
The political economy of monetary solidarity: revisiting the euro experiment

Waltraud Schelkle

1. Introduction: revisiting the euro experiment

We live through one of the greatest monetary experiments of all times. The member states of the European monetary union are much more diverse in terms of income, size and political-economic structure than those of any other contemporary monetary union. The members of the euro area joined voluntarily. In monetary matters, they let themselves now be ruled and monitored by a supranational bureaucracy that has neither a budget to incentivise them nor the means of force to coerce them. The euro is a money in which the issuing central bank is completely “divorced” from any tax-transfer state.¹

None of these complexities have made it into our thinking about European monetary integration, except as reasons for why the euro area had a crisis. Our thinking is still governed by the time-honoured theory of “optimum currency areas” that does not speak to central banking, monetary policy and the financial system.² This theory is all about labour and product market flexibility. It envisages regional fiscal transfers when member states have given up exchange rates, which are seen as a well-functioning and perfectly controllable instrument of adjustment.³ Diversity of member states does play a role, although primarily as an obstacle to irrevocably fixing exchange rates. A currency area is defined as a fixed exchange rate system rather than a monetary system.

The political economy of monetary solidarity tries to understand why a diverse union of formally sovereign nations could ever come about and how it could be maintained under the most extreme stress test. This is not a deductive but a theoretically guided empirical research programme. The idea of European monetary integration was first seriously pursued when the Bretton Woods system broke down in 1971 and a decade of high inflation, low growth and financial turmoil followed. After numerous attempts at managing exchange rates to achieve stability, policymakers decided to deal with the risks of exchange rate volatility by adopting a common hard currency. This would, they hoped, abolish exchange rates as a source of turmoil, and thereby achieve lower inflation and lower risk premia on inter-

est rates. This amounts to forming an insurance pool for certain macroeconomic shocks.⁴ An insurance rationale can also make sense of the diversity of membership: if members are subject to different risks, they can help each other when some of them fall on hard times while others do not. Risk sharing and diversification may not have been the original purpose of institutions that support the common currency; rather, they are a by-product of committing to low inflation. But under the stress test of a severe crisis, these hidden insurance properties of institutions can be revealed and activated. If the members then accept or at least tolerate these risk sharing properties of monetary institutions, I call that monetary solidarity.

The era of national currencies in Continental Europe came to an end in 1998. The exchange rates between the original 11 members were fixed in 1999 and the common currency physically introduced in 12 countries on 1 January 2002. Greece was admitted later because its inflation was too high for the Maastricht convergence criteria, but markets endorsed the move with strong appreciation of the drachma. Throughout the next two decades, more EU member states joined the common currency area, starting with Slovenia in 2007, followed by Cyprus and Malta in 2008. Slovakia and the Baltic states came in after the financial crisis had started. In particular the Baltic states made repeated and ultimately successful efforts to join regardless of the severe bond market crisis in the euro area. At the time of writing, in August 2018, the euro area has 19 members.

What is striking about this very short history of the euro area is the fact that the process was so relentless. With hindsight, we may wonder why such a motley assortment of countries wanted to take part in a monetary experiment, the outcome of which was inherently uncertain. And why did the queue for joining not disappear when the euro area entered an existential crisis in 2010? There was no automatism in this. The queue got only somewhat shorter: the Czech Republic, Hungary and Poland revised their plans to join any time soon. The next section tries to solve the puzzle why the euro looked like a good idea to 19 very different countries.

The good idea materialised in the sense of a stable, initially not very hard currency with low interest rates for all members. In that sense, the experiment had delivered what it promised. The effects on growth and investment were much harder to pin down and varied from country to country. But at half time of its existence, in September 2008, the euro area experienced first a banking crisis that spread throughout the world's rich North Atlantic hemisphere and then entered a sovereign debt crisis phase that seemed to be confined to a few euro area member states. To this very day, there is a debate on whether it was the fiscal and financial irresponsibility of member states like Greece and Ireland or a systemic problem of the euro area that caused the crisis. It almost led to the breakup of the young currency area in mid-2012.

The third section below argues that the crisis indeed revealed a systemic problem of the euro experiment. The limitations on risk sharing between member states that the architects of the euro area consciously introduced can generate negative feedback loops between the domestic banking system and national public finances. If one has this systemic interpretation, then one also needs to explain why these dangerous limitations were introduced in the first place and what helped to prevent the catastrophic scenario which could have ensued from this.

The euro area has undergone massive reforms, with emergency funds that dwarf the lending capacity of the International Monetary Fund and a banking union that makes the ECB the largest bank regulator and supervisor in the Basel Committee. These reforms have been extremely contentious. Emergency lending comes with heavy-handed and intrusive conditions of structural reform and fiscal retrenchment attached. The “beneficiaries” of this treatment complain about the severe hardship that one-sided adjustment imposes, not matched by equally heavy-handed treatment of the banks in creditor countries. The countries that guarantee the emergency lending in turn complain about the fiscal risks on their taxpayers and consider refusing to participate: the Slovakian government refused to take part in the first bailout programme for Greece. The banking union is less contentious but criticised by some for being too little too late while others see it as already going too far in regulation and the socialisation of risks. The fourth section evaluates the reforms in light of the earlier diagnosis of a fragile system. It has arguably become more robust but it remains crisis-prone – and we have to explain why the member states left it at that.

By way of conclusion, I discuss the apparent need to complete the monetary union with a fiscal union and consider the political down-side of monetary solidarity euro area-style. While I find that there is more risk-sharing than meets the eye, not meeting the eye of the general public and even government members is a considerable political problem. This reinforces the view that the maxim of monetary integration must be to maintain political unity in economic diversity rather than pushing for ever closer union.

2. Why the euro looked like a good idea

It is worth recalling that governments did not sleep-walk into adopting the euro under fair weather conditions but integrated against the odds of voter scepticism and market disbelief. This is the significance of the 1992/93 crisis of the European Exchange Rate Mechanism (ERM). The economic background was that the fall of the Iron Curtain and German unification in 1990 had given a boost to European economies which led to divergent inflation rates. In order to keep the fixed, but adjustable, exchange rate pari-

ties, central banks would have to increase interest rates. These were extremely high in Germany because the Bundesbank, true to form, was concerned about the inflationary potential of the unification process. Matching these interest rates would have killed off the post-unification boom that Europe enjoyed after the lacklustre growth of previous years. A fairly public dispute between central banks arose about the best way to proceed: should Germany accept more inflation or should others adjust with a realignment of exchange rates?

The turmoil in foreign exchange markets was triggered by political events. The Danish people rejected the Maastricht Treaty in June and the French barely adopted it in September 1992. Market investors interpreted this as voters being unwilling to put up with demand-restraining policies geared to maintaining the existing parities. Hence, they started to sell currencies of those countries that, in the event of a forced alignment, were likely to devalue most – and thus enforced the alignment. On “Black Wednesday”, 15 September 1992, the British Pound and the Italian lira were forced out of the ERM. In August 1993, the band of 2.25% around a central rate had to be widened to 15% because the French franc came again under severe pressure.

Economists debated the economic causes of the crisis between September 1992 and August 1993 intensely.⁵ Was this a self-fulfilling speculative attack by financial investors as Barry Eichengreen and Charles Wyplosz argued in a widely cited Brookings Paper on Economic Activity? After all, market signals were quite confused and proved later to be wrong on countries’ willingness to maintain demand-constraining policies. The Spanish peseta was under appreciation pressure in the ERM only days before it was massively sold. The speculation against the parity grid started when adjustment policies were well under way, not earlier. Later, Italy defied expectations in that the Banca d’Italia kept its high interest rates even after the currency had been forced out of the ERM. The French economy outperformed the German economy for several years in terms of lower inflation, a more balanced budget and current account surpluses (Germany ran deficits during those years).

Others like William Branson defended the Bundesbank position and argued that it was the fault of ERM members who refused to adjust to the shock of German unification with exchange rate alignment. He had the standard macroeconomic textbook on his side. The late Rüdiger Dornbusch blamed cumulative losses of competitiveness vis-à-vis Germany that created devaluation pressures and sudden overshooting exchange rates, which eventually lead to adjustment when wages and prices are not entirely flexible. These explanations were plausible for Italy and to a lesser extent the UK and Spain, but definitely not France. But what was not easily compatible with these real economy explanations was the fact that two

countries outside the ERM, notably Sweden and Finland, experienced even worse currency, fiscal and banking crises.

This debate matters greatly for how we diagnose the ERM crisis: if Branson and Dornbusch were right, the crisis since 2010 was a foreseeable outcome. The ERM crisis was then the last warning shot that, in the view of critics like Martin Feldstein, out-of-touch cosmopolitan elites chose to ignore in order to pursue a grand integration project directed against US hegemony. If Eichengreen and Wyplosz were right, the euro area crisis was part of a larger financial crisis to which the world economy with its oversized financial markets and liberalised capital flows have become quite prone to. The EU had started liberalising capital movements in 1990.

It is perfectly sensible to criticise the introduction of the euro for being such a leap into the unknown, given that leaping out is nearly impossible because it will be prohibitively costly. But can we explain the decision only by the cosmopolitan aspirations of out-of-touch elites or governments being captured by transnational business, which wanted to enlarge their markets? I think governments and citizens in very different European countries had plausible reasons for why they wanted to join the euro area for national and individual reasons. And they could endorse membership in good faith, ie not with the intention of offloading public debt onto others (an accusation against Italy and Greece) or locking others for ever into their overvalued real exchange rates so as to maintain current account surpluses in all eternity (an accusation against Germany, although interestingly never against the Netherlands or Belgium).

The first good and perfectly honourable reason for joining the euro area was that the ERM crisis could be seen as a warning shot about the lack of monetary sovereignty in a world of liberalised financial markets. Country-specific shocks had been transmitted via exchange rates. Germany, the country causing them, was hardly affected but became the safe haven of financial flows. This was the theory of optimum currency areas turned upside down. It demonstrated to most governments that they had to follow the Bundesbank's policy stance and were exposed to unpredictable financial shocks that were damaging the non-financial economy. So a currency regime that weakened Germany's monetary power and eliminated a major transmission mechanism of instability was not merely a French obsession but a perfectly legitimate national interest of most ERM members. It was exactly their being different from Germany that made them seek currency unification, while the Netherlands with its peg to the D-Mark was not a driving force. But even the Netherlands was wary of the turbulences that accompanied speculation about realignments in the ERM and, like Germany, warmed to the idea of generalised monetary stability.⁶

The second reason was that central bankers came to see the advantages of less volatile and lower interest rates. EU President Delors had put

them into the driving seat of monetary integration, not because they were cosmopolitan Euro enthusiasts but because they were economically literate sceptics with an institutional role in national policy-making to lose. During the inflationary 1970s, monetary stability had become a strong value of economic policy-making, because it also seemed to underpin growth. This new emphasis raised the status of central bankers. Delors knew that if they would not be brought on board, central bankers could derail the whole project. In fact, Margaret Thatcher firmly expected that central bankers would do the blocking for her and was furious when she discovered that the Bank of England governor had adopted the problem-solving attitude of a technocrat on the Delors Committee.⁷ Volatile interest rates can easily topple banks that have a mismatch between, for instance, fixed rate assets and adjustable rate liabilities. High interest rates politicise monetary policy because every move at high levels makes credit prohibitively expensive which deters prudent investors, while the effect on inflation becomes weaker as economic growth is less based on credit.

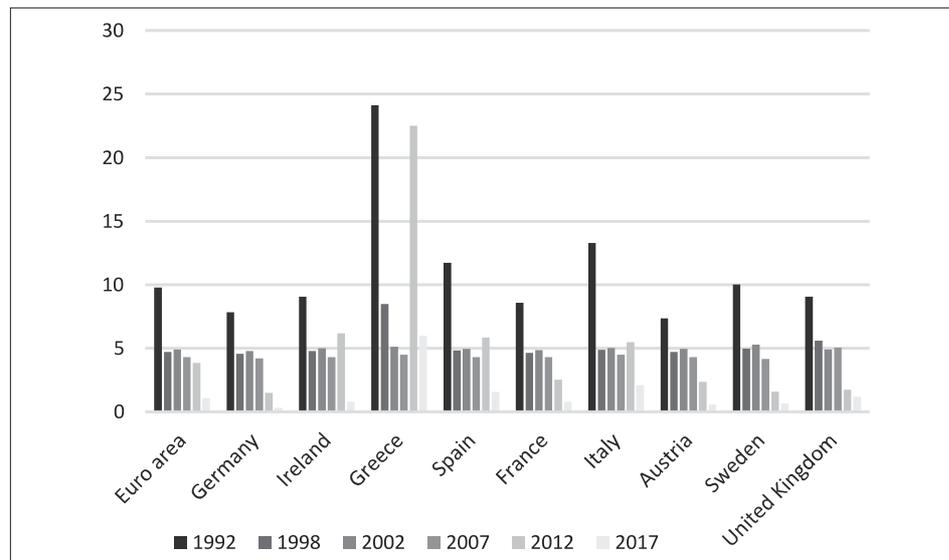
For related reasons, organised labour and non-financial employers in most prospective member states welcomed a currency regime that promised lower interest rates. This does not only lower the financial system's "tax" on investment, it also gives the market signal that investments can take more time to amortise. This is typically better for technological progress and the quality of investment projects than if firms are forced to liquidate their investments quickly. So even in countries with corporatist labour markets, important stakeholders would support the European integration process. With some modification, this reasoning applied to Germany since a common central bank promised to be less narrowly focused on German inflation.

Last but not least, Treasuries welcomed the prospect of gaining fiscal room for manoeuvre with lower interest costs on public debt and longer maturities of government bonds. In a talk at LSE, the Portuguese finance minister once said that the day after Portugal was officially declared to be among the first members of the euro area, the country could issue its first 15 year bond. The following graph shows one of these tangible benefits.

So there were good reasons for joining the euro area. But they were not the same for every member. They may even have changed for each country over the course of the decade when the euro was phased in, notably with the ideological leaning of the government of the day. For instance, the Maastricht Treaty with its liberalising thrust was drawn up under a majority of Conservative administrations in member states that wanted to redefine the role of the state. When the euro was finally introduced in 1999-2001, there was a majority of "new" Social-Democratic governments in power, and this saw the EU sign up to a Lisbon Agenda of creating a competitive

social Europe that was meant to complement the Economic and Monetary Union. A union of democracies must allow for such changes in priorities.

Figure 1: Long-term government bond yields, 1992-2017



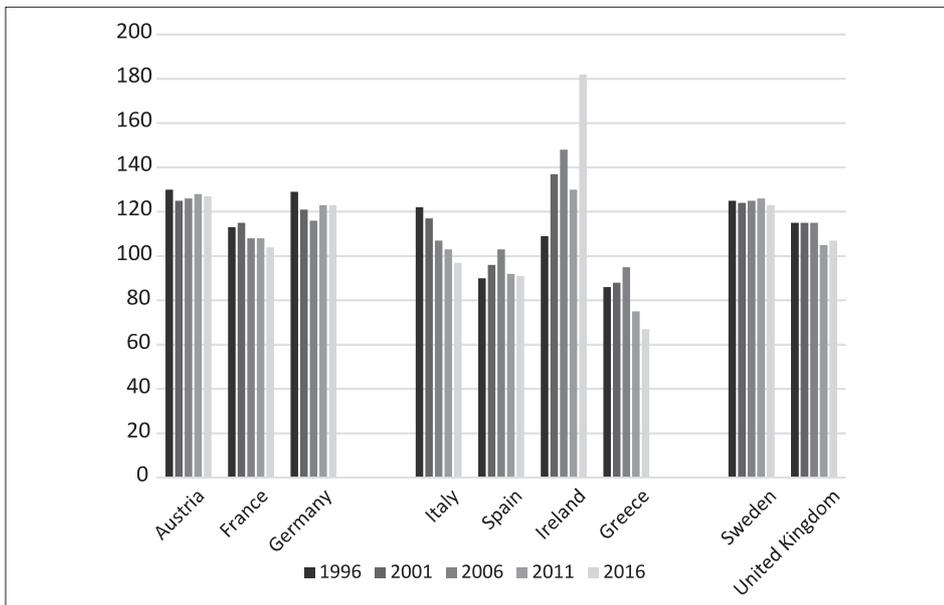
Source: Eurostat, EMU convergence criteria series.

3. Why the euro has disappointed in practice

The euro has disappointed in an important respect, namely financial stability, and this section tries to explain why. But this does not mean the euro area has done badly in all other respects that citizens care about. Contrary to what some critics claim, there was income convergence before the crisis: convergence from below for the poorer member states and from above for the richer ones (Fig. 2). There was not rising inequality across the board, especially not in the so-called periphery (Fig. 3). Both can be related to the introduction of the euro: downward interest rate convergence leaves, in principle, more of national income to wage earners. The stronger the fall in interest rates was, the more this effect may be discernible. Obviously, there were other influences on income inequality, like labour market reforms, the decline of trade union representation in expanding service sectors or sheer rent extraction by owners and managers in oligopolistic industries.

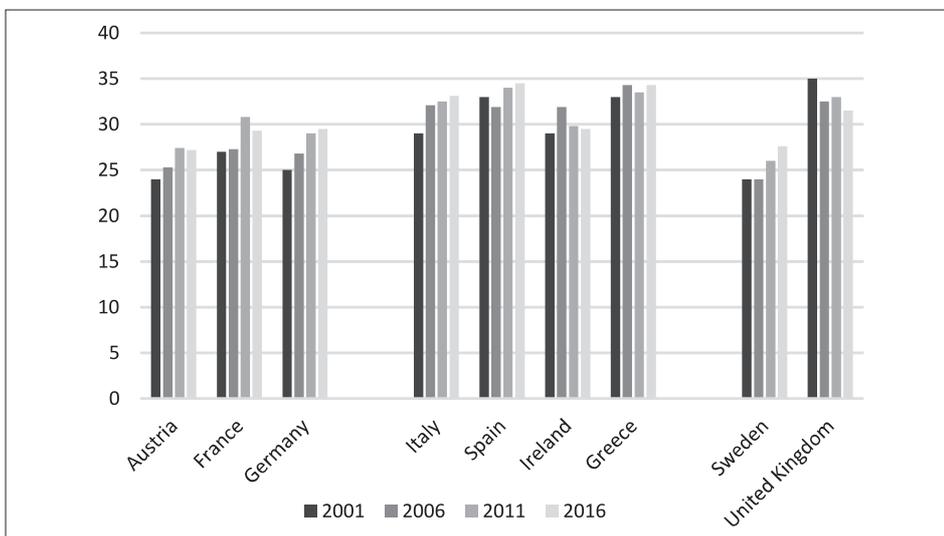
But what went wrong and led to a deep and long-lasting crisis? The answer to this question is twofold. First of all, diversity of membership is a mixed blessing in political-economic terms. On the one hand, members

Figure 2: Income convergence (EU-27 = 100), 1996-2016



Source: Eurostat, GDP per capita in Purchasing Power Parities.

Figure 3: Inequality of income after taxes and transfers



Source: Eurostat, Gini coefficient of equivalised disposable income, 0 = maximum equality, 100 = maximum inequality.

with different risk profiles reduce the overall risk of an insurance pool and can support each other in a variety of ways. On the other hand, members

that are very different may not trust each other and are therefore likely to agree only on minimal insurance.

Related to this, secondly, was the fact that the euro is a money without a state.⁸ Members did not want to create, right from the start, a United States of Europe with a federal budget; again, this seems a sensible decision, especially against the background of the history of the United States of America which was for a long time a (fiscal) state without a national money. Either way, this can easily lead to a particular form of financial instability. The question then arises what held the euro area together and provided insurance for those member states that were particularly affected by financial market panic?

3.1 Why diversity is a mixed blessing

The fact that the euro area started with a relatively large and heterogeneous membership and keeps on expanding is a noteworthy fact. From my perspective, this makes good economic sense but it is politically the more difficult integration path. Mutual insurance is more beneficial, the more diverse and larger the pool of risks. If diversity means negative correlation of risks, then the whole (aggregate risk) is *less* than the sum of its parts (risk of members). Also, if members hardly ever fall on hard times at the same time or in the same way, the lucky are better able to support the unlucky. But insurance also rests on trust as it increases interdependence: the bad luck of one member is shared by all. The lucky insurance providers therefore always have an incentive to question the merit of an insurance claim. The more different the unlucky members are, the more likely is this questioning. We have seen this in the crisis: Southern European countries were criticised for not having well-regulated labour markets even though labour markets had nothing to do with the financial crisis. Their welfare state were seen as too generous even though they tend to be low social spenders. They were accused of having uncompetitive industries even though this is certainly not true for Cyprus, Ireland and Spain.⁹

One can summarise this phenomenon in a political-economic paradox of diversity: the more diverse the membership of an insurance pool, the more beneficial it is economically but also the more difficult it is to realise its potential for risk sharing politically. The paradox can be solved by noting that the insurance properties of institutions, like a common currency, the common central bank or a cross-border payments system, may be a by-product of national incentives: reining in the dominance of the Bundesbank, getting cheaper credit for investors and the Treasury, preventing inflation-prone countries from devaluing abruptly etc. Explicit political agreement on the principle of insurance may not be needed, if risk-sharing institutions can be the by-product of national interests.

Risk can be shared in many ways, especially between states. For instance trade can be a macroeconomic stabiliser of business and employment: in a recession, domestic firms can tide their business over a period of low demand by selling (more profitably) abroad; in a boom, firms can get inputs more cheaply or quickly from abroad. Keeping borders for imports open is a kind of (regulatory) insurance that requires solidarity because most capitalist economies have some slack in labour markets in normal times, so imports are seen as rivalrous to domestic employment. Countries will maintain open borders if they trust that their neighbour will keep borders open when their firms need it. And this requires very little solidarity; it is not even perceived as insurance when the two trading countries have asynchronous business cycles, so that one tends to have a boom when the other is in recession and vice versa.

It is not clear whether a flexible exchange rate could help to make trade a better insurance mechanism, even if we could assume that exchange rates would reliably work to balance trade – a big if. A depreciating currency for the country in recession would reinforce the ability to sell abroad but hurt domestic income further while it would feed the boom of the booming economy through cheap imports. An appreciating currency for the country in recession would stabilise domestic incomes but hurt the competitiveness of firms while it would increase the bottlenecks in the booming economy and feed inflation. Stable exchange rates seem to be a good compromise between these conflicting supply and demand effects. Besides, exchange rates have proven to be determined by financial markets and not goods markets. This “discovery” in the modern theory of exchange rates made the father of the theory of optimum currency areas, Robert Mundell, revoke his support for the theory and advocate the introduction of an improved gold standard.¹⁰

Some useful economic research was done on inter-state and intra-state risk sharing before the euro area started.¹¹ It studied how much output volatility in a country could be smoothed through financial markets in contrast to fiscal transfers. Smoothing here means that the output shock, for instance bad weather or an oil price surge, does not translate fully into corresponding volatility of income and consumption of households. The economic reasoning can be illustrated with a stylised example.

Let us assume we have a federation that consists of three states that are economically specialised:¹² state A is specialised in agriculture, state M in manufacturing and state T in tourism. An exceptionally hot and dry summer leads to an output fall of 20 percent in agriculture, hardly any effect on manufacturing and a 5 percent rise in income from tourism. Trade can help state A in the sense that less supply of agricultural goods makes their prices rise; to what extent this compensates for the farmers’ fall in production depends on the extent to which imports can substitute for domestic ag-

ricultural products. And there are other risk sharing channels: in a monetary union, financial markets are integrated. This means that financial wealth, for households typically savings deposits, pension funds, and life insurance policies are invested across the federation. So their value does not fall in A and rise in T, it rises or falls for all, depending on how big A, M and T are relative to each other. This can smooth consumption in A for households with such wealth. If there is a fiscal federation, state A will pay less income tax and receive some transfers, while T pays more income tax and receives less transfers. . It is quite likely that not all volatility is absorbed and households in A experience a fall in income that will make them reduce consumption, for instance postpone the purchase of new cars from M and take shorter holidays in T. The opposite holds for residents in T, they will consume a bit more (although not as much more as if they had not shared the bad luck with A).

The first estimates of how much financial and fiscal risk sharing channels contribute to the smoothing of an output shock were done for states in the United States. It found that almost two thirds of an output shock that hits one state is absorbed by private capital and credit markets, less than 20 percent by the tax-transfer system, and at most 3 percent by labour migration. The rest is not smoothed, so the shock leads to changes in consumption. The conclusion for the euro area was that financial market integration would do the trick of risk sharing and a federal budget was not of the essence.

This research was useful in that it took the standard scenario of the optimum currency area approach to monetary integration, here: an output shock that had asymmetric effects on these states. But instead of concluding that therefore they need an exchange rate between them, the researchers asked how this risk of country-specific shocks can be diversified, which should be the obvious question that any economist asks. After all, the absurd consequence of the standard theory is that we need many more different currencies in the world: California and Texas are certainly not optimally combined in one currency area, especially since a Texan worker in the oil industry cannot easily become a techy in Silicon Valley, and vice versa. London would certainly need its own currency as it is economically quite different from the rest of the UK.

But a number of objections can be raised against the argument that financial market integration will absorb and smooth shocks.¹³ First of all, the focus on output shocks systematically underestimates the insurance function of welfare states, which tend to stabilise demand shocks, such as the income shocks that arise from cyclical unemployment that tend to depress consumer spending. The financial crisis since 2008 was a demand shock: falling house prices depressed household consumption and income and through that then affected firms' output negatively. Different risk-sharing

mechanisms were activated; for example bank bailouts protected savers and stabilised their wealth, while making fiscal deficits soar. Moreover, public risk sharing channels tend to be more progressive than private market-based risk-sharing. Welfare states stabilising lower incomes relatively more, while private market channels protect those with diversified wealth. Last but not least, it is somewhat misleading to analyse only the risk-absorbing capacity of financial markets when they have generated so much mayhem and volatility in recent decades.¹⁴

Financial market integration has been the Achilles heel of macroeconomic stability ever since the financial liberalisation of the 1980s. This is a bitter irony and a clear failure, given that the idea of European monetary integration was born as an anti-dote to financial turmoil, in the guise of exchange rate instability after the demise of the dollar standard of Bretton Woods.

3.2 Why money without a state is financially unstable

The euro area has a unique feature: it is a monetary union without a fiscal union. In economic terms, a fiscal union would mean, above all, a central budget at the EU level that can go into deficit and thus stabilise the euro area's economy in a recession. At present, the EU budget resembles that of an international organisation that has to be balanced annually and has no built-in stabilisers of the business cycle, such as an income tax or unemployment benefits. But we need to ask whether this standard role of modern public finances, a stabilising function for income and employment, is really what is missing in the euro area.

To recall what erupted in a financial crisis in 2007-8: the collapsing subprime markets in the US made banks stop lending to each other in the wholesale markets in which huge quantities of liquidity are traded. Banks stopped lending to each other because they suspected the other side had assets on their balance sheets which would default when called, especially those asset-backed securities where the asset backing was uncertain. This mistrust then acquired self-fulfilling properties and spread from the subprime to other markets. As banks were short of liquidity, they had to sell assets, which led to a fall in their prices; more assets had to be sold to raise needed liquidity. Even sound banks would therefore see the market value of their asset side shrink while their liabilities did not fall in the same way. It is at this point where a lender of last resort is needed: to stop the fire sale of assets undermining every financial institution in the system.

When the crisis first became apparent in European money markets, in summer 2007, more than a year before the crash of Lehman Brothers, the European Central Bank (ECB) acted with extraordinary liquidity measures. It fulfilled its role as a lender of last resort to a fairly integrated financial sys-

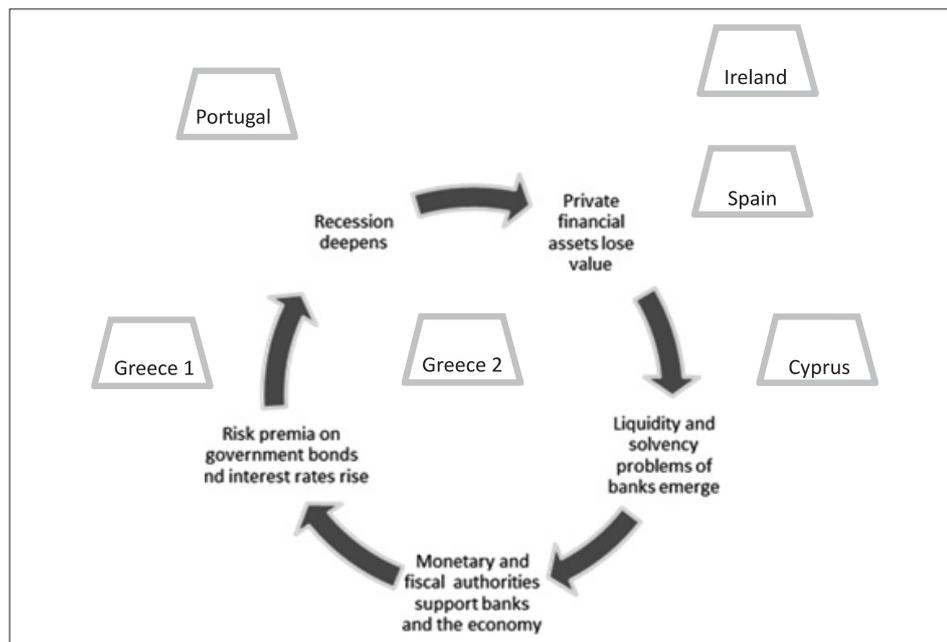
tem even though this role is not defined in the ECB's statute. The problem for all central banks soon became the fact that not all borrowing by banks was for liquidity reasons. They had indeed made bad investments and some of them were insolvent, meaning they had foreseeably more liabilities than assets even if normal times would resume. The UK Treasury had to nationalise the Royal Bank of Scotland and other parts of the British banking system because they were not illiquid but insolvent. The Bank of England refused to lend without restructuring in such cases and instead bought government bonds directly from the Treasury, so as to leave the markets in no doubt that the UK government would have the means to sustain this strain on public finances.

But there was no EU budget that could release the ECB from the role of lender-of-last-resort to insolvent banks. Nor could the ECB do what the Bank of England did for the Treasury, namely monetise public debt directly, which is explicitly prohibited in the ECB statute.¹⁵ In the beginning, member state governments intervened early on to bail out parts of the domestic banking system (which can include subsidiaries of foreign banks). Since the mid-1980s, banks' balance sheets have become huge relative to national economies, however. In the EU, this was certainly driven by the Single Market of relatively unencumbered capital flows. Ireland, which was once among the member states with the lowest public debt-to-GDP ratios, became one with a very high debt ratio almost overnight. The government decided in October 2008 to underwrite the balance sheets of six Irish banks in their entirety and was forced by EU non-discrimination rules to extend the guarantee to foreign subsidiaries. Public debt exploded almost everywhere. The German government had to do one of the biggest bailout programmes for its banks.

Then came the Greek and all subsequent crises which followed one pattern: a negative feedback loop between weak banks and precarious public finances. It can start with either: in Greece, the overindebted government became suddenly a concern for nervous investors in 2009. The trigger was one of those spectacles when Greek governments change: an incoming administration blames the previous administration for understating the dire state of public finances. It can then only get better under the new government. But this time, investors took fright. As Greek bonds were sold off, domestic banks holding them suffered losses. The banks had been one of the most solid parts of the Greek economy, but they became a cause for concern, calling for the government to bail out some of them. In Ireland and Spain, market panic started with banks that suffered from the bust of the housing markets. In Cyprus, the banks took a big hit from the write-down of Greek debt into which they had invested heavily, speculating on another bailout. And Portugal was a victim of the deep recession that burdened its banks with non-performing loans, while public finances struggled with col-

lapsing tax revenues. In all cases, governments holding bank assets (from bailouts) and domestic banks holding government bonds (increasingly so because foreign investors withdrew) set up a spiral of falling bank asset and bond prices with the result of both being shut out of market refinancing.

Figure 4: Crisis countries in the feedback loop between private and public finances



Source: Schelkle (2017).

These different entry points with a common pattern suggest that there is a systemic problem which goes beyond the weaknesses of single countries. This is not to deny that Greece had an unsustainable fiscal policy. The Council of heads of state could have allowed it to default, had there not been the anxiety that this would lead to a second Lehman moment; it was in particular the US administration that implored the European Council not to exercise its policy of no-bailout.¹⁶ Nor does this analysis deny that if the living standard of Portuguese citizens is to keep up with the EU average, firms will have to raise the productivity of employment and the government improve the national education system. Authorities in Cyprus, Ireland and Spain must decide whether they want the well-being of citizens to depend so much on the performance of an oversized banking system. But all these criticisms also mean that these are very different cases and there is not one "Southern European" malaise. Every country in the euro area

could have become the target of a bond market panic: if one had allowed Greece to fail, huge losses for Cypriot, French and German banks would have raised the spectre of major bank failures in each new bond market crisis. The contagion could have spread very quickly and would not necessarily be confined to the euro area; it could reach the UK because its banking system held large claims on Ireland and elsewhere.¹⁷

These diabolic loops are symptoms of missing institutions that can interrupt the feedback mechanisms. Many observers argue that the major missing institution is a federal budget. Hence, one might ask whether the currency was introduced prematurely, instead of waiting for a common budget to be adopted first. The appropriate sequencing of real and monetary integration was intensely discussed before the euro was introduced. It came closest to a debate about the optimality of the currency area to be created. The so-called coronation approach to monetary integration was highly critical and maintained that the prospective members should first converge in real economic terms. The usual suspects, the Bundesbank and German economists, saw the euro in those terms: a crown to be put on the head of an ever closer union once it had developed fully first. The misleadingly so-called monetarist approach claimed that the common currency would itself bring about real convergence, above all through more intense trade, and thus be itself a lever to ever closer union. Another contingent of usual suspects were in this camp, above all French politicians and the federalists of all nations.¹⁸

There was little discussion on whether a central euro area budget should be introduced at the same time as the common currency. But those in favour of coronation who promoted a more evolutionary approach in line with economic orthodoxy often referred to the United States as an example. The US had a national finance minister since 1789 (Alexander Hamilton was the first), and, thanks to several wars, a federal budget and national public debt management were introduced long before the US had a national currency (the Greenback in 1861) and a permanent central bank (the Federal Reserve in 1913). Two previous attempts at introducing a central bank failed as the states resented this concentration of power at the federal level.

The US provides actually very little supporting evidence for the coronation script. It is a counter-example. The United States was the financially most unstable country of the Western hemisphere from the 19th century until the Great Depression.¹⁹ Similar negative feedback loops between banks and state budgets occurred that we observed in the euro area crisis.²⁰ What ended the susceptibility to these diabolic loops was not a federal budget but a federal resolution authority and deposit guarantor invested in Treasury bonds, the Federal Deposit Insurance Corporation (FDIC). The no-bailout imperative has been observed since the 1840s,

when Northern states resisted a third bailout of indebted states in the South for their overinvestment in infrastructure. The national money that was eventually introduced was a currency imposed by the North in the midst of the civil war, without the consent of delegates from the South that had withdrawn from national representative bodies. Creating a state without a national money, as the US did, was a rocky road to ever closer union, financially and politically much more precarious than the EU trajectory.

3.3 How the euro area survived: an example

What stopped the diabolic loop, as the negative feedback loop in the previous crisis is often called, from spiralling out of control? Only a non-market actor with deep pockets can stop such a destructive process. Absent a joint European resolution capacity, this left only the ECB in the first instance. Its lending and bond-buying programmes had to become ever bigger, however, as governments became ever more reluctant to recapitalise their banking systems. The bond market crises did not exactly encourage them to get a grip. It has become common to lecture Europe about the need to be as bold as the US Treasury but most European governments did not enjoy the privilege of a safe haven status for their bonds. Europeans felt more like emerging markets at the mercy of uncontrollable and arbitrary forces, that punished the victims rather than the major culprit.

Moreover, bank bailouts were not popular with electorates who felt the crisis in terms of unemployment, cuts to public services and generally the struggle of making ends meet when real incomes stagnated or even declined. This is a perfectly understandable gut feeling. But bank bailouts also assured savers that they can get their savings back and it is almost a miracle how little savers lost in bank defaults. Unfortunately for policymakers, the bank runs that did not happen also barely registered as an achievement. This left the ECB in a precarious position: it could not withdraw its liquidity support since an unknown number of zombie banks depended on it and the economic recovery in the euro area was very uneven. Withdrawing the life support could have created mayhem, depending on how many and how big those in intensive care were. But the vast amount of liquidity the ECB created found its way in the next stock market bubble, as well as tiding over banks that should be closed or restructured. The ECB found creative ways of providing cheap liquidity to banks, in the hope that they could earn a margin and rebuild their balance sheets out of this profit. In this sense, the member states forced the ECB to a quasi-fiscal policy of recapitalising the banking system. But in contrast to a legislated programme, the central bank could not attach many strings to such a favourable deal, such as a cap on the remuneration of managers.²¹

Another institution of central banking was, in my view, the single most im-

portant insurance mechanism, compensating for the sudden stop of capital flows even when all else failed. This was the TARGET system for clearing among the euro area's banks.²² However, most residents did not notice it and those who did were spooked by a freakish German campaign about a TARGET "trap" that started with a legitimate question and ended with the most outlandish allegations of a conspiracy against German taxpayers.²³ The legitimate question was why TARGET suddenly showed large imbalances: the Bundesbank amassed claims against the TARGET system of hundreds of billions of euro while Spain and Italy were in deficit to the same degree. This triggered a public-spirited debate on the Internet to which some of the brightest minds, including a Federal Reserve banker, contributed to explain what was not exactly news: that interbank markets were frozen and TARGET imbalances acted as a substitute for failing markets. The US cross-district payments system showed similar imbalances.²⁴

TARGET is a platform for registered users with access to central bank reserves, typically wholesale and retail commercial banks, to make payments to each other. Such payments systems act like clearing houses, which is one of the historical origins of central banks: instead of each bank having to entertain an account with every other bank in order to process payments, they have an account with that clearing house. The ECB created a cross-border system for the Eurosystem to have a technically robust and uniform way of implementing its monetary policy. While banks are not required to use TARGET and could use private-commercial alternatives instead, TARGET became the preferred platform in private transactions. Non-euro banks, for instance from the UK, also participate in TARGET with their subsidiaries in the euro area.

To take one step back: we should all wonder why bank customers in the euro area, individuals as well as firms, never experienced an interruption of payment flows even though wholesale banking markets were frozen and banks refused to acquire claims on (lend to) each other. A banking crisis normally spreads into the real economy and via trade across borders because payments are no longer processed and people must take resort to foreign currency that their own central bank cannot generate. Avoiding such a situation by maintaining the payments system is ultimately the reason why a central bank acts as lender of last resort to particular firms in the economy, ie banks with a license and therefore an account at the central bank.

Let's assume, a wine merchant in Belgium wants to import Austrian wine. Obviously, the merchant wants to finance the import using her bank in Belgium and the vineyard owner wants to be paid into his account in Austria. Upon instruction from the customer, the Belgian import bank debits the account holding merchant and instructs the euro area's cross-border payments system TARGET to transfer deposits the bank holds with the Bel-

gian central bank (or to take an overdraft against collateral) and credit the account of the Austrian export bank at the Austrian central bank; the vineyard owner will then be paid. In normal times, the Austrian bank may now consider that it holds excess reserves with its central bank given the payment it received. Excess reserves carry a low interest rate and it may be able to lend it at a slightly higher interest rate in the interbank market. In the simplest case, the Belgian bank is in a matching position and tries to replenish its reserves or replace its borrowing from the central bank if borrowing is more expensive than what it has to pay in the interbank market. Thus, in normal times we would end up with a claim of banks against each other, contracted in the interbank market, while they had initially a claim and a credit from the Eurosystem that operates TARGET.

What we learned in the crisis is that this payments system distinguishes a monetary union from a fixed exchange rate system.²⁵ It eliminates the need for holding exchange reserves and thus prevents a disruption of payments even when the interbank market, which in a monetary union has absorbed the foreign exchange market, does not operate normally. This happened as early as 2007-8. Banks with excess reserves (Austrian in the example above) did not want to lend any more to banks with a liquidity deficit (Belgian in the example above). Such "disequilibria" in liquidity positions can have many reasons and are only loosely related to current account deficits and surpluses. In the crisis, all banks suddenly felt they had to hold more liquidity. By holding all and ever more liquidity reserves in the central bank, they offloaded the perceived credit risk in other banks to their central bank.

Once the banking crisis turned into a European sovereign debt crisis in early 2010, there were massive capital account transactions, including deposit flight out of Greece and Italy. Because interbank lending had ceased, the balances in the payments system were no longer reversed after the payment had been made; instead they were accumulated with central banks. TARGET then lent to banks in countries with liquidity deficits, and borrowed from countries with excess reserves. The consolidated central bank balance of the Eurosystem thus showed that it had become the interbank market maker of last resort:²⁶ This fulfills an insurance function comparable to unemployment benefits: just as the latter replaces earnings from paid work (the labour market), so did the TARGET balances replace the capital flows necessary to process payments.

The consolidated balance sheet of TARGET, or specifically the Eurosystem, thus got larger. To take our example, the central bank of Austria accumulated claims and the central bank of Belgium accumulated liabilities vis-à-vis TARGET. The banks resident in Belgium, unable to obtain interbank credit, can in turn replenish their reserves thanks to the extraordinary monetary interventions that the imminent financial collapse forced

the ECB to undertake. These were interventions like the fixed rate full allotment policy which allowed banks to borrow as much as they wished at an interest rate determined by the ECB. The only limit imposed on Belgian banks would be the availability of eligible collateral (securities to be pledged with a discount or “haircut”), a constraint that in the ECB applied uniformly to banks in the euro area irrespective of the country they were located in and for which standards were progressively lowered during the crisis.

This collateral policy of the ECB was another example of the risk pooling that a common central bank can and did perform.²⁷ It benefitted those member states which were suddenly seen as risky by market investors, for more or less valid reasons that could become self-fulfilling. In that sense, risk sharing is also risk prevention, a simple point that Wolfgang Schäuble and his main advisor, Ludger Schuknecht, failed or refused to grasp.

TARGET is a good example of monetary solidarity. When a crisis hits, it makes sense for all parties involved to compensate those most affected by it. Despite the “accident” in the financial system, trade can still proceed, benefitting importing and exporting firms alike. Even capital and deposit flight can take place, in fact more easily, by those frightened to lose their assets in a bank default, without leaving the currency area itself; they can therefore also quickly return as soon as interbank markets start to function again. These are tangible insurance services to the real economy and the banking system that replaced markets when they failed systemically. TARGET could act as a form of social insurance because all banks in the euro area had chosen to be its members.

TARGET was not created to play this role. Most likely, this is why it was not obstructed by the political-economic paradox of diversity. The campaign in Germany against this arcane institution is evidence that political obstruction would have been an issue. The campaign’s cheerleader, Hans-Werner Sinn, wrote a book with the title “The Target trap”; the euro-sceptic party Alternative für Deutschland included his proposal for a cap on TARGET balances in its manifesto for the European Parliament elections, and a Bavarian tax payer association tried to bring a criminal case against the Bundesbank for running up TARGET balances, although the case was not admitted by the court. Stopping TARGET from working the way it does would have meant reversing the monetary union. There was a precedent for this in the United States during the Great Depression, and it made the Depression worse.²⁸ What the anti-TARGET campaign did, however, achieve was to trigger a concerted effort at rational explanation. This provided insight into its insurance properties and explicitly rejected any limitations of the insurance provided: it turned risk sharing by default into monetary solidarity that is acknowledged and appreciated, except by die-hard euro sceptics, of course.

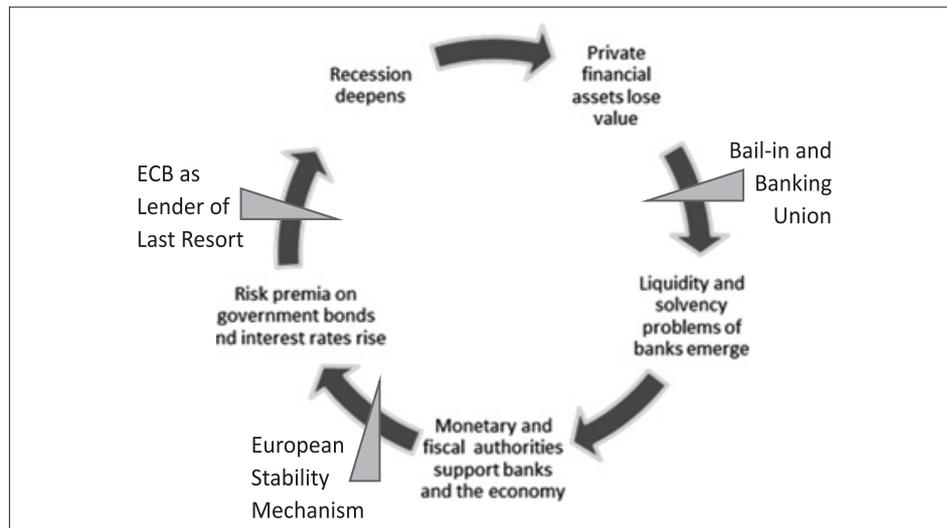
4. Why the euro experiment is not doomed

TARGET was obviously not the only institution that kept the euro area afloat. Extraordinary monetary policy interventions were another crucial factor. How crucial can be inferred from the fact that EU member states outside the euro area, like Latvia and Hungary, had to seek assistance from the IMF and the EU Commission almost immediately after Lehman's collapse in September 2008, despite better macroeconomic indicators than Greece.²⁹ Markets did not see those countries as part of the risk pool and took fright. Swap arrangements among major central banks as well as the Vienna initiative prevented major currency crises from developing: the threat was real enough, however, given the high foreign exchange debt that households and firms in many Central and Eastern European countries had. If their currencies had devalued abruptly, this debt would have increased in value and sent households and banks, many of them foreign subsidiaries, into insolvency. The effects could easily have spread to countries like Austria and Sweden with their high credit exposure to these economies.

The EU and the euro area have gone through a phase of frantic institution building since 2009. While the immediate response to the crisis was ostentatious tightening of fiscal rules, with a supposedly muscular "Six Pack" and a Fiscal Compact, the new rules have yet to be enforced. There are good reasons for not enforcing pro-cyclical rules when the economic recovery is so fragile. The rules tightening was very conspicuous and arguably more for domestic consumption in countries like Germany, the Netherlands and Finland with euro-sceptic popular movements. They have to be assured that moral hazard is kept under control, ie that there is no excessive risk-taking now that we know that the no-bailout rule cannot be exercised when a systemic financial crisis erupts. But there were also two important innovations. First the permanent emergency funds amounted to fiscal capacity building, in contrast to the relentless emphasis on fiscal constraining; and second, the EU worked on tighter financial regulation that led eventually to a banking union for the euro area.

4.1 How a fragile system was reformed

The following graph gives an overview of how various innovations helped to interrupt the negative feedback loop between weak banks and weak government balance sheets. But I will concentrate on the European Stability Mechanism (ESM) and the European Banking Union (EBU) only. My focus is on how the political-economic paradox has been overcome in creating these institutions of monetary solidarity and in what sense they actually constitute monetary solidarity.

Figure 5: Reforms and feedback loop

The European Stability Mechanism replaced a first temporary fund in late 2012. It includes the European Financial Stabilisation Mechanism, by which the Commission can borrow, for the first time, up to € 60 billion against the security of the EU budget. This gives the ESM a capacity to raise up to € 500 billion in capital markets through bond issues that are then guaranteed by the member states, according to a key that is determined by their paid-up capital in the ECB. In this and other respects, the ESM has been very much designed taking the IMF as a role model. The term “creditor countries” is therefore rather misleading: the proper name should be “guarantor countries”. Countries that are themselves in a troika programme are exempted from acting as guarantors for another country. Non-euro members of the EU can also be supported as long as they have signed the Fiscal Compact.

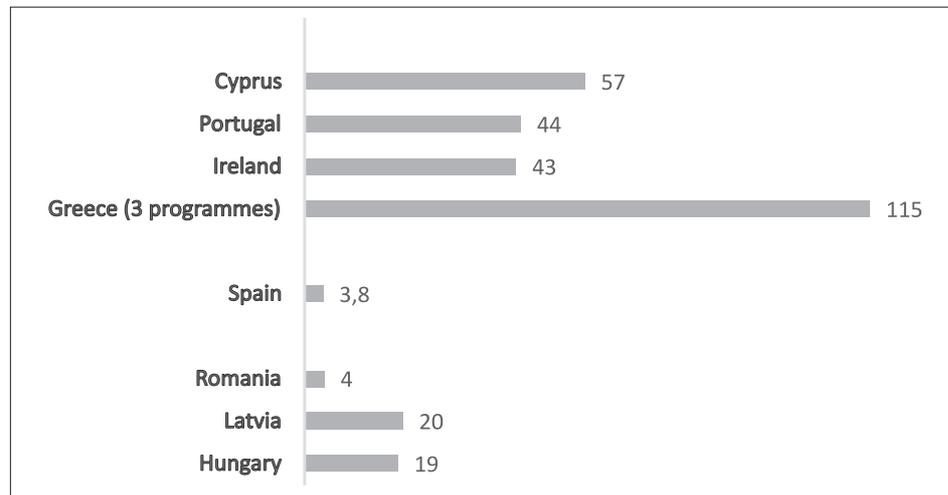
How were the political difficulties of a diverse union to agree to fiscal risk sharing overcome in this case? The lending capacity of the ESM is almost five times the maximum the IMF has lent in any one year (2012). There was massive political resistance to the ESM's creation. The first attempt to create an emergency fund, in May 2010, was forced upon governments by the ECB. Then ECB President Trichet made such a fund a precondition for the first bond-buying programme. This first facility was an obscure legal construct and was meant to last for three years only. The austerity-minded, liberal Slovakian government at the time refused to take part in the first Greek bailout programme. It had just introduced budgetary cuts in parliament and it argued that the case for cuts would be undermined if Slovakia had at the same time to commit funds for a country with a higher per capita

income and a track record of violating rules of membership. We can assume that most governments could see the point but there was also a real anxiety about spreading market panic and small countries freeriding, knowing that their (non-)participation would not make or break a deal. A large cushion of callable capital (€ 80 billion) dealt with that problem in the ESM design: Slovakia had to pay in its share and to that extent guarantee and bear losses in the future, if the capital is ever called. In this sense, the ESM is a mandatory mutual insurance fund.

The official language gives us a clue to why the political obstacles were overcome, apparent in the Slovakian response but also a series of constitutional court cases in Germany. The Commission often refers to the ESM now as a “fire wall”, suggesting that it is built for those not – yet – affected, the guarantor countries, among them those threatened by contagion, rather than as an insurance fund for those shunned by markets. The term “fire wall” is of course also a rhetorical concession to those obsessed with risk prevention as the opposite of risk sharing. The risk sharing is indeed limited because the ESM still does not foresee joint liability, only each according to its share in the ECB capital determined by a member’s size in economic and demographic terms. There is some solidarity involved in the sense that governments guarantee and pay according to ability, not for instance according to some risk criteria or experience rating (whereby previous programme countries would have to guarantee and pay more).

The conditions under which a country can obtain the guarantees also provides evidence of resistance to the creation of this fiscal capacity. The conditions attached to assistance are extremely intrusive and require adjustment that goes way beyond what a typical IMF programme demands. The fiscal turnaround that Greece had to achieve was staggering and it is not surprising that it turned the economy into downward tailspin. Yet two of the ESM programme countries, Ireland and Spain, imposed most of the conditions on themselves, anticipating what market investors supposedly want to see. Moreover, the sums involved in the troika programmes are correspondingly staggering, far beyond the average for IMF programmes, as a Bruegel study has calculated.³⁰ Between 1993 and 2012, an average IMF programme amounted to about 3.5% of a programme country’s GDP. In the EU, only Romania’s IMF-EU programme and the bank restructuring programme of Spain financed by the ESM had about this size. Even for Latin American countries, the average of IMF programmes was 5.5% of GDP. Figure 6 shows the loan sizes for the European programmes.³¹

It is bitter for citizens, in these countries and in the rest of the euro area sympathising with their unfortunate fellow Europeans, that most of these staggering funds go towards servicing debt. Only a fraction pays for unemployment, health care and education in these countries. The burden of adjustment is distributed one-sidedly on the programme countries, both in

Figure 6: Programme size (as % of national GDP)

Source: Eurostat and IMF country reports, own calculations (only disbursed sums included).

contrast to guarantor countries and to banks in the euro area. It is more like a means-tested programme of residual welfare with harsh and stigmatising conditions on the poor than modern social insurance that leaves the beneficiaries their dignity. This high share of debt servicing costs is the perverse outcome of previous successful risk pooling through the euro: the absence of exchange rate risks allowed households, banks and governments to take high financial risks, and the need for adjustment is correspondingly large. And it is so one-sidedly distributed because the other member states would have to bear some of the costs, notably in the guise of higher interest rates in the euro area. I come back to this in the next section.

The banking union contains an element that has tried to address this: bail-in rules. Bail-in is meant to ensure that bank shareholders are part of the insurance pool and bear a good share of the losses. The legislation, applicable to the whole Single Market and in force since January 2016, foresees “a contribution to loss absorption and recapitalisation equal to an amount not less than 8% of the total liabilities including own funds of the institution under resolution” (Art. 44 (5) BRRD). Article 44 defines a clear hierarchy of liabilities, which can be written down or converted into shares (the conversion rate of debt into shares does not have to be 1:1 and can involve a write-down). The bail-in basis includes every liability, from junior to senior debt, unless it is specifically excluded; the most important exclusion is savings deposits below the € 100,000 threshold.

However, the wisdom of applying these rules automatically and uniformly can be questioned. On the one hand, they admit that banks will be

bailed out and so moral hazard is a legitimate concern; shareholders who may suffer losses should be more effective monitors than savers. On the other hand, they may hit shareholders that sensible legislation would like to spare. Pension funds and insurers are important investors in long-term assets: bonds of and shares in banks are such assets. This is one of the mechanisms by which a banking crisis can spread to non-bank financial institutions. Their losses may affect the pensions they can pay out or promise to future customers. Even worse, banks' bonds and shares may also be held by pensioners directly: the latter was the case in the notorious example of four regional banks which failed in Italy in 2015. What made the headlines was the suicide of an Italian pensioner.³² Like many Italians, he held his lifetime savings in the form of shares, i. e. subordinated debt of his bank. These shares were wiped out in the insolvency of Banca Etruria; his suicide note indicated that the loss of his pension savings was the reason for his fateful decision. While EU rules had not yet been in force at the time and Italian banks could be accused of having sold these instruments in bad faith, this sad case indicated the difficulties of creating rules for fair and efficient risk sharing in a diverse union.

The banking union created the world's largest bank supervisor, measured in terms of bank assets of jurisdictions with free capital movement. This can be seen as preparing the ground for a euro area-wide risk pool of banking. Those who opposed it, like the German Treasury, understood this but suspected that other parties would take advantage of the insurance and offload "legacy" problems, ie pre-existing private debt. But even they could see, at the height of the crisis in mid-2012, that an implosion of the financial system would also hurt their economies. And so the banking union was created with the ECB as the single supervisor. Mario Draghi in return gave his "do whatever it takes"-speech. The unique ability of a central bank to create liquidity and pay attention to the macro-dimension of a bank crisis made governments in other jurisdictions, like the US and the UK, also give their monetary authorities responsibilities of financial supervision. But the shift in the euro area was quite "radical".³³

Timid resolution facilities have been created: a Single Resolution Mechanism, eventually paid for by the industry, will amount to € 60 billion when it is fully up and running. This may not be enough to bail out even a single big bank such as the Royal Bank of Scotland. Hence, fiscal backing will be needed in the case of a bigger calamity and this gives national authorities a considerable voice in the decision-making process. There is great uncertainty on how this will work in practice when quick decisions have to be made. A Direct Resolution Mechanism had been created earlier inside the ESM, to the tune of € 55 billion. Spanish authorities argued that it is counter-productive to have a government restructure its banking system with a loan that adds to its debt and may therefore make it a target of a bond mar-

ket attack. The principle that there should be a loan facility that does not contribute to the feedback loop was acknowledged. But then, the mechanism was designed “so as not to be used” as I have heard a senior ECB official say.

The creation of a European Deposit Insurance Scheme got under way because it was agreed as part of the banking union package, but Germany with finance minister Schäuble reneged. Euro area-wide deposit insurance could slow down the deposit flight that is facilitated by TARGET. But it has to be said that in the recent crisis, it would have made little difference: banks did not lend, not because they had no way of refinancing credit, but because they were sceptical about the prospect of repayment. Runs on banks in retail markets were the exception, not the rule.

4.2 What remains to be done

A group of 14 French and German economists has drawn up a coherent package of reforms that can be seen as essential.³⁴ The hope was that there will be a window of opportunity for two newly elected governments led by Emmanuel Macron and Angela Merkel to do a grand reform project. From my perspective, this was always a faint prospect even if the German Grand Coalition had got a stronger political mandate and the new French President had not been preoccupied with a domestic reform agenda. The political climate for such overt integrationist steps is not there, as polities are, for valid reasons, deeply divided over the merit of such moves and the political authority of heads of government is too exhausted to carry the day.

The biggest questions of them all is whether a monetary union can survive without a fiscal union. There are eminent economists like Paul De Grauwe and Paul Krugman but also political scientists like Simon Hix who argue that this is not possible. A fiscal union means to them a budget that can stabilise the macroeconomy, bail out member states if necessary and possibly do all the redistribution that is needed between poor and rich regions to make them feel part of one polity. Others, like Martin Sandbu and the 14 economists disagree and look for minimalist solutions that make the euro area much less crisis prone, short of a fiscal union. The political economy of monetary solidarity is closer to the latter group and complements their research on policy inventions by looking for the latent unity-preserving functions of existing institutions.

A federal budget is not necessarily the best way to achieve risk sharing in a monetary union of democratically governed member states that are very diverse. A central budget for such a union needs democratic representation, given that member states' spending depends more or less extensively on this budget and revenue sources are shared or assigned to par-

ticular levels of government. One would need a euro area parliament with the right to sign off the budget, representing the euro area taxpayer. The present European Parliament could not legitimately do this, as citizens of bigger member states are underrepresented relative to small ones. The MEPs from the smallest member state represent less than 70,000 citizens each while the MEPs from the largest represent more than 700,000 citizens.³⁵ This is to compensate for the fact that French, German, Italian and Spanish MEPs have a great mass of parliamentarians that represent national interests on every committee and in every party family. The political-economic paradox of diversity is a hard constraint for the feasibility of a fiscal union and the corresponding democratic legitimation.

So priorities have to be determined and creative compromises sought. One priority is dealing with the precarious fiscal situation in many countries. For instance, it would take Italy a primary budget surplus (without interest payments) of over 4% of GDP to get its debt stock down to the 60% ratio of the EU fiscal rules within 25 years, even if one could somehow guarantee an average interest rate of 3.5%. This calculation was done by the German Sachverständigenrat in 2013, and the debt situation has deteriorated since then.³⁶ It is inconceivable that the Italian democracy can sustain such a hardline fiscal policy over a quarter of a century. If debt cannot be reduced in an orderly way, however, then the Italian government will have to lean more and more on domestic banks to buy their bonds because foreign bond holders will not do so, or only at rates that would bring the day of reckoning (insolvency) nearer. And as long as the debt situation is so precarious, other sovereigns and the taxpayers they represent do not want to incur common liability with any Italian government, even with trustworthy political leaders; the Italian debt situation is beyond anybody's control.

Constructive proposals therefore concern a) ways to write down sovereign debt; b) some form of joint fiscal liability if a bank rescue is required big enough to touch the interest of other member states; and c) a way to prevent renationalisation of government debt holdings by banks. This would go a long way to making the euro area more robust against the threat of a systemic crisis. The threat has at its core an oversized financial system combined with dangerously limited risk sharing between interdependent economies.

A bankruptcy law for sovereign debtors has been a long-standing demand, first expressed by progressive critics of the IMF in the 1980s and then by the IMF itself but opposed by a Republican majority in Congress in the early 2000s. It has been recently revived by a group of authors convened by the Bruegel think tank.³⁷ The basic idea is not to allow private creditors to hold out and prevent a debt restructuring that any large firm in a similar situation would get, shrinking the economy in the process. The

threat of insolvency would impose much needed discipline on financial markets. Highly indebted governments would pay a higher risk premium, especially at the introduction, which is why the greatest potential beneficiaries tend not to be very supportive of it.³⁸ But a bankruptcy law for sovereigns is an international public good long overdue. It would give policymakers one more instrument to break the diabolic loop when market investors turn the table on governments that have just bailed them out. And since the evident risk sharing is between a debtor country and private bond investors, political resistance may be overcome, even though the risk premia on interest rates mean that all euro area members will have to exercise some solidarity with each other. Insolvency provisions would have to be introduced for the euro area or, even preferably the EU, as this would comprise such a large debt market that investors could not simply shun European government bonds.

Joint fiscal liability is another construction site for the union, given that bank bailouts can easily overstretch national fiscal capacities. A group of financial economists has come up with a privately provided, synthetic euro bond, European Safety Bonds or ESBies.³⁹ Financial institutions would take a well diversified portfolio of euro area government bonds as backing for the issue of a senior tranche ("ESBies") and a junior tranche ("EJBies"). The latter would take losses in the case of a debt write-down. Banks would be allowed to hold only the senior tranche which will be readily accepted by the ECB as security in refinancing operations. This would amount to a guarantee of a floor for the price of these ESBies and so make them indeed safe. Even so, it is somewhat counter-intuitive that one can break the diabolic loop through the same financial engineering techniques, securitisation and tranching, which got the OECD world into a financial crisis in 2007/08. A number of questions are still discussed, in particular whether ESBies are really possible as a purely private investor initiative. Who would want to hold the junior tranche, and at what price, given that banks are no longer meant to hold them? This question drives home the point that without some sovereign debt restructuring, the volumes involved may easily overstretch the willingness of investors other than banks to hold so much government debt. ESBies are still a path-breaking idea in presenting an alternative to a federal budget. This would certainly lower the threshold for political agreement.

Finally, if one needs to make sure that the outstanding government bonds are held at reasonable prices, it is all the more important to require banks to diversify their sovereign bond holdings. This is the dilemma that the first demands for reform to the Basel rules did not address. So far, the Basel rules give government bonds of a certain credit rating zero risk weighting, ie banks do not have to hold capital against them. If positive risk weighting was introduced, banks will shed government bonds in droves,

weakening other large bondholders, pension funds and insurers through falling bond prices. An intriguing idea to promote diversified holdings has been put forward by Nicolas Véron: “sovereign concentration charges” would require banks to hold capital against bond holdings from any one government if they exceed a certain share (eg one third) of their tier-1 (loss-absorbing) capital.⁴⁰ The charge would apply irrespective of whether the bonds have been issued by their own or, say, the German government. This risk weighting method would not discourage bond holdings by banks as such, but it would give incentives to hold them in relatively safe proportions. Such a regulatory measure would decisively contribute to private pooling of fiscal risks.

5. Instead of conclusions: unity in diversity as the norm

The euro is a supranational money without a state. And this is key for those who believe that the euro area crisis was not a problem of a few misbehaving countries. Their labelling as PIIGS, periphery, Southern Europe (which includes Ireland) insinuates uniformity where no such uniformity is to be found: Greece shared with Spain high growth and a high current account deficit but not a housing boom and a positive fiscal balance; Portugal was the one country that did not enjoy a post-accession boom and was tipped over the edge by the deep recession; Cyprus was, like Ireland, a high-income country with an overheating economy, fuelled by problematic practices of tax competition. As different as their vulnerabilities were, their crises all showed a similar pattern: a diabolic loop which they entered from different starting points. This means that the national crises had a systemic component and were not all the fault of past and present governments. If one had required banks to take the losses from their reckless lending, Austrian, French and German bond markets could have panicked as well.

Some observers who share this diagnosis think the euro area is doomed if it does not turn itself into a fiscal federation. A budget at the euro area level requires democratic representation, and it is not clear how a development can be set in motion towards such a democratic united states of Europe. Why should voters endorse steps towards ever closer union when the benefits are so uncertain? In the history of nation states, such questions were usually settled by force: state-building benefitted those who won the war. But the EU is an authority without an army, created to promote peace and cooperation through economic integration. It must convince, not coerce.

It is impossible to claim that a federal budget would do away with financial instability. It is quite likely that it would help to eliminate the symptom of negative feedback loops. But the US still has severe financial crises, in

banking and in stock markets, that affect some US states and municipalities more severely than others. Complete risk sharing is a nirvana. Moreover, additional risk sharing increases risk taking, which is sometimes desirable. But it is not desirable with oversized financial systems, which have to change a lot if they are to make a constructive, as opposed to extractive, economic contribution.

Reforms that avoid the need for grand state-building are therefore not only the more realistic alternative, they are actually the more desirable alternative. Incremental reform, under the threat of latent and actual crisis, will remain the order of the day and this is the fault of no country or person. It is the *modus operandi* of legitimate decision making in a diverse union of democracies: political majorities and their representatives in different member states disagree on such consequential, hard to revise decisions. "Unity in diversity" is a more worthwhile goal for the time being than "ever closer union".

Some of these reforms will have to be innovative, for instance ESBies, because they try to emulate state functions, notably pooling of fiscal liabilities. Others are creative, such as the sovereign concentration surcharge, in that they use known regulatory techniques, such as risk-weighting of assets, and make them compatible with the imperative that a lot of sovereign bonds still have to be voluntarily held by financial institutions. These reforms are in the footsteps of already implemented reforms, like the European Stability Mechanism and bail-in rules for bank resolution: both mechanisms to address sovereign emergencies. All of these reforms must have as their goal that they reallocate risks to those who benefit from taking them in good times and should therefore also absorb the losses in bad times.

Fortunately, we can also rely on existing institutions and their latent capacities to bear, diversify and absorb risks. This is fortunate, because all innovative and creative reforms have two problems. First, they are untested and may therefore not work as intended (eg bail-in rules); and, second, they may be resisted and perverted because they require trust in the other contracting parties not to exploit the collective good (eg deposit guarantee scheme). Tried and tested institutions tend to surprise less and have already overcome the resistance against their creation.

In my research on the political economy of monetary solidarity, I have found that institutions under stress can provide the collective good of risk sharing even though this was not the purpose when they were created. But it requires research to find this in a common currency, in a cross-border payments system, in esoteric features of monetary policy like the collateral that the central bank accepts in its refinancing operations, and even in the specifics of trade policy and migration rights in an economic and monetary union.

There is more risk sharing and solidarity in monetary integration than meets the eye. This must also be brought to the attention of an understandably disappointed and disillusioned European public. Political support for the common currency erodes slowly but surely if only the downside risks come to the public's attention but not the tangible benefits for consumers and investors, tourists and pensioners. Member state governments are always told off for their broken commitments but never publicly acknowledged for the mutual insurance they provide to each other. Greek and Italian governments have relied on the ECB and other safeguards in the euro area crisis but they also contributed more than their fair share in the international refugee crisis and rightly expect that this is part of the overall assessment. Ultimately, politics and economics must come together to make a currency union of diverse member states. This will always be a contentious process but it does not have to be divisive.

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Notes

- 1 Goodhart (1998) 410.
- 2 Mundell (1961), Kenen (1969).
- 3 Krugman (2013) 440.
- 4 Schelkle (2005, 2017) 125-135.

- ⁵ Eichengreen et al (1993).
- ⁶ Maes and Verdun (2005) 339.
- ⁷ James (2012).
- ⁸ Goodhart (1998), James (2012) 390.
- ⁹ Jones (2016).
- ¹⁰ Mundell (1973).
- ¹¹ Asdrubali et al (1996); most recently Alcidi et al (2017).
- ¹² This research developed as part of the optimum currency area approach, which assumed that countries are the unit of economic specialisation, an assumption that Kenen (1969) strongly criticised as implausible for even moderately large economies.
- ¹³ Christev and Mélitz (2011) 29; Dullien (2014) 59-60.
- ¹⁴ Babecky et al (2012).
- ¹⁵ De Grauwe (2011).
- ¹⁶ Barber (2010).
- ¹⁷ BIS (2010) 18.
- ¹⁸ The so-called monetarists, who were in fact primarily of a Keynesian disposition, were to some extent supported by Kenen (1969) 45-48, who hypothesised that the reach of a common currency should be wider than the fiscally constituent parts. This is, after all, what characterises any federal state.
- ¹⁹ Broz (1997) 5.
- ²⁰ Schelkle (2017) 95-108.
- ²¹ Schelkle (2012).
- ²² TARGET stands for Trans-European Automated Real-time Gross settlement Express Transfer.
- ²³ Sinn and Wollmershäuser (2012).
- ²⁴ Schelkle (2017) 280-282.
- ²⁵ Bindseil and König (2011) 4.
- ²⁶ Buiter (2007).
- ²⁷ Buiter and Siebert (2005) challenged this practice while Schelkle (2017), 145-148, defends it.
- ²⁸ Eichengreen et al (2014) 14-16.
- ²⁹ Mabbett and Schelkle (2015).
- ³⁰ Pisani-Ferry et al (2013) 29.
- ³¹ Own calculations based on Eurostat data for national GDP and European Commission data for program volumes.
- ³² BBC (2015).
- ³³ Gelpern and Véron (2018).
- ³⁴ Bénassy-Quéré et al (2018).
- ³⁵ Tailor and Véron 2014.
- ³⁶ SVR (2012) 20-21.
- ³⁷ Gianviti et al (2010).
- ³⁸ The case would have to be made that sovereigns must acknowledge the distortion that they could raise debt too easily over recent decades. This helped them avoiding the hard choices on what should be financed with a democratic mandate and what not, passing a good part of the bill onto younger generations instead. Debt is a regressive form of financing public expenditure because income taxes are progressive while bonds are held by wealthier sections of society, directly or indirectly (the latter through pension and investment funds).
- ³⁹ Brunnermeier et al. (2016); van Riet (2017).
- ⁴⁰ Bénassy-Quéré et al (2018).

Abstract

The euro is a unique experiment in monetary history: a group of rather different countries adopted voluntarily a common currency, and the supranational central bank is deliberately separated from national fiscal institutions. Every member state had good reasons to take the risk of joining this experiment of a monetary pool of diverse countries. However, the experiment has so far been rather disappointing. A political-economic paradox can explain why the member states could agree only on a dangerously limited form of fiscal risk sharing. These limitations materialised in the recent financial and euro area crisis, in which the rescue of insolvent banks remained a task for each member state even though financial market integration had contributed to making domestic banking systems too big for most of them. But the elements of insurance that have been institutionalised in the monetary union also came to the fore in the crisis: notably the cross-border payments system TARGET sustained the euro area as a trade and payments area. The banking union has made risk sharing in the common currency area more robust. But the risk of fiscal overstretch is still real and calls for further reforms.

Zusammenfassung

Der Euro ist ein historisch einmaliges Experiment: eine Gruppe sehr unterschiedlicher Länder hat sich freiwillig eine gemeinsame Währung gegeben; die supranationale Geldpolitik ist von nationalen Fiskalpolitiken bewusst geschieden. Es gab für jedes Mitgliedsland gute Gründe, dieses Experiment eines geldpolitischen Pools diverser Länderrisiken zu wagen. Allerdings hat das Experiment bisher eher enttäuscht. Ein polit-ökonomisches Paradoxon kann erklären, warum die Mitgliedsländer sich lediglich auf eine fiskalisch gefährlich begrenzte Risikoteilung einigen konnten. Diese Grenzen zeigten sich in der jüngsten Finanz- und Euroraumkrise, in der die Rettung insolventer Banken eine Aufgabe für Nationalstaaten blieb, obwohl die Finanzmarktintegration das Bankensystem für viele zu groß werden ließ. In der Krise zeigten sich aber auch die institutionalisierten Versicherungselemente, die den Euroraum gerettet haben, z. B. das grenzüberschreitende Zahlungssystem TARGET. Die Bankenunion hat die Risikoteilung im gemeinsamen Währungsraum robuster gemacht. Allerdings ist das Risiko der Überlastung öffentlicher Haushalte weiterhin hoch.

JEL Classifications: E42 Monetary systems; E44 Financial markets and the macroeconomy; E58 Central banks and their policies; F55 International institutional arrangements

Key words: euro area, financial crisis, monetary integration theory; risk-sharing