in brief...
Tough choices for a troubled euro

Nobel laureate **Christopher Pissarides** was once a passionate believer in the benefits of European monetary union. He now thinks that either the euro should be dismantled or the direction of economic policy dramatically reversed so as to promote growth and jobs and avoid creating a lost generation of educated young people.

One of the most exciting things about working at the LSE is that we get to hear some of the world's top thinkers and policy-makers. One occasion that I recall vividly is the visit of two great Europeans – Valéry Giscard d'Estaing and Helmut Schmidt. Europe had already completed the single market, the Berlin wall had fallen and the European Union was preparing to embrace new members and adopt a single currency.

I was completely sold on the idea. In 2000, I joined the Cyprus Monetary Policy Committee to help bring the euro to my home country; and I worked on the teams in Britain and Sweden on the implications of the euro for the labour market.

Back then, the euro looked like a great idea as a key step in the process of European integration. But it has now backfired: it is holding back growth and job creation; and it is dividing Europe. The present situation is untenable: we need something similar to the rallying calls of Giscard d'Estaing and Schmidt to restore the euro's credibility in international markets. We need charismatic European leaders who will restore the trust that Europe's nations once had in each other. Regretfully, I do not see either materialising.

The euro should either be dismantled in an orderly way or the leading members should do the necessary as fast as possible to make it growth- and employment-friendly. We will get nowhere plodding along with the current line of *ad hoc* decision-making and inconsistent debt-relief policies. (Compare, for example, Cyprus and Greece, where the source of the problem was similar but the solution very different.) The policies pursued now to steady the euro are costing Europe jobs and they are creating a lost generation of educated young people. This is not what the founding fathers promised.

Bringing Europe back to life requires brave action in both monetary and fiscal policy

Doing the necessary to bring Europe back to life requires brave action in both monetary and fiscal policy. It might well require U-turns from those who thought austerity would have only short-term setbacks and it is likely to cost votes in the rich countries of northern Europe. My fear is that we do not have the European leaders who can take this on. Mrs Merkel and Mr Hollande are *national* leaders, not *European* leaders. And Mr Schäuble's economic assessment in the *Financial Times* (16 September 2013) makes me wonder if he ever realised that the eurozone extends south of the Alps.*

The monetary union that we got with the euro created the European Central Bank (ECB) as a central bank in charge of monetary policy but not supervision. The lesson of recent events in Europe is that the split between fiscal and monetary policy is untenable. Under present arrangements, national governments need to recapitalise their banks and insure their deposits. This involves fiscal spending and build-up of debt. Poor bank supervision can lead to a deteriorating fiscal balance.

Current plans to turn the ECB into a supervisory authority must go ahead speedily. We need a single supervisory authority that can dissolve banks when necessary, recapitalise them and insure their deposits. Anything less than that will involve continued short-term tinkering by national governments and lead to more disasters.

The supervisory authority should be well funded and not have to rely on transfers from governments and the International Monetary Fund (IMF) when the need arises. If a Cyprus-style 'bail-in' is the answer, the ECB should say so and face the likely flight of large deposits – Singapore and Hong Kong's gain; Europe's loss. As a Cypriot who experienced first-hand the impact of the decision to plunder deposits over €100,000 to recapitalise bankrupt banks and insure smaller deposits, I dare not think what the consequences of such a capital flight would be for the eurozone as a whole.

We also need at least some central control of individual countries' fiscal finances. Fiscal transfers are already taking place, through the structural funds and the stability mechanisms. But large fiscal transfers are unpalatable to European voters and with some central control over national budgets, they should not be necessary.

Many in Europe think that there is no future without fiscal union – that is, without a US-style federal budget. Fiscal union certainly could do the job: the American west developed with a heavy dose of fiscal transfers from the east via the federal budget. But for present-day Europe, I think this is going too far.

Fiscal supervision is necessary. The European Commission does some but it will be more credible if it is done by an independent body – a Brussels-based 'fiscal policy council' (FPC). Some fiscal transfers will always be necessary but they will be minimised if there are early warning signals from an independent FPC. More and more countries in Europe are finding that an FPC contributes to domestic fiscal stability. A central FPC would do a similar job for the whole eurozone: its role would be complementary to that of the national FPCs and they should work with each other.

Meanwhile, fiscal austerity is destroying jobs. The rest of the world is coming out of crisis and taking on new challenges; and Europe is being left behind, powerlessly watching the rise in unemployment. The troika – the Commission, the ECB and the IMF – and national governments should be softer on austerity. Austerity has created a two-tier Europe: Germany and the smaller northern countries, for which the ECB's monetary policy stance is about right; and the south, for which it is far too tight.

We need more investment in Europe. We should learn how to do our fiscal accounts better and exclude investment projects from the one-year horizons of national budgets. Because governments will be tempted to classify too much spending as investment, we need a European 'growth council' to evaluate which policies are growth-enhancing and exclude them from the budget. It can be as generous or as strict as required by the European Council; either way, it will be a big improvement on the current situation.

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* http://www.ft.com/cms/s/0/e88c842a-1c67-11e3-a8a3-00144feab7de.html