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Challenges of the Euro

The evolution of institutions – even exemplary ones – is never completely smooth. The Federal Reserve System, which is often seen as a model for central banking, looked as if it was deeply flawed on its twentieth anniversary in the aftermath of the Great Depression in 1933. It required further development. Europe's move to monetary integration with a common currency (the euro) is quite a unique process. It is also held up as a model for monetary cooperation in other parts of the world: in the Gulf region, where there are periodic discussions of monetary unification, as well as in Asia and Latin America, where movements towards greater monetary integration also have some support but encounter a plethora of difficulties. Nevertheless, no later than the onset of the global financial crisis (2007-08), it became clear that there were substantial design flaws in the concept of the Economic and Monetary Union (EMU).

Ambiguous integration

There was always ambiguity in the story of European monetary integration: Was it designed to deal with a technical issue, i.e. exchange rate volatility as a barrier to trade and thus to greater economic integration? Was it a quest for price stability? Or was it part of a grand political plan, in which money was used to tie the European knot? In the 1960s, US-based economists (Mundell in 1961, McKinnon in 1963 and Kenen in 1969) developed a theory of optimum currency areas. Although they continued to be influential figures in the European debate, their theories were irrelevant to the final push to monetary integration in the 1990s. The states that signed up to the economic union had different expectations and hopes: Some saw it as a way of building credibility and thus of reducing borrowing costs, while others focused on the constitutionalisation of a stable monetary regime. How could the divergent visions of the potential gains from monetary integration be mutually reconciled?

The European uniqueness after 1999 lay in the creation of a common currency without a corresponding state structure. Previously money had been seen as a creation or even property of the state. Europe, however, had a currency without a state. This could easily be considered a source of intractable problems. As a consequence, when a crisis arose, it was hard to work out whether it came from the peculiar features of a monetary union (that might require institutional completion), or from the pattern familiar elsewhere of capital inflows that encountered a sudden stop and then a reversal.

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Currency without a country

It is easy to see this feature as the fundamental design flaw. It is often claimed – especially but not only by American economists – that the travails of the euro, as well as the history of past monetary unions, show that it is impossible to have a monetary union in the absence of a political union, which establishes a common political process for determining the distribution of fiscal costs.[1] The latest version of the critique comes from Mody.[2] De Grauwe stated the case quite simply: "The euro is a currency without a country. To make it sustainable, a European country has to be created".[3] Successive Presidents of the European Central Bank (ECB) seem to endorse much of this advice, but perhaps more rhetorically than practically. Accepting the Charlemagne Prize in Aachen, Jean-Claude Trichet said, "In a long term historical perspective, Europe – which has invented the concept and the word of democracy – is called to complete the design of what it already calls a 'Union'".[4] Mario Draghi has been even more dramatic, demanding "the collective commitment of all governments to reform the governance of the euro area". This means completing the economic and monetary union along four key pillars:

1. a financial union with a single supervisor at its heart, to reunify the banking system;
2. a fiscal union with enforceable rules to restore fiscal capacity;
3. an economic union that fosters sustained growth and employment;
4. a political union, where the exercise of shared sovereignty is rooted in political legitimacy.[5]

1 M. Bordo, L. Jonung: The future of EMU: What does the history of monetary unions tell us?, in: F.H. Capie, G.E. Wood (eds.): Monetary Unions: Theory, History, Public Choice, London 2003, Routledge, pp. 42-69.
2 A. Mody: EuroTragedy: A Drama in Nine Acts, New York 2018, Oxford University Press.
3 P. de Grauwe: The Eurozone's Design Failures: Can they be corrected?, LSE lecture, 2012.
4 J.-C. Trichet: Building Europe, building Institutions, Acceptance speech for the Karlspreis, Aachen, Germany, 2 June 2011, available at https://www.ecb.europa.eu/press/key/date/2011/html/sp110602.en.html.
5 M. Draghi: A European strategy for growth and integration with solidarity, Speech at conference organised by the Directorate General of the Treasury, Ministry of Economy and Finance – Ministry for Foreign Trade, Paris, 30 November 2012, available at https://www.ecb.europa.eu/press/key/date/2012/html/sp121130.en.html.

This advice seems appallingly radical to many, since almost every politician denies that there is any real possibility of creating something resembling a European state, and almost every citizen recoils at the prospect. The fact that the discussion that Draghi contributed to had been going on for decades suggests that there were no easy solutions.[6]

Rules versus flexibility

A second design flaw lies in the quite divergent views or philosophies in Europe about how to manage the process of integration. The German, or more generally, northern vision is about rules, rigor, and consistency, while the French or southern emphasis is on the need for flexibility, adaptability and innovation. Specific policy preferences follow from the general orientation: The rule-based approach worries a great deal about the destruction of value and insolvency as well as about avoiding bailouts that will set a bad example and encourage inadequate behaviour among other actors (commonly referred to by economists as the moral hazard problem). The discretionary approach sees many economic issues as temporary liquidity problems that can be solved easily with an injection of new lending. Here the provision of liquidity is costless: There is no bailout, no incurred loss, and in fact the knock-on effects make everyone better off. There are, in this vision, multiple possible states of the world, multiple equilibria, and the benign action of government and monetary authorities can shift the whole polity from a bad situation into a good one. To this, adherents of the moral hazard view point out the costs that will pile up in the future from the bad example that has just been set. The German view wants a greater coordination of national policies in a rule-based framework, echoing German federal traditions. France instead looks for united economic government, in line with that country's tradition of centralisation.

Dim growth prospects for Europe

The design flaws go along with environmental or contingent circumstances. European growth prospects were poor even before the global financial crisis because of a mixture of demographic and organisational or institutional reasons. In 2007, the economic historian Robert Fogel predicted that per capita income in the old (15) members of the EU would grow by 1.2% annually, less than half the rate in the US (2.8%) and spectacularly less than India (6.0%) or China (8.0%). He thought that welfare spending and high taxes would handicap growth; he could have added the absence of the large IT giants who, in the US or China, looked as if they were driving growth and innovation.[7] The different corporate structure might be explained by the poorer development of the venture capital sector as well as by markets that were still segmented by national regulation and national politics. From 2018, a slowdown began in Europe which might be interpreted as evidence that German and other 'winners of globalisation' in engineering and automobiles were facing an increasingly unfriendly global environment as a result of both technical change and trade wars.

Another major vulnerability was exposed during the global financial crisis. European economies were much more dependent on banks than the US economy. Banks were a greater source of financing for productive activity (80% of external financing in Europe came from banks; in the US it was 20%). Banks were also much larger in relation to the national economy. In 2007, Deutsche Bank's assets were 80% of German GDP, BNP Paribas's were 87% of that of France, and Bank of Ireland's stood at 100% of the national GDP. The equivalent figures for the large banks in the US were 13% for Citigroup, or nine percent for JPMorgan Chase. In a crisis that was primarily related to banks, Europe would automatically be more vulnerable.[8]

Europe's financial doom loop

Banks and governments were intertwined in Europe. Banks held large quantities of government debt – in particular, French, German and UK banks held large quantities of peripheral European debt, and in the course of the crisis, peripheral banks held larger amounts of their own government's debts. If that government debt became too large, and its amortisation and repayment became problematic, then the values would collapse and bring down banks. The banks would then need to be recapitalised by their own governments, adding to the sum of sovereign debt, and hence to the uncertainty over valuation. This relationship became a well-known stylised fact about Europe's financial dilemma, and was referred to as the 'doom loop'. The initial outbreak of the Eurozone crisis was in Greece, where the domestic banks did not initially appear to be part of the problem (they became a central feature of the difficulty later) and therefore the doom loop did not feature so prominently in early analyses. Immediately after the Lehman collapse, the German Finance Minister Peer Steinbrück and Chancellor Angela Merkel made a joint announcement on 5 October 2008 in which they reassured German savers that their bank deposits were safe; but Steinbrück also

6 M.K. Brunnermeier, H. James, J.-P. Landau: The Euro and the Battle of Economic Ideas, Princeton NJ 2016, Princeton University Press.

7 R. Fogel: Capitalism and Democracy in 2040: Forecasts and Speculations, NBER Working Paper No. 13184, Cambridge MA 2007.

8 H.S. Shin: Global Banking Glut and Loan Risk Premium, IMF Mundell-Fleming Lecture, Washington DC 2011.

added that he would ensure that the burden would not be transferred from the banks to the taxpayer. The problem was that the bank weakness seemed to make it impossible to keep both of these promises.

While the first decade of the euro was dominated by complacent thinking, partly fuelled by the belief that the fundamental global challenges lay in global imbalances, e.g. unsustainable surpluses in China and unsustainable deficits in the US, the second decade began with the threat that the bank-sovereign links in Europe constituted the key fault line in the global economy. Between the summer of 2011 and the summer of 2012, it looked likely that the euro might fall apart.

European struggle with the lender of last resort

In December 2018, Draghi explained that the ECB was "the only driver of this recovery" in parts of the Eurozone.[9] The ECB came to view itself and its vision in heroic terms. Almost all commentators trace the survival of the euro back to some off the cuff remarks Draghi made at the end of a press conference in July 2012. Then, similar to a previous period of enormous financial tension and fragility in December 2011 when the IMF was contemplating the need for very large fund programs, the ECB saved the day (or put off the day of reckoning) through the introduction of new facilities, the Long Term Refinancing Operations (LTROs) and in 2012 the Outright Monetary Transactions (OMTs). The pendulum swung from concern about systemic vulnerability to thinking that the Eurozone problem was a case of two deep-seated national crises – in Greece arising out of an over-extended public sector, and in Italy as a consequence of low growth.

The Europeans then struggled with how they should view the Lender of Last Resort (LLR). Did a LLR simply supply liquidity or was it also important to correct the deeper institutional flaws (including governance failures) that made for vulnerability, slow growth and crisis? Was the European LLR the ECB, which would have the capacity theoretically to create infinite amounts of euros and hence credibility in dealing with market attacks but no mandate to impose conditionality and a self-understanding that stressed independence from political control? Or was it the IMF, a politically controlled and accountable multilateral institution but of global character, with a tradition of policy conditionality and a problem that its resources were finite? Both institutions had obvious flaws in their scope for LLR action, which would be sharply exposed in the course of the financial crisis.

It looked as if some blend of IMF and ECB procedures would be needed. A European version in which the European Stability Mechanism develops into a European Monetary Fund (EMF) might deal with the major challenges that still face Europe and its currency union. The first three challenges are technical-economic in nature, while the final one is concerned with political economy:

- Current account imbalances
- Debt sustainability
- Conditionality and ownership
- Security linkages and leadership

Current account imbalances

The first rationale for a new institutional framework looks back to the original intentions behind the Bretton Woods architecture. The question of adjustment in the international financial system has always been contentious, and the debate about international order at Bretton Woods was shaped by lessons drawn from the unsuccessful attempt to create a stable order after the First World War. The heart of the interwar problem was held to be asymmetric adjustment leading to a deflation bias. The surplus countries of the 1920s, France and the US, were under no pressure to expand, while the deficit countries were forced by the rules of the game to contract. It was easy to project that situation into the post-war world, where it looked as if there would be one country with a huge surplus for a very long time.

The issue of large surpluses has always – at least for fifty years – played a role in the European debate. Other European countries often worried about what they sometimes described as Germany's currency manipulation, which they saw as a mercantilist strategy of securing permanent trade and current account surpluses that would give Germany a commanding control of resources. In each phase of European monetary integration, Germany's partners in consequence tried to devise an institutional mechanism to control German surpluses, and they believed that an institutional move to Europeanisation would admirably do that job. It was the surge in German trade surpluses in the late 1960s that drove the original discussion of a European monetary union that culminated in the 1970 Werner Plan. In the later 1970s, angst about the German surpluses re-emerged and produced the European Monetary System (EMS) initiatives. In the late 1980s, the increase in the German surpluses pushed both the United States at the G-7 level and France at the European level to produce schemes for control. There is a path from Edouard Balladur's proposals to the Delors Committee to the Maastricht Treaty. Only in the 1990s were there no German surpluses: that was the

9 M. Draghi: Draghi's $3 Trillion QE Bet Isn't a Winner Yet as Economy Wavers, Bloomberg, 15 December 2018, available at https://www.bloomberg.com/news/articles/2018-12-15/draghi-s-3-trillion-qe-bet-isn-t-a-winner-yet-as-economy-wavers.

consequence of German unification. German surpluses in the later 2000s formed the backdrop for much of the discussion of flaws in the euro area architecture.

The IMF, while it has often provided excellent analysis of imbalances on a global level, has never really found a satisfactory way of addressing the issue. An attempt in 2007 to strengthen exchange rate regime surveillance ran into the sands, because of Chinese opposition followed by the outbreak of the global financial crisis. In a European setting, imbalances could only be dealt with successfully by more extensive coordination of fiscal policies, and it is hard to see that the analytical side of an EMF would have the political heft to tackle the issue.

Debt sustainability

The second point relates to the more recent experience of the IMF. Over recent decades, a great deal of technical attention in the IMF had been devoted to, and a substantial competence developed in, the issue of debt management and debt sustainability. The view that debt sustainability was central grew out of extensive and painful involvement with over-indebted countries: with low income countries, but also with Latin American emerging markets in the 1980s and with East Asia in the later 1990s. The primary aim of the IMF's crisis management is to make a country's debt sustainable. That is, the country's future projected tax revenue minus its expenditure should be large enough to ensure that the country is able and willing to service its debt. In most cases, there is in truth no clear-cut answer to the apparently simple question, "Is debt sustainable?" Debt may be sustainable in some states of the world (strong growth, low interest rates) and unsustainable in others. In the course of the European debt crisis, the most difficult moments within the so-called troika have concerned the IMF's Debt Sustainability Analysis (DSA).

Many of the leading current proposals for the operation of the EMF suggest an automatic principle of debt reduction in the case of an adoption of a program.[10] The group of Nordic countries, including the Netherlands, informally known as the Hanseatic League 2.0 has set up a bailout scheme that includes automatic debt reductions. The European Commission's proposal, by contrast, does not envisage a sovereign restructuring (or any exit scheme from the euro), because of worries about contagious runs that might spread to countries so large that the existing backstops would be overwhelmed. If the proposal that linked EMF action to debt sustainability were to be realised, Europe would offer an example for how to fix a problem that is much more than simply a European one. It is also a problem that is likely to become more intense as the pressures of political populism lead countries to run larger deficits again.

Conditionality and ownership

Over time, the IMF developed an approach to the politics of economic reform that made it uncomfortable with the enforcer or whipping boy role that it had traditionally been given by the international community (i.e. the big and powerful states). Since the 1990s, it had increasingly emphasised the idea of 'ownership' i.e. that reforms do not work unless they are carried by a deep political consensus. But the Europeans' motivation for calling in the IMF was precisely to find a substitute for the lacking consensus about economic reform.

The most problematic aspect of the troika arrangements was not so much the presence of the IMF, but the way that the central bank – a non-political and technocratic institution – was pushed into making political choices. Thus, the ECB was drawn deeper into political arguments. The effectiveness of the ECB's monetary promise in July 2012 ("whatever it takes") lay in the extent to which it had – and was believed by the markets to have – the backing of the German government. As in the case of the Asian discussion of the 1990s, IMF participation was crucial for the design of a country program. In this case, the lack of clarity about where, how and why the ultimate decisions would be made looked like both a problem of leadership and a problem of democratic accountability.

Security linkages and leadership

The politics of support for a broad array of economic reforms may raise issues different from those generated in a purely economic analysis. Bretton Woods was designed as a multilateral and multipolar system, the expression of the wartime coalition (the United Nations) in which security and economic stabilisation were joined at the hip. Today, there is an urgent need for a similarly connected governance structure at the global level, offering coordination between the profusion of regional bodies that characterise the improvised attempts of leaders to respond to governance challenges.

Today, unipolarity is crumbling but the security challenges remain. The most complex contemporary financial crises – Ukraine or Venezuela – are also overshadowed by a distinct security dimension; and neither the security nor the financial dimension can be tackled on their own. Europe has its own non-economic vulnerability. The nature of the European problem was transformed in 2014-15,

10 See B. Weder di Mauro, J. Zettelmeyer: The New Global Financial Safety Net, in: Essays on International Finance, Vol. 4, Center for International Governance Innovation, Waterloo, Canada 2017; and D. Gros, T. Mayer: A European Monetary Fund, Why and How? CEPS Study No. 2017/11, available at https://www.ceps.eu/publications/european-monetary-fund-why-and-how.

initially by the Russian occupation of the Crimea and the fighting in eastern Ukraine, and again in 2015 by the large-scale inflow of refugees from Syria and other areas. At first, it appeared as if the new problems would prove fatal to the European idea; but then some came to believe that the older debt issue was more easily solved in the context of multiple challenges. Brexit and Trump only increased that impression, and Europe – especially after the election of Emmanuel Macron as President of the French Republic – mobilised to produce a response. It looked as if Europe was having a 'leadership moment,' analogous to that taken so spectacularly by the US at Bretton Woods.

All of Europe's current problems and challenges require responses, and it is hard to see how each could effectively be handled by a separate grouping of countries in a disparate institution, in a coalition of the willing, or what the political scientist Jan Zielonka in 2014 called 'political polyphony'.[11] In each case, some member countries will work out that they will gain from cooperation, but others will realize that they may lose from that particular instance of cooperation. Instead, an analogy from trade negotiations may be a useful way to think of solving the political side of some of Europe's problems. Trade negotiations have been a largely successful exercise in the second half of the twentieth century in which large welfare gains were realised in many areas.[12]

The lesson from previous episodes of trade reform is in part a story of political framing as well as a story of compensatory deals. Countries can calculate that they might lose out on the solution to one of the issues but gain on another. For instance, Germany might have to pay some debt relief for Southern European countries but may also quickly benefit from a European solution to the refugee crisis. The presence of migrants – some from within, some from without – raises the case of how social security is provided. Military integration could raise the effectiveness of defence while cutting costs, especially in those countries with a high military budget. Europe would appear as an arena in which trade-offs and compromises were negotiated, rather than a place where precious concepts of sovereignty were destroyed. Making this sort of pact requires leadership.

It is the question of leadership that fundamentally divides Europe. The euro is divisive because it looks like a straitjacket. And the problem with the imposition of external constraints is that it establishes a psychological mechanism of blame transference. When the policy that results from those external constraints does not produce growth, then the euro is reinterpreted as a trap. When wage growth occurred despite the external constraint and growth faltered, there was no way out. The euro is thus responsible for trapping southern Europe into a low competitiveness scenario. France is suffering from the story that the French elite told when they wanted to join the single currency, namely that of a strong franc, which was nicely labelled the 'franc fort' obviously evoking Germany's financial centre.

The other side also feels that it is in a trap. Sometimes Germany is portrayed as the major beneficiary of the euro – especially in southern Europe. But Germans do not see the trade gains – especially when southern Europe is buying less German exports, fewer automobiles and machine tools as consumption and investment have both collapsed. They see instead the financial claims building up in the payments system; the TARGET2 balances that result from the counterpart to money transfers to the southern banking system.

As in the case of the global system, management cannot come from one country alone, as that would not be legitimate. Multilateral institutions are ways of both diffusing leadership and of making real leadership effective. But their role needs to be precisely defined. They can establish greater trust by monitoring commitment, e.g. assessing the viability and the sustainability of promises. This is precisely the role that Jean Tirole described in 2002 when he saw the IMF and other international institutions as 'delegated monitors'.[13]

Much of the controversy about the design of the EMF revolves around whether it should be an official institution of the European Union. The Commission thinks so, while northern Europeans are sceptical because they fear politicisation of what should be an exclusively technical institution. It is in this area, finally, that there is a specific lesson of history.

A Bretton Woods-style institution in Europe could facilitate – through the technical advice it gives on debt, reform proposals and market conditions – a stronger framework for policy discussion. But because much of the assessment will focus on cross-border effects and linkages, there is no reason to think that this task is better done at a regional than at a global level. On the other hand, the resources raised for program interventions might well be local, and this is where the developing of the ESM mechanism will be helpful. The fundamental trade-offs and the assessment and calculation of the appropriate response to strategic risks can only be made at the political level. That requires a strengthening of the European institutions, and in particular, of the Council. The EMF would be an instrument, but it could and should not be expected to be the primary engine of the revolution.

11 J. Zielonka: Is the EU doomed?, Cambridge UK 2014, Polity Press.
12 M. Bordo, H. James: Partial Fiscalization – Some Historical Lessons on Europe's Unfinished Business, in: L. Odor (ed.): Rethinking Fiscal Policy after the Crisis, Cambridge 2017, Cambridge University Press, pp. 232-257.
13 J. Tirole: Financial Crises, Liquidity and the International Financial System, Princeton NJ 2002, Princeton University Press.