

Opinion **Eurozone economy**

## Banking union success can be replicated on the fiscal front

A grand bargain between the core and periphery eurozone will ensure its survival

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Two-speed economy: local interest rates were too low for Spain during the credit boom - now they may be too low for Germany © Getty  
Enrico Perotti JULY 10, 2017

European monetary union is a deep historical choice with great economic value as well as political legitimacy. A majority of citizens in the eurozone countries appear to support it. Yet every time there is an election there are distress signals and signs of a [backlash](#), especially at the periphery. At a time when the European project appears to be a safe haven from populism, it is time for a grand bargain between the core and the periphery of the eurozone, based on mutual understanding.

The countries of the [eurozone](#) differ in terms of institutional quality, a fact not reflected in economic models. These differences are not as pronounced as those between developed and developing countries, yet the quality of political governance and legal enforcement varies a great deal across the single-currency area. What are the consequences?

A diverse monetary union is good for growth. It is also very redistributive. In good times, it allows weaker economies to borrow and spend more. In hard times, these

weak countries experience fiscal stress as they can no longer devalue. Some solidarity is therefore needed to ensure long-term stability.

**Solidarity in difficult periods is not just prudent, it is essential to the ongoing legitimacy of the single currency itself**

Monetary union created a weaker currency for the core because the euro exchange rate is a weighted average, so it does not reflect the productivity of the core countries. The effect was evident from the start. Germany joined the euro at a time when reunification had led to a trade deficit and falling productivity. Both recovered steadily in Germany under the euro, while they fell at the periphery. Today, the [German surplus](#) is larger than Belgian gross

domestic product.

As strong countries have gained in competitiveness while weaker economies have faced a higher and rigid exchange rate, solidarity in difficult periods is not just prudent, it is essential to the ongoing legitimacy of the single currency itself. Furthermore, it is in the long-term interest of the core. In the event of a euro collapse, capital would flow to safe havens, and core countries may experience a sharp revaluation.

At the EU core there is an intellectual recognition of the gains that have flowed from monetary union. But there is also mistrust of weak institutions. Transfers to a bottomless pit are politically unacceptable. As institutional differences in the eurozone are structural and persistent, solidarity must come with more discipline, ensured by a transfer of responsibility for specific budgets to the centre (for example, to the eurogroup). A eurozone treasury could adopt a sensible policy for the issuing of [eurobonds](#).

The eurozone could achieve lasting stability with a fair and grand bargain, or solidarity in exchange for a shift in sovereign powers to ensure compliance. The [banking union](#) is an example of a credible common institution. Its success can be replicated on the fiscal front.

Up to now, the main relief to rigid currency and fiscal conditions at the periphery has been provided by a relaxed, uniform monetary stance. Once a credible fiscal covenant is set, monetary policy should be allowed to be asymmetric, targeting those points where monetary constraints are tightest. At present the core is at risk of overheating,

while the periphery remains half choked. Recall that local interest rates were too low for Spain during the credit boom. Now they may be too low for Germany.

All eurozone economies are locked in place by the monetary union. If the core attributes its success only to its own (visible) merits, it would ignore basic economics and ensure permanent instability. For the periphery, by contrast, it will be necessary to accept external discipline. The case for solidarity along these lines balances costs and benefits, and would ensure long-term stability.

At a time of great uncertainty, Europe needs a fair and grand bargain more than ever.

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