eurozone would regain at least partially their lost competitiveness and benefit from higher economic growth. The split of the single currency would create a two-speed and possibly "more optimal" currency area!

The Way Forward towards Fiscal Federalism. The launch of the euro and the European Monetary Union transferred national sovereignty over monetary policy to the European Central Bank, which meant that lending to or borrowing from the ECB should happen at a single euro interest rate. This single euro interest rate should also prevail in short term inter-banking lending, but not necessarily in longer-term transactions, which are more likely to reflect the perceived riskiness of the financial institutions that are parties to the transaction. This certainly extends to sovereigns issuing euro-denominated debt to finance their budget deficits.

Somewhat surprisingly, until the onset of the euro crisis, sovereigns borrowed at quasi-identical interest rates with miniscule spreads against German bonds of less than 15 basis points. Investors did not seem to differentiate between the country risks of France or Germany versus Portugal or Italy, as if the single currency had cloaked national sovereigns into a single AAA-rated euro-area bloc. Then, of course, in 2010 the onslaught of euro crisis was a brutal wake-up call for bond markets, with exploding spreads reflecting very different default risks amongst euro-area member countries. The higher the budget and external deficits, the more expensive bond financing became. Unfortunately, the absence of market pressures in the form of higher spreads had failed to impose effective fiscal discipline. Indeed, the evidence from the euro crisis is that bond markets are subject to both complacency and panic. Similarly, institutional mechanisms such as the Stability and Growth Pact have been proven ineffective in providing fiscal discipline.

As a consequence, a number of proposals have been put forward to *mutualize* national sovereign debts as a first step towards a fiscal union (see upper part of Figure 8).

Eurobonds. Would Eurobonds issued collectively by the euro area rather than singularly by individual member countries remedy the euro-crisis impasse and prevent recurrent crises? In effect, such Eurobonds, by replacing national issuance of bonds, would mutualize sovereign public debt. Such Eurobonds could be issued by a European Debt Agency backed by member countries or more simply by national governments that would commit to guaranteeing not only their national debt but every other euro-area sovereign bond issue. Thus, the Eurobond would be backed jointly by the entire euro area rather than by single member countries;[11] and as such, it should be rated as well as the strongest rated euro-area issuer—namely Germany. The euro-wide treasury bond market would easily reach €5,600 billion, or five times the German bund market, and would rival the U.S. treasury bond market of $8,300 billion. The size of the secondary market would bolster its liquidity, which is greatly valued by large institutional investors and would translate in a lower yield. For example, Spain instead of issuing its own sovereign bonds at an interest rate reflecting its country risk notation—say 5% for a 10-year bond—would now pay the same interest rate as Germany of, say, 2%, which would de facto become the euro-area yield for sovereign Eurobonds. As long as the guarantee shouldered by the strongest sovereign does not

10 See See Jens Nordvig, *The Fall of the Euro*, McGraw Hill, 2014.

11 According to Article 125 of the Lisbon Treaty, European Union member countries are not liable for their fellow members' obligations, financial or otherwise. Eurobond issuance would therefore require that Article 125 be amended.

damage its credit notation, the Eurobond yield would remain at 2%. However, should this euro-area wide guarantee weaken the strongest sovereign notation, the Eurobond yield would progressively approach a weighted average of yields facing each euro-area member countries. This yield would be higher than what Germany, the strongest euro-area borrower, pays and considerably lower than the rate paid by the weakest borrower, Greece. In effect Spain would piggy-back on the good name of Germany and other strongly rated euro-area members.

As we discuss later (in Act V), although Germany had long resisted this first step towards integration as it sees it as a thinly disguised morphing of the euro area into a "transfer union," it recently agreed in response to the Covid 19-induced depression to participate in a collective European rescue package that will most likely be financed by Eurobonds.

Blue and Red Bonds. Under this proposed scheme, only a portion of each sovereign debt would be issued jointly as Eurobonds (so called "blue bonds"). Such blue bonds would generate significant savings for weak borrowers, which now issue debt at the same cost as the strongest borrower. Any additional funding would be issued as a junior bond (so called *red bonds*) by the national sovereign at an interest rate that reflects its own country rating.[12] More specifically:

• *Blue bonds* would be the *senior tranche* of the sovereign debt (up to 60% of GNP, according to the spirit of the Growth and Stabilization Pact) of the eurozone member countries; by creating an extremely safe and liquid asset comparable to U.S. treasury bonds, blue bonds would appeal to a wider range investors, including Asian central banks and sovereign wealth funds, thereby lowering the cost of debt to levels approaching if not below the benchmark yield on German bonds. Should the Blue bond market expand to become 60% of the eurozone GDP, its size—approximately €5,600 billion—would, as indicated earlier, rival the U.S. treasury bond market of $ 8,300 billion.[13] The size of the secondary market in Blue bond would bolster its liquidity, which is greatly favored by large institutional investors and would translate in a lower yield.

• *Red bonds* would constitute the remainder of each sovereign national debt. As a *junior tranche* to Blue bonds, Red bonds could only be serviced (interest and principal payments) after the senior tranche of Blue bonds has been fully serviced. Since red bonds would bear most of the burden of national sovereign risk, it is hoped that they would reinforce market discipline by making incremental borrowing more expensive.

Because Blue debt is credit-enhanced by joint and several guarantees, each participant country is in effect guaranteeing all Blue bonds—that is, the collective Blue debt issued by all participant countries. As in the case of simple mutualization of eurozone sovereign debt, this proposal is construed as amounting to a *transfer union* in disguise even though the guarantee applies only to the very safest component of each country's national debt—so safe that it is never expected to default. Indeed, Blue bonds would always be rated as high as the strongest-rated sovereign participating in the bond issue.

Lower-rated sovereigns would benefit from blue bond financing at the lower cost enjoyed by the strongest-rated sovereign, thereby profiting from a significant interest rate subsidy. Thus, under the blue/red bonds scheme, the cost of the blue bond debt component is lower due to the combined effect of its senior status, enhanced liquidity, and joint and several guarantee. Conversely the red debt component is expected to show a marked increase in cost due to its junior status, illiquidity, and lack of eurozone guarantee. Moreover, defaults by lower-rated sovereigns default on their red bonds should not affect the credit rating of blue bonds, which are secured by the higher-rated sovereigns' guarantee. Conversely, Red bonds are strictly rated according to the country risk of the sovereign which issue them. And, critically important, the "no bail-out clause" from either the European Stability Mechanism or other participating sovereign would apply.

Creating a Union-Wide Safe Asset "European Safe Bonds" (ESBies). Various proposals for common issuance of Eurobonds have encountered political roadblocks arising from joint liability amongst participating countries. By contrast, *European Safe Bonds* do not require joint liability among sovereigns. Under this novel scheme, a special purpose vehicle (SPV) akin to those used in securitization transaction would issue two tranches of new bonds secured by a pool of government bonds of the 19 eurozone member countries. The senior tranche, deemed *European Safe Bonds (ESBies)*, would constitute 70% of the total bond issuance and, according to its proponents, "be at least as safe as German bunds." The junior tranche labelled *European Junior Bonds (EJBies)* would have "expected loss rates similar to those of vulnerable euro area sovereign bonds." In effect ESBies would be protected by the junior tranche, which would take the first losses in the event of a crisis. Thus, senior ESBies would be safe as long as EJBies provide a buffer against default.

The SPV's balance sheet would show on the asset side a diversified portfolio of eurozone sovereign bonds, which

12 Alternatively, the transition to this two-tier Eurobond financing scheme could be achieved with the European Debt Agency purchasing 60% of each member country debt at market price and – in the same spirit of securitization with Collateral Debt Obligations – repackage them into a senior tranche and a junior tranche. The senior tranche dubbed European Safe Bonds– perhaps 70% of the total bond issue – would be nearly risk-free (low interest rate) whereas the junior tranche would be much riskier possibly of junk status (higher interest rate).

13 These are 2010 estimates from Jakob von Weizsäcker and Jacques Delpla, "The Blue Bond Proposal," *Bruegel Policy Brief*, May 2010.

would be financed (liabilities side of the SPV's balance sheet) by investors purchasing the two different securities: (1) ESBies, which hold a senior claim on the portfolio (upper right hand-side of the balance sheet); and (2) EJBies, which are subordinated to ESBies and therefore hold a junior claim on the same portfolio (lower right hand-side of the balance sheet). The face value of the sum of ESBies and EJBies should be equal to the market value of a sovereign bond portfolio whose composition would be weighted according to eurozone countries' GDP. In effect, both senior and junior bonds (liabilities) issued by the SPV would be fully collateralized by the underlying bond portfolio (asset).

Although this bond scheme borrows from the technology of securitization, it differs in one important way: the underlying sovereign bonds that collateralize ESBies and EJBies are actively traded in liquid secondary markets, unlike mortgage backed securities (MBSs) whose collateral are illiquid, non-traded, and harder-to-value mortgages. As pointed out earlier, one imperative of a European banking union is to decouple bank risk from sovereign risk. By creating a European "safe" asset, the flight of capital to safety in time of crisis would be channeled from high risk to low risk assets rather than from crisis-engulfed countries to crisis-immune countries. German bunds would no longer be the asset of choice for capital fleeing crisis-prone countries. ESBies, by increasing substantially the supply of safe assets, would therefore diminish the dominance of German bunds and correct the asymmetry in the provision eurozone safe bonds. Indeed, at the present time, AAA eurozone sovereigns (Germany, The Netherlands, Austria, Finland and Luxembourg) collectively account for outstanding debt securities in the amount of €1.9 trillion, or 18% of the eurozone GDP whereas the face value U.S. treasuries is $11.7 trillion, or 65% of its GDP.

Constructing a Banking Union. As eurozone policymakers have been forced to recognize, the incestuous relationship between national banking systems and national sovereigns must be re-engineered to de-couple systemic risk from national budgetary crises. The goal has long been to break the *doom-loop* between the solvency of banks and of their national governments. The doom-loop starts with a national budget crisis that unleashes a confidence crisis in the outstanding sovereign bonds, whose prices plummet. National banks, which typically hold large amounts of their sovereign debt, experience a sharp decline in their asset values when marked-to-market, and may even default. As interest rates skyrocket, refinancing the sovereign budget deficit becomes more expensive, further depressing the market value of outstanding debt. Banks at clear risk of default are bailed out by their respective home governments, which in turn accumulate gargantuan public debt to finance the bailout: this is how Spain—which was fiscally responsible before the euro crisis (with public debt at 36% of GNP)—saw its public debt escalate to 95% of GDP in 2014 after rescuing its banks.

To meet this imperative, the European Union has advocated a tighter banking union by pushing for greater integration along its three pillars:

(1) *single supervisory process* or banking supervision, which is designed to limit systemic risk—that is, the risk of one failing financial institution triggering a domino effect and engulfing the entire financial system;

(2) *single eurozone deposit insurance scheme*, which is the single most effective protection against bank runs, and therefore systemic risk and banking crises, by virtue of its guarantee of household deposits held at commercial banks against default. National deposit insurance schemes are unevenly capitalized and therefore provide widely different levels of protection to depositors in case of a financial crisis. The goal of the European banking union is to correct the fragmentation amongst national deposit insurance schemes by providing all depositors in the Euro-area with €100,000 coverage and to provide—by 2024—permanent funding for a European deposit insurance scheme (EDIS) financed by levying a premium of 0.85% of banking deposits; and

(3) *single resolution mechanism*, which establishes a second line of *reactive/ex-post* defense that is backed by a common resolution fund endowed by the financial services industry. Furthermore, euro-area wide rules whereby bondholders of defaulting banks should be "bailed in" rather than "bailed out" should strengthen the EMU's absorption capacity of asymmetric shocks.

Ultimately, however, the shock-absorbing capacity of a banking union rests upon a credible fiscal backstop that could be provided by a European fiscal union (as we discuss next).

The Rocky Path toward Fiscal Union. Unlike the United States, which has long functioned as a successful monetary union, the euro area remains ill equipped to absorb asymmetric shocks—that is, shocks that affect its members in very different ways. As a Monetary Union, the Euro-area pursues a single monetary policy. Whenever a member country is hit by an asymmetric shock, the ECB is unable to tailor its monetary policy to the idiosyncratic circumstances of the country under duress. The single monetary policy should be conducted to serve the collective interest of all Euro-area countries—and not any EMU member in particular. Nevertheless, by gearing its monetary policy to the average situation of the euro area, the ECB's single interest policy may be too expansionary for some countries and too restrictive for others. And thus the ECB's credo that "one size should fit all" may well end up

fitting none—unless fiscal policy can be used appropriately to correct the asymmetries that are exacerbated by a single monetary policy.

Unfortunately, the single currency incomplete federal architecture which lacks an adequate reactive stabilization apparatus is to blame. Hence the need for the euro area to equip itself with proper fiscal instruments to respond more effectively to asymmetric shocks. Deeper integration of the euro area would involve harmonizing fiscal policies amongst its member states. At its basics, fiscal policy is a three-leg stool: *(1) fiscal expenditures*—where and how should fiscal resources be spent; *(2) fiscal revenues*—what kind of and how much taxes should be collected from households and corporations; and *(3) financing*—assuming the ability to run budget deficits, how to bridge the gap between expenditures and revenues. Given the general understanding that full fiscal integration is politically unfeasible, we begin by suggesting that a more sensible goal is to aim for fiscal coordination and, eventually, some degree of fiscal harmonization.

To suggest the desirability of greater integration of fiscal policies still begs the question of the optimal allocation of fiscal revenues and expenditures between Brussels and national governments. At present, only 3% of total European budgets is controlled by the EU, with the other 97% in the hands of sovereigns. By comparison, the U.S. federal budget accounts for 60% of the country total budget. A major reallocation of fiscal resources on either the revenue or the expenditure side would call for far-reaching amendments to current EU treaties and would unleash extreme nationalistic reactions; indeed, only suicidal governments would pursue such structural reforms in the current political climate! And yet, the unforeseen and unforeseeable outbreak of the corona virus pandemic in early 2020 may well have provided a window of opportunity that proves a watershed for the eurozone.

Act V: Will the Pandemic Prove a Serendipitous Gamechanger?

Hardly limping out of the euro-crisis of 2010, Mediterranean Europe finds itself in the path of hurricane Covid 19. Indeed, the geography of the corona virus pandemic mirrors the imprint of the euro-crisis of a decade ago. Here again, this asymmetric shock has inflicted significantly more damage on the highly indebted and infected "periphery" than on the richer "core" countries. This inequality reflects not only the weaker economies' more limited fiscal resources to respond to the sharp GDP contraction, but also their far greater dependence on "contact" services such as tourism and hospitality. For example, as much as 22% of Greek GDP comes from tourism (mostly foreign), as compared to as little as 7.5% of German GDP. Without [some] fiscal aid, the pandemic-induced deep recession would have engulfed the entire EU.

Rescue Package Dubbed "Next Generation EU": After difficult and protracted negotiations pitting the "core" against the "periphery," in July 2020 the EU Council announced a jumbo recovery package of €750 billion, amounting to 4.7% of the EU GDP,[14] that was designed to counter the devastating economic toll triggered by the corona virus pandemic. If disbursed over the next three years, "Next Generation EU" will add €250 billion to the annual EU budget of €166 billion, or a mammoth increase of 150%. Most importantly, more than half of the rescue package (€390 billion) will be provided not as loans, but as outright grants, to sovereigns most in need. The case for grants is their direct contribution to budgeted revenues, to avoid the effect of loans in compounding the sovereign's indebtedness.

This landmark deal would have been unimaginable even six months ago since it crosses two red lines in the EU treaties: First, it empowers the European Commission to borrow an unprecedented amount of money (€750 billion) with the backing of the credit of its member states. Second, since the majority of the rescue package (€ 390 billion) is to be distributed as grants to mitigate the asymmetric shock devastating Mediterranean Europe (GIIPS), this package represents the first case of intra-EU fiscal transfers.

How Will the Emergency Rescue Package Be Financed? The European Commission will issue long duration bonds that will most likely be rated AAA and serviced by making use of the increased taxing power devolved by EU member states to Brussels. This new collective European debt will presumably enjoy joint-and-several guarantees, but there is no plan to mutualize member states' legacy debt. In this sense, the new agreement falls short of the famous "Hamiltonian" accord in 1790, when the U.S. Federal Union assumed all the debt incurred by U.S. states during the war of independence, thereby laying the foundation for a strong central government.[15]

Governance: how will rescue funds be allocated? Each member state will submit their "National Recovery and Resilience Plan" to the European Commission along with their draft budget. The European Commission will then assess these plans against its own internally generated country-specific recommendations. Unemployment and the extent of Covid-19-induced GDP contraction in 2020 will likely be the deciding allocative criteria, with Italy and Spain expected

14 "Next Generation EU" is expected to be front-loaded and disbursed mostly in 2021-22: it comes on top of national stimulus programs.

15 The first U.S. Treasury secretary Alexander Hamilton engineered this radically new centralized fiscal policy.

to receive the lion's share (approximately 50%) of the €750 billion emergency fund. The European commission's authority as the "central planner" may be politically challenged since the self-styled "frugals"—Netherlands, Austria, Denmark and Sweden—have reserved the right to apply an "emergency brake" on the final recovery fund disbursements should they disagree with the distributive decisions of the European Commission's technocrats. Indeed, the hammering out of this mammoth fiscal response to a shared crisis demonstrates a rare moment of near-solidarity among member states and sets an interesting precedent. Will the EU embrace this opportunity to build more deliberately greater fiscal integration among its member states to complement its single monetary policy?

Epilogue

The "Fathers" of the European Union had a grand vision of "building peace through prosperity." The construction of a United Europe, by creating a level playing field unencumbered by tariff and non-tariff barriers, was expected to enable European companies to achieve economies of scale and scope, thereby boosting growth and standards of living. The single market delivered on these promises, at least until the launch of the euro in 1999. The single currency, by imposing a straitjacket on the euro area, is rolling back if not completely reversing these cumulative gains. Today, close to half of the euro area—mostly the GIIPS—is shackled to an "overvalued" euro and is struggling to fully recover from the euro crisis. The other half—mainly Germany—has been super-charged by an implicit export subsidy provided by an "under-valued" euro. Short of seriously embarking on a common fiscal policy for the eurozone, creeping pauperization will increasingly fuel Europhobia and could unleash political mayhem—and so the vision of peace through prosperity appears to be fading. And yet, for all the havoc that the 2020 pandemic is unleashing on the eurozone, it may prove to be the *silver lining* of a renewed lease on life for the single currency: Is the European Union finally embracing a fiscal union, or is this a one-time response to what may well prove to have been a once-in-a-lifetime opportunity?

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