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The Eurozone's Path to a Federalist Future

Alan Lamond

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Summary

As it becomes clear that the euro is here to stay it is becoming equally clear that the future of monetary union is a federalist one, based on the need for closer economic, fiscal and political union to ensure its stability. As originally intended, therefore, the single currency is acting as the chief propellant of the European project, whose ultimate purpose is the establishment of a federal-type union of European states. In order to maintain popular support for closer union, however, federalists need to be very clear about what it should and should not involve in each of the three policy areas concerned.

In the economic area the aim should be to progressively convert the eurozone, already a single market, into a single economy in which possibilities for specialization, economies of scale and growth would be enhanced. Particularly essential for this purpose, and for the maintenance of economic stability, is the establishment of banking union. Fiscal union requires the creation of a central budget large enough to make possible both automatic and discretionary transfers of income, and to help manage overall demand, within the eurozone as a whole. Political union is necessary not only to facilitate central decision-making but also to legitimize it and, through the development of a cross-border political life, to make it more democratically acceptable to the eurozone's citizens. What all this means, in short, is that closer union needs to be based not on the mutualization of debt, but on the mutualization of interests, among which is the interest most European countries share in acquiring the ability to play a powerful collective role in world economic and political affairs.

Although its survival is now virtually assured the eurozone will continue to be vulnerable, pending full achievement of closer union, to two main threats to its stability. Contrary to the claims of some eurosceptic economists and commentators these do not derive from any fundamental inability of some member governments to cope with the two basic constraints on economic management associated with monetary union, namely, the existence of a one-size-fits-all interest rate and the absence of exchange rate flexibility at the national level. They are represented by the continuing existence of problems of debt sustainability in some countries and by the danger that in any country receiving bail-out assistance popular opposition to the

conditions attached to it might force the government concerned to refuse to implement them. To counter these threats eurozone governments must place less emphasis on austerity and do more to promote economic growth in the zone as a whole; at the same time they must target more carefully and apply more flexibly the conditions imposed on governments receiving financial help.

The growing recognition that the steps being taken towards closer union are ensuring the eurozone's survival will have a highly important political consequence. Since all member states of the EU, other than those that have opted out of monetary union, are expected to adopt the single currency when they are able to do so, the federalist future of the eurozone will increasingly come to be seen as the future of the Union as a whole. This perception will transform the debate in Britain about EU membership into a sharply polarized one between pro-Europeans and anti-Europeans, a debate in which the prevarication at present described as euroscepticism will cease to be possible. The coming show-down will be crucial in determining not only the country's place in Europe but also its future role in the world.

Introduction

For all pro-Europeans, and particularly for federalists, the future of the euro is an issue of vital concern. This is not because there is any necessary dependence of progress towards closer political union on the existence of a common currency. Today many economists are in fact arguing the converse, i.e., that the euro will not survive without closer political integration. They might point to the example of the USA, which had a federal government and constitution before it had a central bank and uniform dollar currency. In the different circumstances of Europe, however, the chosen path to closer union has been an economic one, the first step on which was the establishment of a customs union and a single market for goods, services, labour and capital. The second step, monetary union, was intended to advance further the process of economic integration through the introduction of a common currency managed by a European Central Bank (ECB) operating a common monetary policy in conjunction with national central banks.

The logic behind the introduction of the euro was therefore essentially economic. Nevertheless pro-Europeans believed that by cementing the economic links between its member countries monetary union would also promote closer political links between them. Ironically it is the debt crisis the eurozone has been experiencing, more than any perceived economic benefits its members have been enjoying, that is lending justification to this expectation, because an important effect of the crisis has been to widen demands in political and business circles within the zone for closer political as well as economic integration. It may not be surprising that the president of the European Commission is calling for a European federation of nation states but when the head of France's main employers' organization (Medef) backs the same idea, when both the chief executive of the Federation of German Industries (BDI) and the German chancellor herself call for a political union of eurozone member states, and when the French president comes close to endorsing the same goal, then all pro-Europeans ought to sit up and take notice. That the so-called European project is indeed a federalist one is the truth that is now beginning to speak its name, while ever closer union is being seen increasingly as a process that needs to be accelerated and not just accepted.

Among economists a similar evolution in thinking has taken place. Initially the outbreak of the peripheral debt crisis led many of them to the view that the days of the eurozone were numbered (some commentators were even forecasting its collapse within weeks or months) but after Greek debt was successfully restructured in early 2012 economists began to back away from such dire predictions and have continued to do so. Most, but not all, now accept that the eurozone can survive provided certain conditions are fulfilled and in this regard their views are converging with those of business and political leaders. The consensus that has emerged is that, if its long-term stability is to be ensured, monetary union must be complemented by closer economic, fiscal and political union. Federalists should feel greatly encouraged by this evolution in attitudes towards the European project but they now face an important task. Since, in public discussion, the nature of the deeper integration required in the eurozone is inadequately or too vaguely described, they need to help advance the debate by setting out a clearer view of what closer union should mean in practice in each of the three areas concerned. An attempt to do this is made in the first part of the present paper. At the same time federalists have to recognize that since the deepening of integration in the eurozone will inevitably take a great deal of time they cannot neglect or ignore the ongoing problems of the zone, for if it were to break up before the necessary degree of integration could be achieved the entire European project would suffer a catastrophic and perhaps fatal blow. Already potential threats to it can be seen in some of the negative political consequences of the debt crisis.

In Britain, the eurozone's troubles have caused anti-European attitudes to harden and opposition to euro membership, already powerful, to strengthen further. In Parliament the substantial anti-European caucus in the House of Commons has been encouraged to persist with its demand for a popular referendum on EU membership while a wealthy private research foundation has awarded a prize of no less than a quarter of a million pounds for a winning essay on how a break-up of monetary union could best be managed. In the eurozone itself one consequence of the crisis was a surge in support for anti-European parties of the extreme left and right. A more serious one was an increase in euroscepticism in some northern or 'core' member countries. It is true, and highly encouraging, that despite the unpopularity and grim social effects of the austerity programmes in place in peripheral member countries facing debt or other problems, opinion surveys are not revealing, so far at least, clear majority support in any of them for abandonment of euro membership. The possibility that this situation might change, however, together with the existence of anti-European and eurosceptic sentiment in core member countries, makes the achievement of eurozone stability urgently necessary. For that reason the second part of the paper is devoted to a consideration of the ongoing problems of eurozone governance and the attitude to them federalists should adopt.

1. Closer union in practice

Economic and banking union

From its inception the purpose of economic and monetary union (EMU) was to enable its member countries to progressively integrate their economies until the eurozone, already a single market, came closer to being a single economy. The theory was that within a more fully integrated economy there would be greater possibilities for specialization and the realization of economies of scale which would enhance wealth creation and incomes in the eurozone as a whole. The role of the euro was to further the integration process by eliminating exchange rate uncertainty as a factor influencing investment flows within the zone and by ending the need for currency hedging in intra-zonal trade. Some economists belittle the importance of these effects and given the difficulties and recessionary conditions the eurozone has been facing their scepticism is not surprising. Once the zone's stability is fully restored and recovery gets under way, however, the vital role of the single currency in promoting economic integration and growth should become clearer.

It has now been recognized that another indispensable component of EMU is banking union. The need for this stems basically from the fact that in the eurozone lending by banks, including cross-border lending, plays a predominant role in the financing of businesses. This contrasts with the situation in the US, where a much greater proportion of such financing takes place via corporate bond issuance. The soundness of its banks is therefore of great importance to the eurozone for the maintenance of its economic stability in general. Two special factors, however, have caused the establishment of banking union to become particularly urgent. One is the recognition that the debt crises in Ireland and Spain were to a large extent due to the need for the governments of these countries to rescue failing banks which had engaged in irresponsible lending, particularly for housing and construction. The other is the breakdown that has occurred in the so-called transmission mechanism through which the ECB influences the interest rates charged by commercial banks on their loans to businesses. Because so many eurozone banks remain under-capitalized or in difficulty they have restricted their lending and kept the interest rates charged on loans relatively high, even though the ECB has reduced its policy rate to near zero.

It is generally accepted that banking union should have three components. The first is a centralized system of bank supervision and the second is a central resolution authority which would be able to wind up failing banks, without cost to taxpayers, before they begin to pose risks for financial stability. The third component would be a eurozone-wide deposit insurance scheme which would supersede the existing arrangement whereby governments are obliged to guarantee bank deposits of up to 100,000 euros. The member governments of the zone have already agreed that the ECB, with the help of national supervisors, should be responsible for the central supervision of eurozone banks. Agreement on the second and third components of banking union will no doubt take longer to reach but as regards bank resolution governments have accepted the principle that bondholders as well as shareholders, and perhaps also holders of uninsured deposits, should be 'bailed in' if a bank has to be restructured or wound up. To help ensure that no bank is too big to fail, however, retail banks need to be effectively separated from investment banks in order to prevent their deposits from being used for the riskier lending activities of the latter.

Meanwhile federalists have to recognize that the single European market, of which the eurozone is the principal part and whose functioning is vital for the process of economic integration, is in several respects incomplete. Most importantly trade in services, which account for around two-thirds of economic output in the eurozone, has not yet been fully liberalized. To remedy this situation more efforts are required to harmonize national regulations and standards, differences in which hinder or prevent service providers from operating freely across borders. The establishment of an effectively unified labour market is inevitably impeded by the language problem but the restrictive effect of this would be modified if, via fiscal union, common arrangements for social insurance and personal taxation were instituted.

Economic integration implies also the establishment of a level playing field for competing enterprises in the eurozone through the application of common standards of corporate governance and of employee and consumer protection. A useful step in this direction was the creation of the possibility for national firms, by agreeing to observe certain prescribed rules of corporate governance, to acquire the status of European company (Societas Europaea) which enables them to operate anywhere in the EU without restriction. An even more useful step for the eurozone would be to institute (again via fiscal union) a common system of corporate taxation.

Fiscal union

Any attempt to describe what true fiscal union in the eurozone would mean in practice must start by making clear what it would not mean. Some commentators suggest that it could consist principally of central supervision and control of national budgets by officials of the European Commission. This would imply an extension of the regime imposed on countries receiving assistance from the European Stability Mechanism (ESM) to all member countries, whether they were being bailed out or not. Such an arrangement would be more appropriately described as fiscal policing than as fiscal union; it would provoke intergovernmental tensions and likely prove to be a recipe for fiscal disunion rather than union. It might be argued that such a regime could be acceptable if it was operated symmetrically, i.e., if the Commission was able also to order governments to adopt more expansionary fiscal policies if it deemed this desirable, but there is virtually no chance that agreement on this could be reached.

The same is true of the suggestion that fiscal union would be constituted by some permanent arrangement whereby eurozone member countries shared responsibility for all or some of each other's debts, using instruments such as collectively guaranteed eurobonds or a central debt redemption fund. The idea of debt mutualization already faces strong opposition in many member states on the grounds that it would create moral hazard but this is by no means the only difficulty associated with it. For example, the type of eurobonds which are much discussed in this connection would be issued by national governments bearing responsibility for servicing and redeeming them but would be guaranteed jointly and severally by all eurozone governments. Since governments could not be permitted to issue unlimited quantities of such bonds the question arises of the basis on which national quotas for them would be determined. Would they represent a standard percentage of each country's GDP or would they be related in some way to perceived needs? A further question is that of what would happen if a government threatened to default on these bonds. The fact is that the sole function of such eurobonds would be to provide an interest subsidy on the amounts borrowed with their help by governments of below-average creditworthiness. It might be argued that such a subsidy would be justified as a solidarity measure but whether it would be an appropriate one is highly questionable.

The term 'fiscal' relates to the raising and spending of public revenue and most economists as well as federalists would agree that true fiscal union would involve something more than the purely disciplinary arrangement constituted by the already existing fiscal pact. This pact (which in any case needs to operate flexibly) simply obliges signatory governments to keep their structural budget deficits, i.e., average deficits over the economic cycle, within prescribed limits. A true eurozone fiscal union would involve the establishment of a central budget, and related revenue-raising arrangements, covering a substantial portion of total public spending in the zone. A central treasury would exist alongside the national ones and the greater the relative size of its budget the smaller national budgets would need to be and hence the less likely systemically dangerous debt crises of the kind the zone has been experiencing would become. The possibility of debt difficulties arising in individual member states would not be eliminated, as the experience of the US shows, but the smaller their budgets were the easier they would be to manage and the size of any ESM loans that might nonetheless become necessary would also be smaller. Another potential benefit of fiscal union lies in the fact that a large enough central budget might be used to manage overall demand for the purpose of promoting economic stability in the zone as a whole.

The establishment of any kind of fiscal union would require intergovernmental decisions on the areas of spending to be covered by the central budget. Theoretically the easiest to agree upon would be those in which the benefits of such spending would be more or less equally shared by all the member states, as they would be in fields such as energy provision, public health and safety, environmental protection, research and development, etc. In principle defence spending would fall into this category but would not be easy to agree upon. Another possibility would be to use the central budget to underpin common systems of sickness and unemployment insurance. (As already mentioned the existence of such schemes would facilitate the movement of labour within the eurozone). As in any insurance schemes benefits would not be matched closely by contributions and a certain degree of automatic income transfer would take place. A central budget could of course also be used to effect discretionary transfers of income between member states. Such transfers would take place if the budget was used as a source of direct subsidies of any kind to particular member states, including any involved in debt relief or other kinds of financial assistance. They could also be effected through central infrastructure spending which benefited some countries more than others.

It is noteworthy that most of the commentators who insist on the need for the eurozone to become a fiscal union appear to regard the capacity to bring about deliberate income transfers as the most important attribute of such a union. For these commentators 'fiscal union' and 'transfer union' are practically interchangeable terms and some make their position completely clear by calling simply for the latter. The fact has to be faced, however, that any attempt to give fiscal union this character would encounter strong political resistance. Difficulties would arise also in negotiating the central taxation arrangements or other means of revenue-raising that would be required in a fiscal union. The simplest possibility would be the levying of a federal value-added tax but, depending on the size of the central budget, a progressive income tax might also have to be considered. For the purpose of clarification a further point should be made regarding fiscal union. Under it the central treasury would be able to issue its own bonds which would appropriately be described as eurobonds, in contrast to those being advocated for the purpose of mutualizing sovereign debt. Both kinds of bond would be collectively guaranteed but unlike the latter ones the former would be issued centrally to raise money for collectively agreed purposes.

In the light of the foregoing description of fiscal union it is clear that its creation will be a lengthy and difficult political process. It will involve a substantial amount of additional sovereignty-sharing and correspondingly tough negotiations among eurozone governments. A major problem will be the likely hostility of many eurozone citizens, already opposed to bail-outs, to any kind of permanent fiscal arrangement involving the redistribution of income between member states. Moreover, even if governments reached agreement among themselves on fiscal union they would not be able to impose it on their citizens in a top-down manner. This raises the question of how the democratic legitimacy of decision-making in the eurozone, and indeed in the EU as a whole, can best be assured, a question examined in the next sub-section.

Political union

In the European context political union implies some type of federal union and recognition of this fact is growing. Nevertheless the calls for closer political union that have been provoked by the eurozone's recent problems are not calls for the start of work on the drafting of a federal constitution. Like economic and fiscal union, political union necessarily has to be built step by step, each of which is designed to serve some immediate purpose as well as the longer-term one of the European project as a whole. Political union, however, is more directly and closely related to the latter purpose than either economic or fiscal union and in calling for it federalists need to emphasize this fact. Otherwise there is a danger that many European citizens will see political union as being required simply 'to save the euro', particularly since in the public mind the fundamental purpose of the European project is less clear than it should be. Federalists must seek to persuade these citizens that, in view of the already described benefits of economic integration, the euro is indeed very much worth saving. At the same time, however, they must stress that the purpose of political union is to enable the states involved in it to speak and act jointly on the world stage, as well as to assist their economic and fiscal integration.

Originally the main purpose of the EU as a whole was seen to be the prevention of further wars between the nation states of the continent. This aim is still a perfectly valid one, as the award of the Nobel peace prize to the Union showed, but since such wars have now become unthinkable the aim has lost most of its capacity to inspire and enthuse. Today, federalists must point out the potential ability of the political and economic 'clout' of a federal-type European union to put it in the same league as states like the USA, China, India and Brazil, a status which none of the EU member states could attain on its own. Some citizens of the larger European states may be indifferent to this prospect but hopefully federalists can win support for the project of political union by inviting them to contemplate the main consequence of its failure, which would be a world in which all the key players would be non-European powers. There is no doubt, however, that a special problem exists in the UK, where euroscepticism is rife. The hope must be that a majority of Britain's citizens will eventually come to recognize that it makes more sense for their country to become an influential federal partner of its European neighbours than to remain merely a junior partner of a distant United States.

Federalists also need to make clear the more immediate purpose of political union in the eurozone, which is to facilitate collective decision-making within it and at the same time to make it more democratically legitimate. Achievement of the first aim will require an extension of qualified majority voting to areas where veto rights at present exist, a step that may require treaty changes and in some member countries the holding of referendums. In addition some new bodies, such as a treasury and perhaps a defence council, may have to be created and the roles and titles of existing ones altered. The European Commission, for example, may have to become more like a civil service, with a corresponding change in the title of its president. A possible difficulty might be a blocking of steps to political union through the exercise of veto rights by an EU member state which does not wish to participate in it, in which case the steps would have to be taken outside the framework of the Lisbon Treaty.

The need to ensure the democratic legitimacy of easier collective decision-making has particularly important implications for the role and powers of the European Parliament and the way it is elected. It is sometimes suggested that the democratic deficit of the EU could be remedied via the direct election of the president of the European Commission. However, voters in any election need to know for what, and not simply for whom, they are voting. This is a requirement particularly important in elections to the Parliament but it is not being adequately met at present because its members are elected as representatives of national parties and hence of their stances on national rather than European issues. European manifestos, which receive scant public attention, give no clear guide to their stances on the specific issues with which voters are principally concerned. The result of this situation has been a steady decline in voter participation in these elections to a low of 43 per cent in the last ones in 2009, together with a fall in the size of the pro-European majority in the Parliament.

It is obvious that the best remedy for this situation would be the emergence of truly transnational parties which took clear and distinctive positions on European matters. If the Parliament consisted mainly of representatives of such parties it would be better able to assure the democratic legitimacy of closer political union. It is also obvious, however, that the creation of any such party from scratch in many countries simultaneously would be extremely difficult. The most practical answer to this problem might therefore be to start the formation process in the Parliament itself, where a great deal of contact takes place between members who belong to different groupings but take common positions on European issues. If these like-minded MEPs were to form themselves into new cross-party alliances these could perhaps become embryonic transnational parties. For example, if MEPs who were firm federalists took the initiative to form such a group they might proceed, with outside collaboration, to the drafting of a manifesto or platform setting out their positions on the main controversial issues in European politics. (A draft of such a platform by the present author, entitled *A Pro-European Platform for a Pan-European Party,* designed to serve as a basis for discussion, was released by the Federal Trust in 2010; with due heed to developments since that year it can still be used for this purpose). This move could lead to the creation of a party which, via the efforts of local activists, might acquire a formal existence outside as well as inside the Parliament. The procedure could then be copied by other MEPs, leading to the formation of rival transnational parties.

National parties which accept the need for the development of a democratic cross-border political life in Europe should logically accept also the need for a process of the kind suggested above, leading to the formation of transnational parties which would contest only elections to the European Parliament. What any national party should want to see is the emergence of a cross-border party whose stances on European issues corresponded fully to its own, a process which it could itself encourage and assist. Once such a party had been created the national party would have no need to compete with it in European elections ; instead its role in them would be to throw its support behind the candidates of what would be in effect a transnational sister party. The development of a true cross-border political life in Europe will obviously take much time and it needs to start with the creation of at least one federalist transnational party. If this cannot be achieved in time to influence campaigning in the forthcoming elections to the European Parliament in early 2014 it will be all the more necessary in these elections for national parties to make completely clear their own positions on all the main issues in European politics which will then be confronting the continent's citizens.

1. Stabilizing monetary union

In considering how monetary union can be stabilized pending achievement of closer economic, fiscal and political integration it is necessary to examine the various weaknesses alleged to be inherent in it and the extent of the threats they pose to the euro's future. Many economists are still arguing that EMU is a basically flawed and ultimately doomed project because, in their view, the eurozone is not an optimal currency area. This is a concept associated with the name of the Nobel prize-winning economist Robert Mundell, who was the first to put forward a definition of such an area in 1961. Since the use of a single currency by a group of states requires acceptance of a one-size-fits-all interest rate decided by a common central bank, as well as a single exchange rate, entry into a full monetary union creates new economic management problems for all the participating states. Among the necessary conditions for overcoming them economists have stressed the importance of full mobility of labour and capital, as well as coordination of fiscal, trade and financial regulatory policies. In meeting these requirements the EU as a whole has made great progress. It is a customs union with a common external tariff and trade policy and a single market in which there are not supposed to be any restrictions on the movement of goods, services, labour or capital. Within the eurozone itself rules have been laid down for the maintenance of fiscal discipline and new arrangements for centralized banking regulation are being made.

It is nevertheless true that in some respects the eurozone still falls short of constituting an optimum currency area. Because of language and other difficulties labour mobility within the zone is limited and inadequate progress has been made in liberalizing trade in services which, although they are much less tradeable than goods, account for the bulk of GDP in the zone and in the EU as a whole. In some member countries, moreover, debt sustainability remains uncertain. However, the fact that the euro currency area remains to some degree sub-optimal does not mean that it is non-viable. In practice the viability of a currency area does not depend on its possession ab initio of some minimum degree of theoretical optimality. What matters is the ability of all its member governments to manage their economies successfully while subject to the two basic constraints that membership of such an area imposes on them, i.e., the need to accept the existence of a single base interest rate for the area as a whole and the absence of exchange rate flexibility at the national level. The practical implications of these twin constraints therefore require closer examination.

The interest rate constraint

The ECB's base interest rate, i.e. the so-called repo rate at which it provides liquidity (short-term loans) to eurozone commercial banks, is the policy tool the Bank uses to tighten or loosen basic monetary conditions in pursuit of the primary objective laid down for it by the Maastricht Treaty, which is to maintain price stability in the eurozone as a whole. Since the Bank has to focus on the average rate of inflation in the zone its monetary policy inevitably has a broad brush effect which cannot by itself prevent substantial deviations from that rate in individual countries. When the eurozone is in a state of general recession and the ECB lowers its repo rate to zero or close to it, then the rate is likely to be one that truly fits all. Otherwise, however, its real level (i.e. its level after taking inflation into account) may be either too high or too low for particular member countries. For example it might be undesirably high for a country whose economic growth rate was much lower than average. This would not be a major difficulty if the government of the country concerned could counter it by applying an adequate amount of fiscal stimulus but if it had already allowed itself to become heavily over-indebted this might not be possible. This, however, would be a problem of the government's own making and if it existed it would be a much more important constraint on macroeconomic management than its inability to manipulate short-term interest rates.

Somewhat greater are the potential difficulties that would be faced by any eurozone member country for which the ECB's policy rate in real terms was lower than appropriate, i.e., one where inflation was substantially higher than average. This might be a country whose labour market lacked flexibility and where wage costs were easily pushed up. In such an inflation-prone country an expansion of lending by banks at low real interest rates, reflecting their ability to borrow relatively cheaply, might accelerate inflation. This ability can have even more serious consequences. Notably in Ireland and Spain, the bursting of housing and construction bubbles created by cheap and imprudent mortgage and other lending by banks had disastrous effects on employment and incomes and obliged governments to rescue banks in danger of collapse, thereby adding heavily to their sovereign borrowing requirements and debt. The appropriate answer to both these problems, however, is closer supervision of banks, not reversion to a national currency. For example, if bank regulators deemed mortgage lending to be excessive or imprudent one measure they could take would be to lower the limits on the proportion of property values such lending could represent. National regulators can be subject to pressure from private interests, however, and governments may fail in their supervisory duties. Hence the importance of the plans for banking union, which provides for central supervision of banks by the ECB.

Inflation of course can also be generated by excessive spending by governments but here again the answer is not an independent monetary policy. In the eurozone the fiscal pact is intended to be a key constraint on public spending. For over-indebted governments another is constituted by their borrowing costs, since the effective interest rates at which governments can issue sovereign bonds are now influenced much more than they were before the original Greek debt crisis by market perceptions of debt sustainability. Bond yield spreads (over German bond yields) are influenced also by short-term speculative considerations and tend to be fickle but sharp rises in them can act as warning signals to over-indebted governments. If these are not heeded an ultimate constraint on borrowing by such governments will be the possibility that they might be forced to seek bail-out assistance and to accept the conditions attached to it. The above arguments may be summed up, therefore, by saying that the existence of a one-size-fits-all interest rate and single monetary policy does not create any insurmountable economic management problems for eurozone governments and does not by itself constitute any serious impediment to the maintenance of the zone's stability.

The exchange rate constraint

The other basic economic management constraint faced by eurozone member countries and which, it is widely argued, constitutes the principal threat to the zone's stability or even viability, is the one-size-fits-all exchange rate. As in a unitary state this is the rate required to balance the external payments of the zone as a whole, which consist of payments on current account (the trade balance) and movements of capital. In a unitary state the trade balances of the geographic regions comprising it have no implications for central macroeconomic management (though they may have some for regional policy) and are unlikely to be calculated. In the eurozone, however, such regions are sovereign states whose trade balances with each other and with the rest of the world are calculated via the zone's Target 2 inter-bank payments system. These balances are then translated, after account is taken of private capital flows, into net creditor or debtor positions of their national central banks with the ECB. This means that member countries running persistent current account deficits because of a lack or loss of trade competitiveness, and which for the same reason have difficulty in attracting inward loan or investment capital, will tend to build up debtor positions of this kind, while surplus countries will tend to become ever bigger creditors.

During the first nine years of the euro's existence (1999-2007) the five peripheral member countries whose problems have been threatening the zone's stability, viz., Greece, Ireland, Italy, Spain and Portugal, ran persistent and mostly upward trending current account deficits expressed as proportions of GDP. Nevertheless, since private capital inflows were sufficient during this period to keep them low, the so-called Target balances of these countries did not attract attention. The financial crash of 2007-08 caused aggregate net private capital flows into the five countries to shrink, however, and in each of the three years 2010-2012 they were negative. Even though the trade deficits of the peripheral countries (with the exception of Italy) all shrank after the crash their net cumulative effect since then, combined with that of the net capital movements, has been to hugely increase the aggregate liabilities of their central banks in the Target system. The principal counterpart of this increase has been a massive rise in the net creditor position of the German Bundesbank with the ECB, which by the end of 2012 stood at a level of almost 700 billion euros or over a quarter of the country's GDP. It is clear, therefore, that if the eurozone were to break up before such large imbalances had been corrected or greatly reduced the Bundesbank might suffer heavy losses. Unsurprisingly, German economists have been prominent in highlighting this fact.

The work of German and other economists in exposing what one of them described as "the hidden balance of payments crisis of the eurozone" will no doubt have reinforced the view of eurosceptics that the lack of exchange rate flexibility at the national level constitutes a serious and perhaps fatal threat to the eurozone's stability. The opposite view is that imbalances in the Target system do not matter. The truth is that both of these contentions are flawed. The first one ignores the fact that the eurozone's problem children, with the exception of Italy, have all substantially reduced their current account deficits from the peak levels, relative to GDP , they reached after the 2008 crash and that one of them (Ireland) has actually been in surplus since 2010. It also takes insufficient account of the reason for the capital flight from the periphery countries between 2009 and 2012 which widened the payments imbalances reflected in the current Target positions. Ironically this flight, which was reversed in the latter months of 2012, was caused precisely by fear that the countries experiencing it might regain exchange rate flexibility via exit from monetary union and adoption of a new national currency. As regards the opposite contention, it can be argued that from a purely technical point of view net capital outflows from a eurozone member country do not matter unless and until they reach a level where capital controls become necessary (as in the case of Cyprus), while current account deficits will sooner or later, in one way or another, eventually self-adjust. From the point of view of eurozone citizens, however, this argument takes no account of the fact that any net capital flight from a poor or slow-growing member country will be socially as well as economically harmful, while the way in which trade deficits adjust, and the time the process takes, will matter very much indeed. If the first of the above arguments is too alarmist, therefore, the opposing one is too complacent. Hence both require closer examination.

Since the eurosceptic argument regarding the exchange rate constraint relates essentially to the problem of persistent current account deficits, consideration needs to be given to how these may arise and to the ways in which they may be corrected. It should be noted first that the existence of a current account deficit means that the total spending of a country is exceeding its income, so that the country as a whole is in a state of net current indebtedness. Underlying this is indebtedness of private and/or public entities as well as individuals, that of governments being represented by their budget deficits. The peer and market pressures which drive the correction of fiscal deficits in the eurozone have already been mentioned in the preceding sub-section. Private current indebtedness, household and corporate, is intermediated mainly by banks and unless these are effectively supervised (as they will be under banking union) it may partly reflect excessive and imprudent lending by them. In any case, as far as individuals are concerned, those who cannot repay their bank loans or overdrafts will face penalties and will be refused further credit. As regards corporate indebtedness, if failing firms cannot repay or roll over their bank loans they will become insolvent; this will lead to the closure or down-sizing of uncompetitive businesses and a consequent fall in employment and incomes. The result of both these kinds of insolvency will be a decline in total private spending in the economy, which in turn will tend to reduce imports and hence the country's trade deficit. For some time at least these effects may be limited by the operation of automatic stabilizers (unemployment and other social benefits) which will increase the strain on the public finances and link the uncompetitiveness problem to any budgetary one the country concerned may have. It is nevertheless true that, like net capital flight, trade deficits cannot persist indefinitely and that their adjustment will involve some social pain and a decline in per caput income.

In a currency union there is no economic necessity for all its member countries to have similar standards of living or levels of employment. It is clearly undesirable, however, for current account imbalances to be corrected in a way that widens disparities in these standards and it is here that the question of exchange rate flexibility arises. The eurosceptic argument is that, if persistent current deficits reflect mainly a lack or loss of trade competitiveness, then an exchange rate depreciation, brought about by exit from the euro and adoption of a new national currency, provides an easier and quicker remedy for this problem than the alternative one, a so-called internal devaluation, which means essentially a fall in unit labour costs. There is more than one way, however, in which these costs can be reduced. The most direct (and perhaps unavoidable) way is through wage cuts but they might also be lowered via labour market reforms providing for greater flexibility in wage agreements, working practices, dismissal rules, etc. Such reforms would in any case be necessary to attract increased investment, which could be expected to have the effect of raising productivity, and to the extent that competitiveness was improved in this way the less would be the pain involved in trade balance adjustment.

Although an internal devaluation will have at least some negative social effects it has to be noted that a real devaluation brought about by departure from monetary union would also result in some social pain, as well as increases in production costs, caused by rises in the prices of imported consumer goods, raw materials and manufacturing inputs. A government contemplating such a move would therefore have to weigh carefully its likely net effect, taking into account factors such as the price elasticities of demand for imports and exports and the availability of spare production capacity. It would also have to bear in mind that unless the fundamental causes of the country's uncompetitiveness were remedied, and wage pressures resisted, its exit from monetary union would be followed by further inflation and exchange rate depreciation (as the experience of Italy before it joined EMU demonstrated) while much of its debt would remain denominated in euros.

In addition to the above considerations there is a further, more basic one, that any government contemplating exit from the eurozone should not overlook. When, as often occurs, the constraint represented by the one-size-fits-all exchange rate is referred to as the inability to devalue, the misleading impression is given that the exchange rate is a valuable economic management tool that eurozone member governments could acquire by leaving the zone and introducing a new national currency. Since the final collapse of the Bretton Woods system in 1973, however, the world's main currencies are no longer linked to gold or the US dollar at fixed parities but are instead floating ones, i.e., their exchange rates are determined by market supply and demand conditions. These in turn depend mainly on the basic balance of payments situations of the countries concerned but also on short-term capital movements which reflect speculative assessments by market operators of the economic prospects of each country relative to those of the others. Currency exchange rates are therefore inherently unpredictable.

In this connection it may be noted that although the UK in 2012 ran a current account deficit larger in relation to GDP than that of Greece, Italy or Spain, as well as a budget deficit relatively two and a half times greater than the average one in the eurozone, the exchange rate of the pound sterling against the euro in that year was on average about 6 per cent higher than in 2011, while against the dollar the average rate was barely changed. This situation at one point prompted a suggestion by one British economist that the Bank of England might try to force down the average exchange rate of sterling through purchases of foreign assets, a move that might be described by some as external quantitative easing but by others as currency manipulation, which is forbidden under IMF rules. It was not until early 2013, after fears of a eurozone break-up had receded, that a significant weakening of the pound occurred. These facts undermine one of the main arguments employed by eurosceptics in Britain against the country's entry into monetary union. They show also that no eurozone member country that considered exit from the zone as a cure for uncompetitiveness could pre-determine or control the extent to which its new currency would depreciate. If the fiscal and monetary policies being pursued in the country were judged by the market to be sound the currency might weaken less than was hoped; otherwise it might depreciate much more than was desired, with severe consequences for import prices and inflation.

The argumentation of this and the preceding sub-section leads to the conclusion that neither the single interest rate nor the single exchange rate constitutes a macroeconomic management constraint serious enough to induce any member country to escape it by leaving monetary union, especially in view of the economic upheaval and problems with euro-denominated debt that would follow such a move. It is now clear that the principal economic management problem associated with membership of EMU is the need to maintain debt sustainability. It is the difficulty a number of member countries have had in coping with this problem that has been threatening the stability of monetary union and which continues to do so. The question that remains, therefore, is that of how this stability can best be assured.

The requirements for stability

It is a significant but generally overlooked fact that throughout the series of debt crises in the eurozone there has been no sign of a collapse of confidence in the euro on the world currency market in the form of either a flight from the currency or a dramatic fall in its exchange rate. In part this may reflect awareness that the ECB could if necessary print money but mainly it shows that the market realizes that the only potential threat to the euro's existence lies not in any fundamental non-viability of monetary union but in the unlikely possibility that one or more of the nine or ten biggest member countries might take a political decision to leave it. It is becoming ever clearer that such a possibility is indeed a remote one. In fact in none of the seventeen member countries does any mainstream political party favour abandonment of the euro and in none of them, despite some increase in euroscepticism in core countries and resentment against austerity in over-indebted ones, is there any mass popular demand for exit from monetary union. In the case of the troubled peripheral member countries this may well be because their citizens perceive that, for the reasons adduced in the preceding sub-section, reversion to a national currency would be a 'cure worse than the disease' for their problems. The danger exists, however, that in one or more of these countries popular opposition to severe austerity measures imposed as a condition for bail-out assistance might induce a government to refuse to implement them. Without exiting from monetary union the government concerned might conceivably even default on the country's debt, although it could do this only if it first achieved at least budget balance before interest payments (since a default would immediately end its ability to borrow) and, if the country's banks were cut off from credit in the Target system, current account balance as well. Another danger is that the government of a large member country might get into a situation where it required a bail-out so big that it would have to be accompanied by a debt restructuring. These eventualities now represent only 'tail risks' but every effort will need to be made to prevent them since the occurrence of any of them would provoke a new crisis and renewed instability.

Eurozone governments have already taken a series of steps designed to prevent further debt crises and generally to preserve the stability of monetary union. These consist of arrangements for conditional lending to governments by the ESM, the readiness of the ECB to provide ample liquidity to banks and, subject to conditions, to support sovereign bond prices on the secondary market, as well as a fiscal pact which commits signatory governments to maintain budgetary discipline. All of these arrangements have been proving their effectiveness. Nevertheless eurozone governments need to consider what further action they ought to take, pending achievement of closer banking, fiscal and political union, to counter the residual dangers the zone still faces, particularly the political ones, together with the principles on which such action should be based.

The principle most often evoked by federalists in this regard is that of solidarity, and for many a particularly useful expression of it would be some kind of arrangement for the mutualization of debt. Solidarity is indeed the principle on which the entire European project is based but there can be differences over how exactly it should be demonstrated in practice. Some may take it to mean unqualified support but others may interpret it as something more like tough love. Moreover, even among citizens of the same country, solidarity has its limits. In 2012 some publicity was given to the fact that citizens of relatively wealthy Catalonia in Spain and Flanders in Belgium were complaining that via the tax system they were subsidizing other parts of their respective countries. Italians have long accepted the permanent financial help given to the mezzogiorno region of their country but one political party continues to try to make an issue of the matter. In Germany citizens pay without complaint a special addition to their income tax bills, which is actually called the 'solidarity supplement', introduced to provide help to the federal states that constituted the former East Germany.

Particularly in the wealthier southern states of the country, however, resentment is often expressed against the system of Länderfinanzausgleich, under which the states do not levy any income taxes of their own but instead receive back a portion of the revenue raised by the federal income tax. Whereas the latter tax is a progressive one, however, the revenue returned to the states is allocated in proportion to their populations, so that an element of income redistribution is involved. In early 2013 two of the states which are net losers under this system in fact lodged a formal complaint against it with the Federal Constitutional Court.

It is not surprising therefore that in the eurozone, where separate countries and not simply different regions of a single country are involved, there exists strong resistance to proposals for introducing sovereign eurobonds, or for creating a central debt redemption fund, in order to provide what is perceived as undeserved help to over-indebted member countries. This resistance is particularly understandable in the core countries which are already exposed to the risk of financial loss via bail-out loans and credit positions of their central banks with the ECB. In these circumstances the federalist approach to the ongoing stabilization of monetary union needs to be based not on the mutualization of debt but on the mutualization of interests. What this means in practice is that eurozone governments should as far as possible treat the zone as a single economy and not just a single market and promote its stability through action they can recognize as being in their own interest as well as that of countries in debt or other difficulties. The main immediate implication of this principle is that national policies should be coordinated in support of a new common economic strategy for the eurozone as a whole which places more emphasis on growth and less on austerity, especially in view of the poor prospects for growth in 2013. Governments, as well as the IMF, now accept the need for such a strategy but they are not fully agreed on how best to implement it.

As far as austerity is concerned one thing they ought to do is to give more careful consideration to the impact of the conditionality attached to financial assistance on not only the economic but also the social and political situations in the countries receiving it. Conditions need to be carefully tailored to each country's circumstances and, provided they are satisfied that required reforms will be carried out, eurozone governments should always be prepared to show a good deal of flexibility with respect to the time limits for their implementation as well as to the duration of loans granted and the interest rate charged on them, as they have now done in the case of

Greece. As regards growth, a frequently made and persuasive proposal is that governments in strong fiscal and competitive positions (notably Germany) should do more to stimulate their economies by, for example, encouraging wage increases and undertaking more public investment. The higher spending generated by such a move would raise demand for imports from other eurozone countries; although imports from non-member countries would also increase this would tend to weaken the euro's exchange rate to the advantage of all the zone's exporters.

There are also other types of growth-promoting action by eurozone governments that could be considered. One possibility would be for them to increase the capital of the European Investment Bank, as suggested by Robert Zoellick, former president of the World Bank. The extra capital would enable the EIB to borrow more money in the market, which it could then use to make infrastructural or other investments in the economically weaker eurozone member countries that would enable them to improve their competitiveness and growth potential. Such action would pass the collective interest test because these investments would be expected to generate a return and would not have the character of rescue loans. An analogous proposal, put forward by two German economists, is for their government to set up a kind of sovereign wealth fund which would attract money from private savers by offering them a guaranteed real interest rate and the possibility of an additional yield when returns from the investments made by the fund were high enough. Some at least of these investments could be expected to be made in other eurozone countries and to help promote growth in the zone as a whole. As the authors point out, any that were made in outside countries would tend, like increased imports from these countries, to weaken the euro's exchange rate, with the useful effect already mentioned.

Conclusion

The aim of the present paper has been to show that monetary union is successfully playing the role originally intended for it, which was to cement the economic links between its member countries and thereby further the wider aim of unifying Europe as a federal entity of some kind. The evidence for this is the fact that the eurozone has survived its debt crises intact and that the risk of any voluntary exits from it is now remote. Although in the future the zone may experience new economic difficulties and political tensions as a result of policy errors or disputes, it can be said that it has become virtually immune from crises of an existential nature. Given that the ESM and the ECB stand ready to help deal with any further debt or borrowing problems that eurozone member countries may face, it requires only a determined federalist approach to them by these governments to ensure that the euro is here to stay. When all speculation about the currency's survival finally ceases the attention of politicians, financial markets and commentators will switch to the next steps the zone plans to take on the path to its federalist future, namely, the establishment of banking, fiscal and political union. Many new issues will arise during this process and one of the most pressing will be the need for its further democratization via the creation of transnational political parties which would contest elections to the European Parliament.

In Britain the ending of all doubts about the permanence of monetary union will have important implications for federalists. The term 'eurosceptic' has always been a somewhat ambiguous one. It can be applied to those who question whether the federalist European project (and particularly monetary union) can work but who are not necessarily opposed to it. It is also used to describe those who doubt strongly that the project, feasible or not, is one in which their country ought to participate. As it becomes ever clearer that monetary union is not going to collapse, and that its member governments are determined to press ahead towards closer union, British federalists can hope to be able to persuade more and more of their fellow citizens who are eurosceptics of the first kind to shed their doubts and become more pro-European. Their task has been complicated, however, by the promise made by the British prime minister to hold a referendum on the country's membership of the EU if his party wins a majority in the general election due in 2015.

This move has generated inevitably a great amount of uncertainty regarding Britain's future economic and political relationships with the other member countries of the Union. What is basically uncertain, of course, is whether or not his party will gain a majority in the election. What the prime minister's decision makes certain on the other hand is that the issue of whether it would be appropriate to hold a referendum on the complex matter of EU membership and, if one were to be held, what the question to be answered with a simple 'yes' or 'no' vote ought to be, will be vigorously debated in the election campaign. Until the terms of the debate become clearer it will be difficult for pro-Europeans to decide what exactly their position with respect to it should be. In the meantime, however, they ought to note two potential dangers for their cause associated with a referendum process. The principal one is that, even if all the main political parties called for a 'yes' vote in a plebiscite, a very low turn-out might allow 'no' voters to obtain a majority in it, even if they represented a minority of the electorate. Given the prevalence in the country of euroscepticism of the second of the two varieties described above, as well as of outright anti-Europeanism, such an outcome is not inconceivable and this suggests that the validity of a referendum should be dependent on the attainment of some minimum level of voter participation in it. The second danger is linked to the prime minister's declaration that, before calling a referendum, he would seek to negotiate a number of changes in Britain's relationship with its fellow members of the EU. What he would ask for and what he might obtain is not yet clear but the implication of the declaration is that if he were satisfied with the result of his negotiations he would invite voters to endorse it as a final settlement of Britain's position in the Union. From a pro-European point of view the danger in this strategy is that ratification of such a settlement by referendum might enable it to be presented by eurosceptics as a democratic 'so far and no further' decision by the electorate and used to prevent any closer involvement of the country in the wider European project for decades to come. Needless to say, pro-Europeans will have to make every effort to ensure that both of the above-described dangers are avoided.

As it becomes clear that the euro is here to stay it is becoming equally clear that the future of monetary union is a federalist one, based on the need for closer economic, fiscal and political union to ensure its stability. As originally intended, therefore, the single currency is acting as the chief propellant of the European project, whose ultimate purpose is the establishment of a federal-type union of European states. In order to maintain popular support for closer union, however, federalists need to be very clear about what it should and should not involve in each of the three policy areas concerned.

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