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What is the best Institutional framework for the Eurozone, so to function in an efficient manner?

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WHAT IS THE BEST INSTITUTIONAL FRAMEWORK FOR THE EUROZONE, SO TO FUNCTION IN AN EFFICIENT MANNER?

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1. Efficiency on the workings of the Eurozone presupposes the establishment of **an automatic adjustment mechanism** that **corrects** the observed balance of payments **inbalances** among the members states, and therefore renders any attempt for a member state to run a balance of payments surplus self-defeating. In the **absence of** such an adjustment mechanism, an **agreement** could be reached by the members **to coordinate** their policies (Demopoulos and Yannacopoulos 1998, 1999, 2001, 2016).

2. Why is the establishment of such an automatic adjustment mechanism so important for the stability of the Eurozone? Because in a monetary union the **"rules of the game"** should **be respected;** that is, a country member with a **current account surplus** should have an expanding money supply, **while a country with current account deficit** a contracting money supply (symmetric behavior).

3. However, if the Eurozone works as a **decentralized economic system**, which means that if each member's objective is to maximize its own utility, without considering the effects of its policy on the others, the **"rules of the game" are not necessarily respected,** this may lead the currency area to equilibria, however, **with systemic distortions,** that may destabilize the Eurozone.

4. These **inefficient** outcomes may be removed if the Eurozone members agree to **coordinate** their economic policies and reach a **stable agreement** that cannot be challenged by no one (Demopoulos and Yannacopoulos, 2016).
Coordination of macroeconomic policies, however, means that countries with a balance of payments deficit have to contract their economic activity, while countries experiencing a balance of payments surplus have to follow policies that stimulate their domestic demand. Thus, imbalances are corrected and the equilibrium in the currency area is restored. Otherwise (if the surplus countries insist on keeping their surpluses), the cost of adjustment is born entirely by the deficit countries, and the net result is a deflationary bias, leading to economic recession and unemployment (Demopoulos and Yannacopoulos, 2012c). Obviously, "**a Political (federal) Union**" cannot be founded **on such an unstable economic background.**

5. In reality, the behaviour of the countries, in a fixed exchange rate regime, as in the euro area, is **asymmetric**: In such a sysyem, the process of adjustment is compulsory only for the debtor and optional for the creditor (Keynes, 1980). The creditor has the options of hoarding its surpluses (by compressing domestic spending) or adjusting, while the only option for the debtor is to deflate and allow unemployment to rise**.**

6. This asymmetric behaviour is **evident in the eurozone** (Eichengeen, 2012). **Surplus countries**, like Germany, feel less pressure to adjust than their deficit counterparts. In fact, during the crisis, **severe austerity measures** were imposed on the deficit countries of the union, while the creditors continued to follow policies aiming at balancing their budgets. **The deficit countries** have been forced to reduce their wages and prices (internal devaluation) without compensating wage and price increases (internal revaluation) by the surplus countries (Demopoulos and Yannacopoulos, 2012b, 2013b, 2015).

7. The net result has been a deflationary bias, that explains the high level of unemployment in the South. And since **deflation** increases the real burden of the debt (both public and private), the ultimate outcome has been to leave the heavily indebted nations of the euro area between a rock and a hard place (Eichengreen, 2012).

8. This situation is reminiscent of the Stackelberg game, with the surplus country acting as a leader and the deficit country as a follower. In this game, **the leader** has to decide whether to defend its surplus in its current account or to adjust. **The follower** (the deficit country), informed of the leader's choice, chooses its own action from its set of actions. **If the leader** chooses to **defend its surplus** (as it usually happens), **the options** for the **follower** is either to deflate and allow unemployment to rise or to abandon the currency area (Demopoulos and Yannacopoulos, 2016).. **The first option open to the follower** (remaining in the union, is to deflate and allows unemployment to rise), **does not lead to a stable solution**.

9. Efficiency on the workings of the Eurozone requires that the European Central Bank operates as a lender of last resort.

As De Grauwe (2011, 2013a, 2013b) and De Grauwe and Yuemei (2013) have emphasized, deflationary macroeconomic policies lead to recession and (through the operation of automatic stabilizers) to an increase in budget deficits. Increased budget deficits increase the ***distrust*** **of the markets as to the ability of the country to service its debt.**

This is because the **members of the euro zone** borrow **in a currency**, **the supply of which do not control, and therefore they cannot guarantee** to bondholders that cash will be available at maturity. **The European Central Bank that could**, in principle, provide that liquidity (acting as a lender of last resort) **is reluctant to do so, for a combination of statutory, political and ideological reasons** (Eichengreen, 2012). The **distrust** of the markets leads to bond sales. **Liquidity is drawn from national markets, domestic interest rates increase drastically**, forcing authorities to apply even more budgetary austerity, which in turn leads to a more intense recession.

The combination of increasing interest rates and debt levels **may push the member country into a default crisis. It follows that financial markets acquire great power to force a default crisis on a member of a monetary union. The lack of a lender of last resort leaves union members vulnerable to self-fulfilling liquidity crisis** (De Grauwe, 2013a, 2013b, 2013c).

10. These inefficient outcomes can be removed if the members of the currency area **coordinate** their policies: austerity in the deficit countries has to be matched by budgetary stimulus in the surplus ones. Coordination requires an agreement among the participants. This agreement (if reached) would be stable if it cannot be challenged by anyone.

This is possible when the self interest of each member of the currency area taken individually (*individual rationality*) **is also good for the union as a whole** (*group rationality*) (Demopoulos and Yannacopoulos 1998,1999, 2012c).

This condition is not likely to be met today. Germany, for example, and the other surplus countries of the euro area, may be reluctant to sacrifice their positions as creditor nations. But if *individual rationality* dominates, imbalances and their negative effects on the currency area (deflationary bias and unemployment) will remain.

11. A monetary union with these shortcomings is not viable. We believe that imposing a single currency without, at the same time, providing the system with an **adjustment mechanism** to correct imbalances among the member states is an economic mistake. Europe is not an optimal currency area. The imposition of a single currency in a *heterogeneous* area without geographical mobility, **deprives the member countries the flexibility to adjust in times of economic distress** (Baldwin and Giavazzi, 2015, 2016; Marsh, 2013).

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