Design Flaws of the Euro

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It is a great honor to have been invited to present a lecture at the Central Bank of Ireland in honor of T.K. Whitaker. He was appointed Secretary of Department of Finance in 1956, in the midst of a crisis, as he put it, the "dark night of the soul," in a country gripped by the "consciousness of our not having made a great go of our affairs since Independence."[1] Europeans are currently at a similar point of inflection – and reflection. They might well think that they have not made a great go of things since the introduction of the common currency. At such moments, it is easy to think that the whole project is flawed. At the least, a considerable redesigning is required. As Governor Honohan put it recently: "release 1.0 of the euro was under-designed, and robust only to moderate shocks." Thus "the institutional architecture of the euro area is being rapidly overhauled towards a fairly early release date for euro 2.0."[2]

What is the design flaw? It is often claimed – especially but not only by American economists - that the travails of the Euro show that it is impossible to have a monetary union in the absence of a political union. Tom Sargent used the bully pulpit of the Nobel Prize Acceptance speech to tell Europe to follow the U.S. example in the aftermath of the War of Independence and assume the debts of the individual states. Assumption for Hamilton was "the powerful cement of our union." Paul de Grauwe has recently stated the case quite simply: "The Euro is a currency without a country. To

[1] T.K. Whitaker, *Interests*, Dublin: Institute of Public Administration, 1983, p. 9. John. F. McCarthy, *Planning Ireland's Future: The Legacy of T.K. Whitaker*, Dublin: Glendale, 1990, pp. 12-13.

[2] Patrick Honohan, "A view from Ireland – the crisis and the euro," Address to the David Hume Institute and the Scottish Institute for Research in Economics, Edinburgh, 13 November 2012.

make it sustainable a European country has to be created."[3] The Presidents of the ECB seem to endorse this advice. 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". 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 economic and monetary union along four key pillars: (i) a financial union with a single supervisor at its heart, to re-unify the banking system; (ii) a fiscal union with enforceable rules to restore fiscal capacity; (iii) an economic union that fosters sustained growth and employment; and (iv) a political union, where the exercise of shared sovereignty is rooted in political legitimacy."[4] This advice seems appallingly radical to many, since almost every politician denies that there is any real possibility of creating a European state, and almost every citizen recoils at the prospect. Hence we face the dark night of the European soul.

The Choice for State or Non-State Money

In choosing a "pure" money in the 1990s, free of any possibility of political interference and simply designed to meet the objective of price stability, Europeans were taking an obvious risk. They were obviously and deliberately flying in the face of the dominant modern tradition of thinking about money. The creation of money is

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[3] Thomas Sargent, "United States Then, Europe Now," Nobel Prize speech 2011: http://www.nobelprize.org/nobel_prizes/economics/laureates/2011/sargent-lecture.html; Paul de Grauwe, "The Eurozone's Design Failures: can they be corrected?," Nov. 28, 2012, LSE lecture: http://www2.lse.ac.uk/publicEvents/pdf/2012_MT/20121128-Prof-Grauwe-PPT.pdf .

[4] Jean-Claude Trichet: Building Europe, building institutions, Speech by Jean-Claude Trichet, President of the ECB on receiving the Karlspreis 2011 in Aachen, 2 June 2011; Remarks by Mario Draghi, President of the ECB, Treasury Talks 'A European strategy for growth and integration with solidarity', A conference organised by the Directorate General of the Treasury, Ministry of Economy and Finance – Ministry for Foreign Trade, Paris, 30 November 2012 . See also Mario Draghi in *Die Zeit*, Aug. 29, 2012, http://www.ecb.int/press/key/date/2012/html/sp120829.en.html

usually thought to be the domain of the state: this was the widely prevalent doctrine of the nineteenth century, which reached its apogee in Georg Friedrich Knapp's highly influential *State Theory of Money.* Money could be issued by the state because of government's ability to define the unit of account in which taxes should be paid. In the *Nicomachean Ethics,* Aristotle explained that money owes its name to its property of not existing by nature but as a product of convention or law.[5] Greek coins usually carried depictions of gods and goddesses, but the Romans changed the practice and put their (presumed divine) emperors on their coins. Christ famously answers a question about obedience to civil authorities by examining a Roman coin and telling the Pharisees, "Render unto Caesar the things which are Caesar's."[6]

The design of the Euro makes the novelty clear. Unlike most banknotes and coins, there is no picture of the state or its symbols—no Caesar—on the money issued and managed by the European Central Bank. This feature sharply distinguished the new money from the banknotes that had circulated before the common currency and that were carefully designed to depict national symbols. Especially in the nineteenth century, the formation of new nation-states was associated with the establishment of national moneys, which gave the new polities a policy area in which they could exercise themselves. European leaders in the late twentieth century were self-consciously stepping away from that tradition – in large part because of a widespread sense that national money had been subject to political abuse with inflationary consequences.

In an obvious sense, the story of Ireland for a long stretch of the twentieth century is a refutation of the claim that a currency union necessarily implies a common state, although there is no doubt that the effective currency union over more than half a

[5] Book V: "money has become by convention a sort of representative of demand; and this is why it has the name 'money' (*nomisma*)-because it exists not by nature but by law (*nomos*) and it is in our power to change it and make it useless."
[6] Matthew 22: 21.

century with the UK until Ireland joined the EMS constrained Irish choices.[7] The experience of that period certainly holds out some lessons. As Whitaker pointed out, "The Bank never held the view, apparently favoured by some economists, that the parity link with sterling provided an automatic and painless mechanism of adjustment, obviating the need for concern about relative deviations of incomes, prices and costs as between Ireland and Britain, and, therefore, for domestic initiatives to correct them." [8]Domestic threats were principally "excessive public expenditure and borrowing, excessive credit creation, excessive income increases."

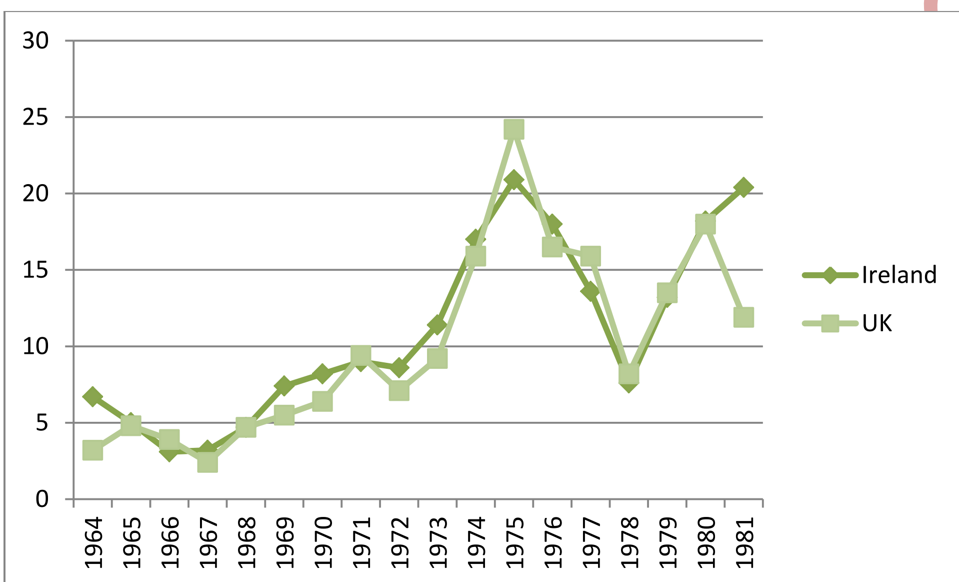

Fig 1: Ireland and UK CPI

[7] Patrick Honohan, "Currency Board or Central Bank? Lessons from the Irish Pound's Link with Sterling, 1928-79," *Banca Nazionale del Lavoro Quarterly Review* 200, 1997, pp. 39-70.
[8] Whitaker, *Interests*, p. 178.

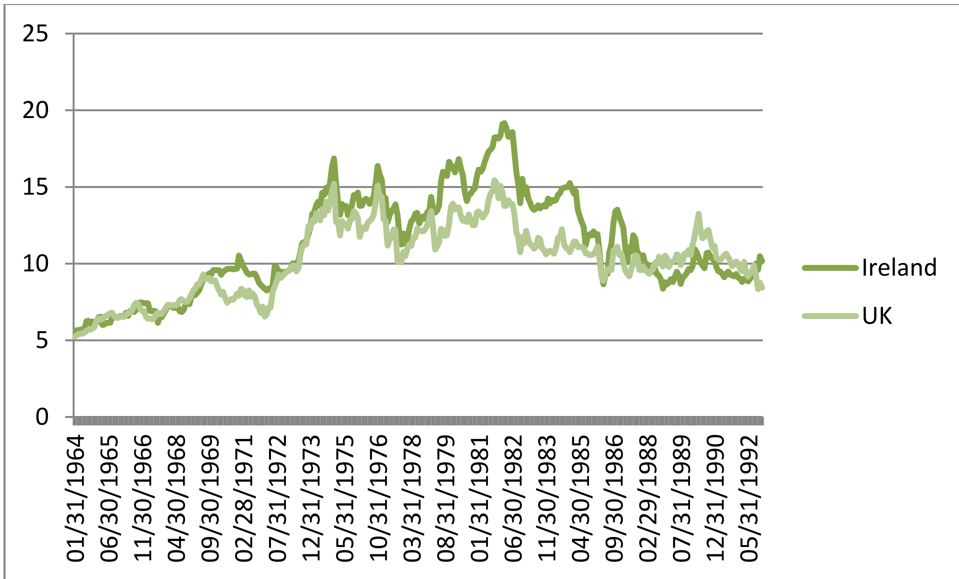

Fig. 2: Ireland and UK 10 Year Bond Yields

During the period of the parity link, Irish prices unsurprisingly moved closely in line with those of the UK. Irish bond yields were very close to those of the UK until 1979. After that, EMS membership caused Irish borrowing rates to soar. There were two main backgrounds to the Irish break with sterling: diversification of Irish trade toward the EC and away from its previous dependence on the UK, and higher levels of UK inflation than in most of continental Europe. Whitaker in 1976 stated that: "no small country dependent on international trade can defend itself in the end from the inflation prevailing in its main trading partners".

There is indeed a long tradition of thinking of currency union as a way of solving a collective action problem. Walter Bagehot and his influential periodical *The Economist* in the mid-nineteenth century pleaded vigorously in favor of what seemed like a common sense solution: "Commerce is anywhere identical: buying and selling, lending and borrowing, are alike all the world over, and all matters concerning them ought universally to be alike too." This obvious appeal was accepted by all the luminaries of the time, including John Stuart Mill and Stanley Jevons. Money, he argued, should not be seen as the creation of the state. "We commonly think, I believe, that the coining of money is an economic function of government; that the Government verifies the quality and quantity of metal in the coin out of regard to the good of its subjects, and that Government is admirably suited to this task—that it is a very reliable verifier. But in truth, if we look at the real motives of governments, and the real action of governments, we may come to think otherwise. The prevalent notion about coinage is not an economic but a mystic notion. It is thought to be an inalienable part of sovereignty; people fancy that no one but a government can coin—that it is nearly a contradiction that anyone else should coin. A superstition follows the act."[9] Bagehot thought it much better to conceive of money as serving the needs of commerce (and of the people more generally) rather than the interests of the state and its rulers.

There were two big pushes at monetary experimentation. Both coincide with an intensification of the pace of technical change, and a surge in globalization – interconnectedness through flows of goods, labor, and capital. At the time Bagehot was writing, Napoleon III and his advisers had already pushed through the Latin Monetary Union, by which the coinage systems of France, Belgium, Switzerland and Italy were homogenized, with a standard franc or lira coin of a standard weight and purity of silver that would circulate freely in the member countries of the currency union. The 1867 World Monetary Conference, held in Paris, went substantially further in its ambitions. Only a very slight alteration of parities would be required to bring into line France, Great Britain, as well as the United States, which was just recovering from the massively costly and destructive Civil War. France was on a bimetallic standard, in which its coinage was set both in terms of gold and silver weights; Britain was on a pure gold standard; and the United States was considering a return to a stable currency based on metal. The proposals in this form were not realized (the small parity alteration required for Britain was too contentious politically); but in a sense the gold standard as a completely credible common standard was a sort of monetary union.

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[9] Walter Bagehot, *A Practical Plan for Assimilating the English and American Money as a Step Towards a Universal Money*, London: Longmans Green, 1889, reprint of 1869 edition, pp. vii – viii.

In the late twentieth century, a new wave of globalization pushed a new interest in monetary unification. But by then, the state theory of money had become so dominant that the initiative seemed incomprehensible or bizarrely political. It is possible to find alternatives to the state theory: but they were often regarded as being rather eccentric, however distinguished or eminent their proponents. Such was the case of Friedrich Hayek's proposals for non-national money created by competitive issuers; or John Maynard Keynes's plan for a non-national internationally issued Bancor; or indeed the 1931 papal encyclical *Quadragesimo Anno*, which in the wake of hyper-inflations produced by war finance and then radically destructive deflationary episodes generated by the gold standard complained of "the virtual degradation of the majesty of the State, which although it ought to sit on high like a queen and supreme arbitress, free from all partiality and intent upon the one common good and justice, is become a slave, surrendered and delivered to the passions and greed of men."

So the state tradition remained unchallenged. Ireland had eccentrically preserved a currency union out of a breaking-up state; while Europeans seemed to be taking on a currency union in order to make themselves into more of a state.

Myths about the Origins

The primary flaw of the Euro is the consequence of the intellectual domination of the state theory: we interpret the story primarily in terms of politics. A big obstacle to clear thinking lies in a propensity to develop myths about the origins of the Euro. The problem about the two most influential - but completely wrong - theories that currently circulate about how and why the Euro was created is that both inflame political passions but give no guidance at all on how to find solutions. Both focus obsessively on the politics of the German role in driving monetary union, so that it again appears as solving the German question is central to the future of Europe. Both are mirror images of each other: in one Germany appears as uniquely virtuous, in the other as terribly vicious. Looking at the real history of the Euro can clear up misconceptions, but also highlight the real problems that remain to be tackled.

In the first view – the virtuous German story - the currency union was a high-minded European political project that ignored economic realities. It was needed to stop the recurrence of war between France and Germany. Both proponents of the Euro project such as the veteran German Foreign Minister Hans-Dietrich Genscher but also by opponents such as the economist Martin Feldstein have touted this theory.[10] But it is implausible. Americans are perfectly aware that they haven't had a war with Canada or Mexico recently (although in the long past there were indeed such conflicts), and that they don't need a currency union to improve relations with neighbors. On the other hand, Americans are aware that civil wars can occur in malfunctioning currency unions (in the mid-nineteenth century, at exactly the time Napoleon III was dreaming of world monetary union): and Ireland too also has its own terrible twentieth century experience of the damage done by civil war.

Then there is the vicious view of the origins of the Euro, a conspiracy theory about a deep-seated German masterplan. Some of its earliest proponents were British (like the former U.K. Chancellor of the Exchequer Denis Healey), but now it is circulating widely in southern Europe.[11] Since Germany had lower rates of wage inflation than France and much lower rates than the Mediterranean countries, a locked currency would guarantee increased export surpluses, at the price of misery elsewhere. A German grasp for European economic primacy would succeed at the end of the twentieth century and in the new millennium where a similar German military plan had failed one century earlier.

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[10] Martin Feldstein, ‘The Failure of the Euro: The Little Currency that Couldn't,” *Foreign Affairs*, January/February 2012.
[11] Denis Healey, *The Time of My Life*, New York: Norton, 1990, pp. 438-9.

This view seems as absurd as the first myth about peace and money. If this is what the Germans were aiming at, wouldn't other countries be able to get some whiff of the nefarious plot? And more importantly, if this were really a strategy it is a pretty short-sighted one (not really that much better than the disastrous Schlieffen Plan of 1914 to defeat both France and Russia at the same time). Plunging one's neighbors into national bankruptcy is not a good way of building any kind of stable prosperity.

For the critics, Germany's currency manipulation was a mercantilist strategy of securing permanent trade and current account surpluses, that would give Germany a commanding control of resources. In each phase of the negotiation about European monetary integration, Germany's partners in consequence tried to devise an institutional mechanism to control German surpluses.

That is a debate that goes back a long way. Raymond Barre, then Vice-President of the European Commission, for instance argued in 1968 that Germany should take "energetic measures for speedier growth and the stimulation of imports," as well as "special action to inhibit the flow of speculative capital into Germany."[12]

In the Bretton Woods era of fixed exchange rates and controlled capital markets, even relatively small deficits could not be financed, and produced immediate pressure on the exchange markets. The deficit countries then had to apply fiscal brakes in a stop-go cycle. Germany's partners, notably France, were faced by the prospect of austerity and deflation in order to correct deficits. This alternative was unattractive to the French political elite, because it constrained growth and guaranteed electoral unpopularity. Their preferred policy alternative was thus German expansion, but this course was unpopular with a German public worried about the legacy of inflation and was opposed by the powerful and independent central bank, the Deutsche Bundesbank.

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[12] Horst Ungerer, *A concise history of European monetary integration : from EPU to EMU,*: Westport, Conn. : Quorum, 1997, p. 61

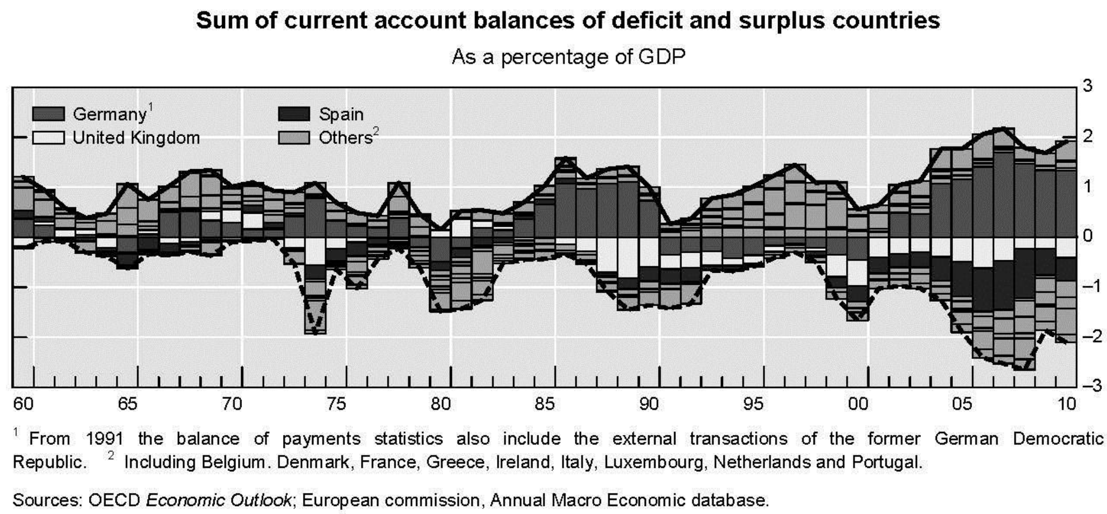

Fig. 3: Current Accounts in Europe 1960-2010

Solving the question of the German current accounts in the European setting at first appeared to require some sophisticated and ingenious political mechanism, that would force French politicians to do more austerity than they would have liked, and Germans less price orthodoxy than they thought they needed. A political mechanism however requires continual negotiation and public deliberation, that would have been painful given the policy preferences in the two countries (and in those countries that lined up with each one of the Big Two). The increased attraction of monetary union was that it required no such drawn out political process. The operation of an entirely automatic device would constrain political debate, initiative, and policy choice.

Monetary union was thus conceptualized as a way of simplifying politics. This had been a feature of European arguments from the beginning. Robert Triffin in 1957 had showed how a problem could be reduced to its most basic level: "The significance of monetary unification, like that of exchange stability in a free market, is that both exclude any resort to any other corrective techniques except those of internal fiscal and credit policies."[13]

The problem of current accounts grew bigger, the surpluses and deficits ever larger. The monetary union occurred after a drive to capital market liberalization, and was intended to be the logical completion of that liberalization. Current account imbalances were apparently sustainable for much longer periods – though not for ever. The effects of movements in capital in allowing current account imbalances to build up to a much greater extent, and ensuring that corrections, when they occurred, would be much more dramatic, was already noticeable in the late 1980s and early 1990s, before the move to monetary union. Indeed, those large build-ups in the imbalances were what convinced Europe's policy-makers that a monetary union was the only way of avoiding the risk of periodic crises with currency realignments whose trade policy consequences threatened the survival of an integrated internal European market. The success of the early years of monetary union lies in the effective privatization of current account imbalances, so that the problem disappeared from the radar screen of policy debates. It would only reappear when the freezing up of the banking system after 2008 required the substitution of public sector claims for private claims: with that the old problem of the politicization of current account imbalances immediately reappeared.

The rather more mundane truth about the evolution of Europe's monetary order is that it was in fact the outcome of global debates about currency disorder. European monetary integration appeared urgent in the late 1960s, as the Bretton Woods regime disintegrated, and in the late 1970s, when U.S. monetary policy was subject to big political pressures and the dollar collapsed.

The most decisive push for a European solution to a global problem occurred in different circumstances. When the dollar was soaring in the mid-1980s, when American manufacturing was threatened and when there appeared to be the possibility of a

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[13] Robert Triffin, *Europe and the Money Muddle*, London, 1957, p. 289.

protectionist backlash, the finance ministers of the major industrial countries pushed for exchange rate agreement. At the G-7 finance ministers Louvre meeting in 1987 they agreed to lock their exchange rates into a system of target zones.

In practice, nothing came of that global plan, but then Edouard Balladur, the French finance minister who had largely been responsible for the Louvre proposal, came up with a tighter European scheme. When German foreign minister Hans Dietrich Genscher appeared sympathetic, Europe's central bankers were asked by the president of the European Commission, Jacques Delors, to prepare a timetable and a plan for currency union.

Negligent Planning?

When it comes to planning for the Euro, the case for flaws becomes stronger. How solid was the plan of Delors? Did the participants sincerely want to get committed to a real marriage – the analogy that came to be increasingly used to describe the new sort of commitment? What basis was there for agreement?

It has become fashionable to say that the moved of the early 1990s were undertaken in a mood of carelessness (*Sorglosigkeit*), in Otmar Issing's phrase, or that Chancellor Kohl was neglectful (*leichtsinnig*) – according to Hans Peter Schwarz's monumental new biography. [14] Kohl promised a political union: on November 6, 1991, he told an ecstatically applauding German parliament that "one cannot repeat it often enough: political union is the indispensible counterpart of the economic and monetary union." But when the governments negotiated a few weeks later in Maastricht, there were very concrete plans for the monetary union, and for the political union – none at all. Does that really mean that everyone was just unbelievably careless, and that, in the

[14] Hans-Peter Schwarz, *Helmut Kohl: Eine politische Biographie*, Stuttgart: DVA, 2012; , Otmar Issing, "Europa in Not – Deutschland in Gefahr," *Frankfurter Allgemeine Zeitung*, June 11, 2012

same way as the British empire was allegedly acquired in a fit of absent-mindedness, the European dream was wafted on a post-unification euphoria?

In fact, the planning for monetary union was unbelievably sober and meticulous. In the debates of the central bankers' group that Delors chaired in 1988-89, before the fall of the Berlin Wall, two really critical issues were highlighted: and they were the ones that really mattered.

The first concerned the fiscal discipline needed for currency union. An explicit discussion took place as to whether the capital market by itself was enough to discipline borrowers, and a consensus emerged that market discipline would not be adequate and that a system of rules was needed. The influential Belgian economist from the BIS, Alexandre Lamfalussy, a member of the Delors Committee, brought up cases from the U.S. and Canada as well as from Europe where cities and regions were insufficiently disciplined. Jacques Delors himself at this time appropriately raised the prospect of a two speed Europe, in which one or two countries might need a "different kind of marriage contract."[15] There is a tendency for fiscal policy to be pro-cyclical, particularly when the cycles are driven by property booms, in that enhanced fiscal revenue from real estate exuberance prompts politicians to think that the increase in their resources is permanent. But the pro-cyclical fiscal element may be magnified in a currency union.

The need for fiscal discipline arising from spillover effects of large borrowing requirements is a European issue, but it is clearly not one confined to Europe alone. In emerging markets, this problem was identified after the 1997-8 Asia crisis, and the problem of major fiscal strains became primarily one of the industrial world – and especially of the United States. An appropriate response would involve some democratically legitimated mechanism for limiting the debt build-up, as in the Swiss

[15] In the second meeting of the Delors Committee, October 10, 1988, see Harold James, *Making the European Monetary Union*, Cambridge Mass. 2012.

debt brake (*Schuldenbremse*) which was supported by 85 percent of voters in a referendum.

The second flaw in the European plans identified by the central bankers as they prepared monetary union was much more serious. In the original version of a plan for a central bank that would run a monetary union, the central bank would have overall supervisory and regulatory powers. That demand met strong resistance, above all from the German Bundesbank, which worried that a role in maintaining financial stability might undermine the future central bank's ability to focus on price stability as the primary goal of monetary policy. There was also bureaucratic resistance from existing regulators. The ECB was thus never given overall supervisory and regulatory powers, and until the outbreak of the financial crisis in 2007-2008 no one thought that was a problem.

By 2010, however, it was clear that there was a very big problem. There had previously been a stream of private sector money from north to south in Europe. The flows of capital had important effects on wage rates, differential inflation levels, and hence on the position of competitiveness. In the monetary union, there was no policy tool to limit inflation through a national monetary policy, and hence in the borrowing countries (now often referred to as the periphery), interest rates were lower than they should have been had a Taylor rule been practiced. Indeed Ireland had negative real rates for substantial periods of the 2000s. After the financial crisis, the sustainability of the flows was threatened by banking crises in the periphery, and the long-developing competiveness positions now looked like an argument that the debt levels (private or public) were unsustainable. Growth prospects that looked brilliant before the crisis no longer existed; so there was a debt servicing problem. That in turn seemed to endanger the banks, including particularly big north European banks that had already taken losses on U.S. sub-prime investments. Funding dried up as U.S. money market funds no longer wished to buy paper issued by European bank borrowers. One of the most obvious lessons of the first phase of the financial crisis was that the failure of big banks would have disastrous consequences. That mantra of the policy technocrats produced its own pushback among many voters and politicians: shouldn't the banks bear some of the burden. At Deauville in October 2010, Chancellor Merkel and President Sarkozy agreed that there should be PSI, Private Sector Involvement.

Far from reassuring markets, the move to make private lenders bear some of the cost of past mistakes made for greater nervousness – much more so, indeed, as Jean-Claude Trichet of the ECB had insistently warned. For a decade, markets had interpreted the no-bailout clause of the Maastricht Treaty as making default impossible. It now seemed to be encouraged by the official sector. After Deauville an unhappy mechanism was created which increased the potential for large bank losses and heightened market nervousness. The official sector put in more money, in effect a substitution for the absent private sector flows of the pre-crisis era; and as that occurred and as the public credit was given seniority, the problems of the private sector debt increased rather than diminished.

Who ultimately is to absorb losses from very large banking sector problems? Do states, which rely on borrowing because they cannot increase taxes, have the capacity to do that when the financial sector is failing? It looked as if only monetization of debt by the central bank could solve the problem in the short run, but in the long run that would be a solution involving a write off of debt by means of an inflationary process.

In July 2012, the crisis took a new phase, and the ECB calmed the markets with the announcement of OMT – not so much the actual practice of bond purchases, but the willingness of the central bank to step in to eliminate risk premia stemming from fear of a currency union break-up. In the words of Mario Draghi: "To the extent that the size of these sovereign premia hamper the functioning of the monetary policy transmission channel, they come within our mandate. Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. Believe me, it will be enough."

The burden of policy innovation now has shifted to governments and to the political process. The test for this new phase will come at some time in some member country: out of a combination of radical popular unrest and electoral or political uncertainty. At that point, there will be a need for a new flexibility. Let me sketch out two flexi monetary solutions, and one flexi political solution.

1. Currency Innovation

In 1992-3, the EMS crises almost destroyed the path to the Euro, but the crisis was resolved by instituting greater flexibility: through wider (15 percent) margins in the exchange rate bands. The modern equivalent to the band widening of 1993 would be keeping the Euro for all members of the Eurozone but also allowing some of them (in principle all of them) to issue – if they needed it – national currencies. The countries that did that would find that their new currencies immediately trading at what would probably be a heavy discount. California adopted a similar approach at the height of the recent financial crisis, issuing IOUs when faced by the impossibility of access to funding. The success of stabilization efforts could then be read off from the price of the new currency. If the objectives were met, and fiscal stabilization occurred and growth resumed, the discount would disappear. In the same way, after 1993, in a good policy setting, the French franc initially diverged from its old level the band but then converged back within the band. Such a course would not require the redenomination of bank assets or liabilities, and hence would not be subject to the multiple legal challenges that a more radical alternative would encounter. There would also be the possibility that the convergence did not occur. The two parallel currencies could then coexist for a very much longer time period. This is not a novel thought. It was one of the possibilities that was raised in the discussions on monetary union in the early 1990s, that there might be a common currency but not necessarily a single currency.

2. More flexibility in monetary policy

A common criticism of monetary union is that it requires a single monetary policy, that thus becomes "one size fits all" and deprives policy-makers of a policy tool in responding to particular national or regional circumstances. When the EC Committee of Central Bank Governors began to draft the ECB statute, it took two principles as given: price stability as the primary objective of the central bank; and the indivisibility and centralization of monetary policy. This would not be "in contradiction with the principles of federalism and subsidiarity."[16] But in fact the second assumption was not really justified either historically or in terms of economic fundamentals.

Think first of the gold standard. A critical part of the gold standard was that individual national central banks set their own interest rates, with the aim of influencing the direction of capital movements. Incidentally the same differentiation of interest rates also occurred in the early history of the Federal Reserve System, with individual Reserve Banks setting their own discount rates. The Eurozone is now moving to a modern equivalent, driven by a new concern with macro-prudential regulation. Bank collateral requirements are being differentiated in different areas. This represents a remarkable incipient innovation. In the aftermath of the crisis, some policymakers are beginning to see that a monetary union is not necessarily identical with unfettered capital mobility. Recognition of diverse credit quality is a step back into the nineteenth-century world, and at the same time forward to a more market-oriented and less distorting currency policy.

3. More political flexibility

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[16] James, *Making the European Monetary Union*.

In the aftermath of a big financial crisis, banking regulation is inevitably linked to implicit or explicit lender-of-last-resort functions and to resolution for failed banks. So there is also a significant fiscal cost, and that raises the same thorny political questions. In particular, what is the optimal unit for handling the resolution issue? The logic of possible bank workouts points to a desirability of larger banks and more cross-national banks as a risk-sharing mechanism. But the fiscal cost and the fact that only states can bear that cost push in the opposite direction, and have led in the past three years to a dangerous disintegration or renationalization of finance in Europe.

What is now termed a banking union – that is common European regulation with some fiscal capacity for resolution in the case of failed banks – is a very belated but necessary completion of the monetary union. Even this step is still uncertain, and excites a great deal of opposition from Germans who do not want to bailout south European banks. The critics have correctly identified the problem, that some sort of permanent fiscal mechanism is required in order to pay for the bailouts and thus in fact implies a move to a real political union which regularly redistributes resources.

Problems of transfers in a large unit are at the heart of the political process of building federations or federalism.

Integration had its own historical momentum, and if and when it goes into reverse, that process will also have a counter-momentum. The argument against European structures depends on hostility to a transfer union that might lead to some redistribution of resources. Why should our money be taken away and given out to people in a very different area? What sort of claim do those very different peoples have?

Look at the Pridnestrovian Moldavian Republic or Trans-Dniestr. This little unit with a population of half a million emerged in the early 1990s after the dissolution of the Soviet Union (population almost 300 millions), out of dissatisfaction with a Republic of Moldova (population 4 millions) that had separated in the 1940s from Ukraine (population 50 millions). Trans-Dniestr has its own government and parliament, army, constitution, flag, a rousing Soviet-style national anthem, and of course its nationhood would be incomplete without its own currency. This political entity is a precise counterpart in the political world to a well-known physical phenomenon of splintering or fissuring. When stressed, a big surface bifurcates in big chunks, but then the disintegration continues into smaller and smaller fragments.

Germans thinking about the likelihood of contemporary transfers to southern Europe doubtless also remember the story of German unification after the collapse of communist East Germany in 1989-90. There were massive transfers, and national resources were devoted to gigantic infrastructure projects, with new roads and railways. That was not enough to halt the hollowing out of East Germany, as many of the ablest and most entrepreneurial people moved out. The experience put enormous strain on the concept of national solidarity.

If European integration went into reverse, the outcome would not be a series of happy and prosperous nation-states, living in a sort of replica of the 1950s or 1960s. South Germans would wonder whether they are not transferring too much to the old industrial rustbelt of the north. The Bavarian journalist and politician Wilfried Scharnagl has recently produced a powerful book arguing that Bavaria should go it alone. Northern Italians who already support an anti-EU *Lega Nord* in "Padania" would definitely want to escape from the rule of Rome and the Mezzogiorno. Most dramatically, Artur Mas, president of the Generalidad de Catalyuna has called for a plebiscite on Catalonia's right to self-determination that sets his land on a confrontation course with the Spanish constitution and with the EU.

The better way of discussing transfers within a large and diverse political order is to think of them as individualized or personalized. In particular, a European-wide social security system would not only be a logical completion of the labor mobility requirements of the single European market. It would provide an important buffer in that booming areas would pay in more, and shrinking areas would draw out more – without these payments going through government bodies and appearing as transfers from north to south – whether in a country such as Italy or in the whole of the European area. Defusing the political problem requires less statehood, rather than necessarily requiring the erection of a European super-state.

Restraint is required for another reason. We know that a commitment to monetary stability is only possible in the context of governments that can credibly commit to a fiscal regime in which there is no long term build up of claims that cannot be funded through taxation - or in modern parlance, avoid fiscal dominance. That was a problem to which federal systems of the past were especially vulnerable.[17] Hyperinflation almost tore apart early 1920s Germany, with separatism in Bavaria, the Rhineland and Saxony. In late 1980s Yugoslavia, as the socialist regime disintegrated, the monetary authorities in Belgrade were closest to Serbian politicians such as Slobodan Milosevic and to Serbian business interests. The Croats and Slovenes wanted to get away. In the Soviet Union, inflation appeared as an instrument of the central Moscow bureaucrats, and more remote areas wanted to break away. A coherent and stable framework is needed to stop the proliferation of fiscal actions that destroy monetary stability.

Lessons

The unhappy marriage analogy for Europe's current malaise is helpful. Europeans may have thought they got married for the wrong reason: neighbors who have a quarrelsome or violent past are not always well advised to heal themselves by marrying. Then they convinced themselves that they had a unique relationship that

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[17] Thomas D. Sargent and Neil Wallace, "Some Unpleasant Monetarist Arithmetic," *Federal Reserve Bank of Minneapolis Quarterly Review*, 531, Fall 1981, pp. 1-17.

should not be interfered with by the rest of the world. The problem was that they didn't understand what marriage was really about, that they had exaggerated expectations of romantic marital bliss, but also and that a stable marriage is almost impossible when the surrounding society is profoundly unstable.

The Euro story is about the breakdown of governance mechanisms in the face of enormous financial claims. It holds broader lessons, for other countries and also for the United States.

Those lessons are not that different to those identified by then Governor Whitaker in 1968/9 thinking about threats to the currency in the *de facto* Irish monetary union with the UK: excessive credit creation, excessive income increases, and excessive public expenditure and borrowing. [18] Those lessons from the 1960s do not require much updating. Here they are in a twenty-first century idiom.

(1) Mega-finance is a danger to fiscal stability, because first it permits the easy financing of deficits, but also the development of the "excessive income increases." Its breakdown then requires large government funded rescues and raises the problem of fiscal sustainability.

(2) Fiscal sustainability in the long run requires some sort of politically negotiated agreement. That needs to be rule-based, but also to establish rules that permit flexibility as part of a strategy of immediate crisis response. Rules do not often constrain governments, so it is better to run stabilizers through non-government institutions.

(3) Without such flexibility sovereign bankruptcy becomes a disastrous and destructive event that uncontrollably generates contagion.

[18] Whitaker, *Interests*, p. 179

Though all the underlying problems have been around for a long time, there is always a temptation to do what Europeans did until the financial crisis, that is merely hope that with time the problems would vanish.

The management of cross-national problems and the containment of nationalistic quarrels certainly require technical fixes. But it also needs more. A politically legitimate mechanism for solving the problem of international adjustment was the unsolved problem of the twentieth century. In Europe and elsewhere it generated enormous conflict. Fixing that issue is a European but also a global agenda for the twenty-first century.