BRINGING STABILITY TO EUROPE

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- The European sovereign debt crisis is the result of capital flows across the single market.
- The danger that such capital flows could unleash market speculation was known from the start; indeed, the single currency was created to remove the threat of exchange rate instability.
- The problem is that the architects of the single currency did not consider the impact of capital market integration on the banking sector or on the relationship between banks and national governments.
- Once markets lost confidence in the security of their cross-border investments, investors began to pull back their capital and the internal market for financial services started to disintegrate.
- The creation of a banking union is part of the solution. However, the euro area also needs a common 'risk-free' asset to use as a safe haven in times of crisis.

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The European sovereign debt crisis has reached a turning point. European heads of state and government formed a monetary union to pair with the common market (or economic union – hence, economic and monetary union). In doing so, however, they failed to create any sort of fiscal union and they also failed to give the political union enough authority (or legitimacy) to act in case something went wrong. This worked well, but only for a while. Stresses accumulated in the form of excessive borrowing and wide differences in price and wage inflation across different parts of the single currency.

Shocks emanating from the collapse of U.S. housing markets subsequently cast Europe's single currency into crisis. Banks failed, governments borrowed, and bond markets went into a rout. European leaders first decided to form a kind of fiscal union (compact, six-pack, two-pack) but then realized they needed a banking union as well. Unfortunately, such proposals lacked the legitimacy that only a political union could entail. Failing that, the monetary union might fall apart taking the economic union along with it. This leaves Europeans with an unenviable choice. Either they embrace many unions at once, or they may find themselves with no union at all.

The purpose of this briefing paper is to show how Europe's many unions might contribute to a more stable situation. The paper has six sections. The first introduces the economic union at the heart of the European project and shows the connection from economic union to monetary union. The second suggests why a banking union was overlooked and a fiscal union was ignored. The third considers the idea of a narrow political union as a problem of both rules and political discretion. The fourth shows how it worked during the 1990s and early 2000s. The fifth explains how it resulted in a sovereign debt crisis. The sixth offers a plan of action to bring this crisis to an end.

From Economic Union to Monetary Union

The argument begins in the 1980s. The '1992 project' focused primarily on the elimination of non-tariff barriers to trade through the promotion of a new approach to technical harmonization and standards. It also embraced the fundamental principle that goods, services, labor and capital should be able to move freely across the European marketplace. The goal was to help Europeans compete globally and so enhance prosperity and welfare for all countries involved in the project.

This idealistic vision entailed risks. Goods should not trade freely to the detriment of national health and safety standards. The trade in services should not be allowed to undermine standards for training and quality either. Labor mobility should not shunt the burden of unemployment or other social benefits from one country to the next. And capital flows should not give rise to destabilizing speculation.

The point about financial speculation was particularly important. The breakdown of the Bretton Woods arrangement brought unexpected volatility to international currency markets that scarred European economic performance. Hence, policymakers made successive attempts to broaden the zone of monetary stability. Ultimately, from about 1983 onward, they managed to stabilize currency markets by coordinating macroeconomic policy around Germany as a role model.

This convergence on Germany stabilized European currency markets, but it could not withstand speculation. Hence, any increase in capital mobility risked undermining what the leaders had accomplished. Tomaso Padoa-Schioppa's reflection group made this point explicitly in April 1987:

> The institutional fragility of the European Monetary System (EMS) will be tested in fundamental ways by the process of removing exchange controls, as envisaged in the White Paper (on the completion of the internal market). The degree of convergence of inflation rates and coordination of monetary policies will have to be raised to a very high standard, if the present exchange rate regime is not to be destabilized.[1]

The Padoa-Schioppa group considered three responses – maintain the fixed-but-adjustable exchange rate regime at the heart of the EMS, loosen currency pegs to allow exchange rates to float more

1 'Efficiency, Stability and Equity: A Strategy for the Evolution of the Economic System of the European Community' (Brussels: Commission of the European Communities, II/49/87, April 1987) p. 62. This document will be cited as the 'Padoa-Schioppa Report' in further notes.

freely in the marketplace, and tighten the system of fixed-but-adjustable exchange rates by introducing closer monetary policy coordination. The first option was impractical given the increase in the potential for speculation as capital markets became more integrated. The second would have caused more harm than good as exchange rate volatility threatened to undermine the trade in goods and services. Hence, the Padoa-Schioppa group concluded that 'the third option – stronger EMS mechanism coupled with strengthened monetary coordination – is the course to be followed if the basic performance of the EMS is to be preserved as capital movements are liberalized'.[2]

The Padoa-Schioppa group stopped short of calling for a monetary union, the reason being that the group was 'essentially concerned with minimum changes required successfully to implement, and benefit from, full economic and financial integration in an enlarged Community by the year 1992'. Nevertheless, the group acknowledged that:

> In several respects, the monetary union is the first best solution from an economic point of view, because it offers two main advantages compared with an EMS-type exchange rate system. Firstly, the absence of exchange rate uncertainty fosters integration and rationalization of economic activity. Where uncertainty exists, businesses require a higher rate of return on investments that will serve the union-wide market. Secondly, with countries no longer able to pursue accommodating monetary policies, private agents will be much less tempted to seek price and wage increases in the belief that the possible repercussions will be offset through devaluation, and fiscal authorities will be subject to a tighter capital market constraint.[3]

European Commission President Jacques Delors provided the first blueprint for the euro soon after the Padoa-Schioppa report was published.[4] This blueprint took most of the concerns raised by the Padoa-Schioppa group into account. Specifically, the Delors plan called for a program of nominal convergence to tighten the coordination in monetary policy across countries and to help reconcile existing differences across countries in public debts and deficits.

Neither Banking Union Nor Fiscal Union

The Berlin Wall fell after the release of the Delors report. As a consequence, the debate about European monetary union got caught up in larger concerns about German unification and the fate of Europe. When politicians turned their attention to the single currency, it was always part of a wider political project. Nevertheless, the wider political context within which the monetary union was launched had little impact on the design of the single currency. A few questions of timing and character were resolved only once the dust began to settle following the collapse of communism. But most of the main features reflected the conventional wisdom spelled out in the Padoa-Schioppa report.

Cross-border banking and other financial services were only tangential to the debate. While the architects of the single currency argued that the movement of capital across national boundaries militated in favor of monetary integration, they did not claim that cross-border financial institutions should be treated any differently inside or outside the monetary union. Instead, they handled these issues as part of the internal market in a manner that reflected the decentralizing ethos embedded in the new approach to technical harmonization and standards. The idea was to do the minimum necessary to ensure that banks and other financial services could be permitted to do business across national boundaries 'on the basis of the principle of mutual recognition and "home country control".'[5]

This attitude derived from a commitment at the heart of the theory of optimum currency areas that factor market integration across countries weakens the case for national currencies and flexible exchange rates and eases the problem of adjustment within a common currency. The potential significance of cross-border banking or insurance

2 Ibid. p. 98.

3 Ibid. p. 106.

4 'Report on Economic and Monetary Union in the European Community' (Brussels: Commission of the European Communities, April 1989).

5 'Padoa-Schioppa Report' p. 46.

in terms of union-wide prudential oversight or systemic risk lay outside the scholarly debate. Hence, it lay outside the architecture for the single currency as well. The Maastricht Treaty made it possible for the European Central Bank (ECB) to play a role in bank supervision, but built on the presumption that cross-border banking and financial services would remain under home-country control.

Meanwhile, European political leaders rejected the idea of fiscal union as too controversial. Instead they focused attention on fiscal convergence and the prohibition against running excessive deficits. This prohibition fits with the goal of maintaining price stability; excessive deficits are inflationary. The prohibition against excessive deficits is also important for preserving the macroeconomic autonomy of the member states. The more heavily a government is indebted, the less room it will have to use fiscal policy to stimulate the economy in a downturn. Hence, governments should pay down their debts and rein in their deficits so that fiscal policy could be available for aggregate demand stabilization within the single currency.

Neither the Maastricht convergence criteria nor the subsequent stability and growth pact constrained public expenditure as a percentage of gross domestic product, nor did they prohibit deficit spending during periods of duress. What they offered were benchmarks for consolidation and guidelines for indebtedness. Critics of this approach have been quick to suggest that it is an inadequate alternative to fiscal solidarity across the union as a whole. Supporters counter that fiscal convergence is less likely to engender conflict than fiscal transfers.

The empirical evidence offered by the critics of the Maastricht Treaty was debatable. Although some estimates showed that U.S. common fiscal institutions offered significant income stabilization across regions, other estimates showed less influence and some even demonstrated perverse effects. The empirical evidence offered by supporters of the European approach to fiscal convergence as opposed to common fiscal institutions was robust. Conflict over inter-regional transfers is evident in virtually every federal system and in a few unitary countries (like Italy) as well. Conflict over net contributions from the member states to the European Union is even more apparent.

Political Union

The question that bedeviled the architects of the single currency was the relationship between monetary union and political union. The Maastricht Treaty sowed the seeds for two different conceptions, one broader and the other narrower. The broader view is found in the debate about European identity and citizenship. This is a notion of political union that assigns rights (and responsibilities) not only to the EU member states but also to the European citizens. These rights include, for example, freedom of movement as well as political access and social protection. The underlying aspiration is to lay the foundation for greater democratic legitimacy to accrue to the European Union as a whole. The narrower vision focuses on those elements of political union that were seen necessary to sustain a single currency. This is the notion of political union that the German constitutional court emphasized in its October 1993 ruling on the Maastricht Treaty. Having decided that a true European democracy does not yet exist, the court looked for patterns of democratic legitimacy that could sustain a more limited European construct.

There are essentially three ways to understand the problem. Political union can be a collection of norms or values shared across those countries that participate in the project. It can be a framework of rules that member states must accept as a condition for participation. And it can be a collection of institutions for the member states to use when making decisions about the management of the project as a whole.

The political union that European heads of state and government promoted was a mixture of shared norms and values reflected in commonly accepted rules. The Maastricht convergence criteria are a good example. Three of the criteria set rules for price inflation, nominal exchange rates, and long-term interest rates that measure convergence around the norm of price stability. Governments must show that they are able to keep inflation in check, that they can convince the markets that national performance will not differ from other countries, and that they are committed to this goal over the long term. The other two Maastricht convergence criteria focus on rules to avoid excessive deficits and to take the politics out of central banking. The stability and growth pact only strengthened the mechanisms for

enforcing European commitments while at the same time adding new rules to the mix.

What the architects of the single currency left out was political discretion – meaning the ability for European political leaders to choose between competing objectives. Indeed, the Maastricht Treaty makes it clear that any discretion over the management of the single currency must be held outside politics. Not only are the member states enjoined from trying to influence the conduct of monetary policy, but the ECB also has the power to define its own mandate. Indeed, the lack of political discretion extends across the framework for policy coordination. Hence the treaty provided procedures for enforcing the rules against excessive deficits but it did not provide procedures for setting the rules aside.

The absence of political discretion was by choice and not omission. It reflects a German bias for rule-based economic systems. It also reflects the fact that macroeconomic policy choices are contentious. Rather than create institutions to channel this conflict up to the European level, the architects of the single currency sought to manage macroeconomic policy conflict within the member states. The role of European institutions – like the ECB – was to create a stable environment within which national debates over macroeconomic policy could take place. Political union exists in the framework of norms, values, and rules that promote stability. Political union does not extend to choices about amending or suspending this framework.

Before the Crisis

The completion of the internal market had an impact long before monetary union could begin. Cross-border capital flows shattered the fixed-but-adjustable exchange rate mechanism first in 1992 and then again a year later. The results were not the same everywhere. The United Kingdom (and Denmark) abandoned any pretense of joining the single currency; other countries like Ireland, Italy, and Spain redoubled their efforts to achieve membership. Even Greece began to position itself as a candidate for membership.

Once the turmoil in European currency markets subsided, capital began to flow across countries. The easiest way to show this is to look at two different measures of variation – the standard deviation across long-term sovereign debt instruments and the standard deviation across current account performance as a percentage of gross domestic product. A fall in the variation across national interest rates implies a convergence in the price of capital across countries. A rise in the variation of current account performance implies a movement of capital from countries with surplus savings to countries with greater opportunities for investment. Both of these movements started in the early 1990s and stabilized by the end of the decade. They reflect the influence of the liberalization of capital markets and an explicit objective of the 1992 project.

The launch of the single currency took place at the end of this process and the effect varied from one country to the next. It provided an anchor for countries like Greece that had struggled to hold off distributive conflict. Hence Greece lost twice as much competitiveness in the 1990s as it lost in the 2000s – and it experienced no increase in relative real unit labor costs once the single currency was in place. But for countries like Ireland or Italy that forged a broad social partnership in order to achieve the goal of participation, the single currency created an excuse to relax. Both countries surrendered some of the gains in competitiveness they had made in the 1990s as workers struggled to recapture foregone wage increases.

Much has been made of the relative competitiveness gains that Germany has experienced since the introduction of the single currency in the early 2000s. However, a longer analysis shows that this is exaggerated. Germany lost much ground immediately after the country's unification at the start of the 1990s and recovered again after the reforms introduced at the start of the 2000s. Meanwhile the countries on the periphery of the euro area never suffered a dramatic loss and so never required an equivalent recovery.

The implications can be seen in the comparison between levels of manufacturing employment in Germany and in the peripheral countries of Portugal, Ireland, Italy, Greece and Spain (PIIGS) during the period from 1991 to 2007. Both Germany and the PIIGS countries started out with roughly 10 million manufacturing workers in the early 1990s; by the mid-to-late 2000s, the PIIGS countries still had

roughly 10 million manufacturing workers while Germany's manufacturing labor force had fallen to 7.5 million. Moreover, the difference is not due to relative labor market rigidities. Over any 17-year period, roughly 40 percent of the manufacturing labor force moves into retirement; in the PIIGS countries those retired workers were replaced.

A similar point can be made in reference to export market shares. Germany is a much larger exporter at the world level than the PIIGS countries combined. Nevertheless, it is possible to index their relative market shares to compare performance over time. If 1991 market shares equal 100, Germany's share of the world market was down to 82 in 2007, having recovered from a low of 75 in 2000. In 2000, the PIIGS still had 92 percent of their 1991 world export market shares; by 2007 that figure had fallen to 85 percent. Germany showed improvement under the euro and PIIGS performance worsened, but the PIIGS countries still come out ahead.

The combined influence of capital market integration and a common currency was mixed. The peripheral countries were more productive and competitive than they would have been without access to foreign sources of capital but their business models were contingent upon having access to cheap finance. Meanwhile, the prices of many assets in peripheral economies were overinflated by the surge in foreign demand for everything from government debt and commercial real estate to bank deposits and consumer finance. The interdependence was evident in the European core as well. The banks in Germany and elsewhere were heavily exposed to peripheral country assets even as German manufacturers were dependent upon access to peripheral country markets.

During the Crisis

The tipping point came when investors started to worry about the safety of their investments. The shock came with the collapse of Lehman Brothers in September 2008. Two countries were at the forefront: Ireland and Greece. The Irish government struggled to stabilize its banks; the Greek government struggled with its finances.

The Irish banks had assets under management far larger than the country's gross domestic product (or the government's tax base). Many of those assets were exposed to losses in commercial property markets in Ireland and some even to mortgage paper or derivatives in the United States. Nevertheless, the Irish government decided to stabilize the banks by guaranteeing the liabilities of the Irish banking system. Investors holding Irish sovereign debt instruments saw the government's debt-to-GDP ratio increase from 25 percent in 2007 to 44 percent in 2008 – with clear signs of a steep upward trajectory.

The onset of the Greek case was more unexpected. The Greek government announced an upward revision for its annual deficit in October 2008. Although the revision was small, the timing was bad. Investors spooked by Lehman Brothers reacted strongly. The difference between Greek and German long-term sovereign debt yields jumped from 89 to 165 basis points (or one-hundredths of a percent) across the month of October and capital started to flow out of Greece on an unprecedented scale.

The situation stabilized in early 2009 after German Finance Minister Peer Steinbrück made an explicit commitment that euro area countries would not be allowed to go bankrupt. It worsened again in March 2010 when German Prime Minister Angela Merkel insisted that aid to member states would only come as a last resort. In between those two episodes, Greece held national elections in October 2009 and the government changed over from center right to center left. That changeover brought the Greek crisis to popular attention because the incoming Pasok government restated the government's accounts again, increasing the deficit much more significantly. However, the market reaction was muted: the yield on Greek long-term sovereign debt instruments remained roughly unchanged and capital actually flowed into the country, not out.

The failure of the Greek government to contain its finances was important for financial markets to the extent to which it threatened the principle of cross-border investments. While investors could believe that Greece would be bailed out, it was reasonable to worry more about Ireland where the scale of the government's commitment to the Irish banking system was hard to imagine. Once it became clear that Greece would not be rescued, however, investors had good reason to switch their attention. Greek sovereign debt markets collapsed in April 2010, forcing the Greek government to request a European

bailout. When Chancellor Merkel began talking about the need for private sector involvement in re-profiling Greek sovereign debt obligations, the fear spread from Greece back to Ireland – pushing the Irish government to request a bailout of its own. Then when the first Greek bailout proved inadequate, the contagion spread to Portugal.

From one episode to the next, the crisis has been defined by the level of investor confidence and the flight of capital from the periphery of the euro area back to the core. In this sense, the speculation that used to plague currency markets now haunts the markets for sovereign debt. The first victims were countries that were heavily indebted to other parts of Europe, like Ireland, Greece and Portugal. However, the crisis soon engulfed countries with little net foreign exposure. Belgium narrowly escaped an implosion of its sovereign debt markets by bringing its historic political crisis to an end; Italy experienced a similar narrow escape by replacing Silvio Berlusconi's center-right government.

After Italy moved out of the spotlight, investor concern focused on Spain – which was more like Ireland than Greece. The Spanish government had solid finances; its weakness was its banks. The Spanish government did not commit to underwrite the whole of the country's banking system but it did commit to provide sufficient resources to stabilize the systemically important smaller banks. In turn, such commitments undermined investor confidence in Spanish public finances. Hence the country has experienced a massive flight of capital abroad. This resulted in a series of pronouncements – by the European Council in June 2012 and by European Central Bank President Mario Draghi, both in late July and early September. The goal of these messages was to reassure the investment community that the crisis could be contained. So far the results have been positive but this optimism may prove only temporary.

Making the Crisis Go Away

The solution to the crisis is to restore confidence in cross-border investments in order to stabilize the functioning of the internal market. That confidence will not be enhanced if the single currency is taken away. The result of such an action would only be to restore the old concern about destabilizing speculation – the status quo ante of the early 1990s. Even the loss of one participant from the single currency would make it harder to reassure the markets that the others are there to stay.

The creation of a banking union would do much to improve the situation. The main lesson from the crisis is that monetary integration strengthens the interdependence across national banking systems and between national banking systems and government finances. The arrangement is only as strong as the weakest link in the chain. Hence it is necessary to create institutions for system-wide reinforcement. This is what current European Commission proposals for common euro area banking supervision, deposit insurance, and banking resolution are meant to achieve. These institutions are necessary to stabilize the overlap between economic union and monetary union. They were not recognized as important when the single currency was originally created; they are clearly important today.

Such a banking union does not require a fiscal union. The institutions for deposit insurance and banking resolution should draw resources directly from participating banks just as the banks themselves draw profits from doing business across the internal market or from doing business with private sector actors whose own prosperity is enhanced by the existence of an integrated European marketplace. The free movement of goods, services, labor and capital means that banking and other financial institutions are 'national' only in name.

A European fiscal union incorporating increasingly powerful common fiscal institutions and possibly fiscal transfers remains too controversial. It is also unnecessary. Most of the damage done to peripheral economies during the crisis comes from the rapid reversal of capital flows across the single market and the requirement for national governments to bail out the banks.

The sudden unwinding of cross-border investments also jeopardized countries like Italy which, while heavily indebted domestically, had little net foreign borrowing. The reason is not the size of the Italian debt market, but the large foreign holdings of Italian sovereign debt. A European fiscal union would not address this type of exposure. Instead it would create highly visible patterns of redistribution from countries that repatriated their investments

abroad (like Germany) to countries that suddenly experienced a run on domestic deposits (like Italy or Spain).

There is, however, one fiscal institution that could help to channel volatility in international capital markets into less damaging pathways during the flight to safety. The creation of a common 'risk-free' asset that could trade equally across all euro area countries would make it possible for investors to move their capital to safety without crossing national boundaries. This would prevent the sudden evacuation of liquidity on the periphery of the euro area and it would also prevent the inundation of capital back into the core. The simplest way to construct this risk-free asset in quantities sufficient to play the role of safe haven for capital across the euro area as a whole would be through the use of common (or mutual) sovereign debt obligations across euro area countries – 'eurobonds'. There are already proposals on the table to prevent such eurobonds from creating moral hazard. The challenge now is to build consensus around implementation.

This is where discussion inevitably turns to political union. Up to now the single currency has rested on a union of norms and values that are embedded in common rules for good behavior. New institutions will necessarily expand the political union on both fronts – by introducing shared notions of acceptable banking risk and common risk for sovereign debt obligations, for example. This has also reoriented the debate towards the broader vision of political union, perhaps leading to a strengthening of the EU's representative institutions.

What is unclear is whether either a banking union or common sovereign debt instruments make it necessary for the single currency to create new institutions for exercising political discretion over macroeconomic policymaking. My belief is that they do not. The euro exists to serve the common market. A banking union would help underpin both the common market and the euro. Common debt obligations would strengthen the collection of institutions – common market, single currency, banking union – as a whole. Within this tight area of overlap of unions, the euro area can continue to function without politicizing macroeconomic policy. Indeed, the single currency would be more stable if conflicts over macroeconomic policy could be managed at the member state level.

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