

Monetary integration in crisis: how well do existing theories explain the predicament of EMU?

Transfer
19(1) 37–48
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DOI: 10.1177/1024258912469345
trs.sagepub.com



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Summary

Three theories or rationales can be invoked to explain the formation of the monetary union as well as its policy architecture. One sees its rationale as forming an optimal currency area, another as making macroeconomic policies credibly stability-oriented and a last one as overcoming collective action problems of mutually beneficial policy coordination. Each theory also implies an explanation for why the euro area is in crisis now. The article contains a critical assessment of these theories, with a view to how they have informed crisis management of the euro area but have also failed so far to stabilize the monetary union effectively.

Résumé

Trois théories ou logiques peuvent être invoquées pour expliquer la formation de l'union monétaire ainsi que son architecture. On peut considérer que sa logique s'articule autour de trois axes : la formation d'une zone monétaire optimale, l'établissement de politiques macroéconomiques crédibles axées sur la stabilité et la recherche de solutions aux problèmes d'action collective de la coordination mutuellement bénéfique des politiques. Chaque théorie implique également une explication des raisons pour lesquelles la zone euro est aujourd'hui en crise. L'article contient une approche critique de ces théories, en évaluant la manière dont elles ont traité la gestion de la crise de la zone euro, mais sans jusqu'ici stabiliser l'union monétaire de manière efficace.

Zusammenfassung

Um die Währungsunion und ihre politische Architektur zu erklären, kann man drei verschiedene Theorien heranziehen. Die eine sieht die Logik einer Währungsunion darin, einen optimalen Währungsraum zu schaffen; die andere sieht ihr Ziel darin, für eine glaubhafte Stabilitätsorientierung der Wirtschaftspolitik zu sorgen; und nach der dritten Theorie dient eine Währungsunion der Überwindung von Problemen kollektiven Handelns bei der Koordinierung von wechselseitig nutzbringenden Politiken. Aus den verschiedenen Theorien lassen sich auch verschiedene Erklärungen dafür ableiten, weshalb sich die Eurozone momentan in einer Krise befindet. Der Beitrag unterzieht

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diese Theorien einer kritischen Bewertung und untersucht, wie sie zum Krisenmanagement in der Eurozone beigetragen haben und weshalb es ihnen bislang nicht gelungen ist, die Währungsunion tatsächlich zu stabilisieren.

Keywords

Crisis, economic theory, euro, monetary integration, optimal currency area, policy coordination

Introduction

The creation of the monetary union of Europe was a political decision, taking shape over several years in a grand bargain. In the course of this process, policy-makers tried to find an economic rationale for this unprecedented exercise of monetary integration to assure the wider public that EMU would bring tangible gains in prosperity. The crisis has raised doubts about the wisdom of this truly historical decision to introduce one currency for a group of sovereign democracies at different levels of economic and institutional development. It thus seems to be the right time to review the economic rationales for EMU and its governance, i.e. the rules and mechanisms that would govern policies in the common interest.¹

There is first the theory of optimal currency areas concerned with flexibility and effectiveness in the adjustment to shocks. This theory was developed in the 1960s when trust in the ability of governments to steer economies effectively was still considerable. This literature asked specifically what could be needed before one could recommend giving up exchange rate changes as a tool of macroeconomic stabilization. The second theory by contrast originated in a critique of activist government intervention such as exchange rate management (and of theories recommending it). This optimal control theory is concerned with credible commitment, i.e. the ways by which promises of monetary and fiscal authorities to pursue or refrain from particular policies can be made binding. Giving up the exchange rate and delegating price stabilization to a supranational independent central bank is a radical way of keeping the promise of non-inflationary policy. Last but not least, the theory of (second-best) policy coordination does not deal so much with the question why one may or may not found a monetary union but what it takes in terms of cooperation between policy-makers once it exists. Sharing a currency creates more interdependencies that can be positive (e.g. easier trade) and negative (e.g. faster transmission of price increases). The theory asks what institutions of policy coordination can help to make every member take into account the effects of interdependence in their own policy actions and how the union as a whole can reap the benefits of diversity.

This article stresses the differences between the three approaches because they seem to me largely incompatible in their assumptions and policy conclusions. Alternatively, one can take the valid points of each, as does the standard textbook of De Grauwe (2012), and synthesize them in a single theory of monetary integration. Each theory is dealt with in turn in the first three sections of this article. In each section the theory is first outlined, then I tease out its implicit explanation for the euro area crisis and some evidence how the respective theory informs crisis management and longer-term reforms. Finally, I critically discuss how well the euro area crisis can be explained by

1 EMU, i.e. the acronym for Economic and Monetary Union, is here used synonymously with monetary union even though, strictly speaking, EMU also alludes to the internal market.

these approaches. I conclude the article with my assessment of the economic and political underpinning for these rationales of EMU.

Monetary integration as the creation of an optimal currency area

The theory of optimal currency areas (OCA) originated in a thought experiment by the mainstream Keynesian economist Robert Mundell (1961): if the exchange rate between two countries is ‘irrevocably fixed’, what can substitute for this loss of an adjustment mechanism when a shock hits the economy or business cycles between regions are not fully synchronized? Mundell’s own answer was that labour mobility and/or real wage flexibility can substitute for the loss of flexible exchange rates. Others followed him in developing what became known as ‘OCA criteria’. McKinnon (1963) changed the question slightly to: when is the exchange rate as an adjustment mechanism redundant? His answer was that open and/or small economies can do without flexible exchange rates with their main trading partners because they have to adapt to world market conditions anyhow. Kenen (1969) gave an answer to both questions in that he stressed that similarly diversified production structures make the integrated areas less susceptible to idiosyncratic (‘asymmetric’) shocks for which they may need exchange rate adjustment. In the absence of this similarity, the sub-optimal currency area needs fiscal transfer mechanisms to help the region that is hit harder by a shock to get out of its slump. These three articles make up the core of OCA theory. But in light of the EMU experience, it is worth mentioning a fourth contribution to this literature, namely Fleming (1971). He stressed that if currency areas fix the exchange rate between them, they must have similar policy preferences as regards inflation; one can see a justification of the Maastricht process in this.²

This early vintage of OCA theory treated the loss of the exchange rate as a cost that had to be compensated while the gain would be saving on transaction costs. This old, fairly mechanical, version has another renaissance these days, for instance in Krugman (2010). He has a point when he gives Milton Friedman, a stern advocate of flexible exchange rates, some credit for inventing OCA theory. The older vintage made giving up the exchange rate appear to be a costly exercise, and it is not unreasonable to infer this economist’s favourite message, namely that price flexibility is best, from this literature.

The reason for the comeback is obvious: this theory told us all along that the European monetary union is not an OCA. But then, no country in the world is.³ Neither the US nor the European monetary union are small open economies. Even the United States has too little labour mobility to compensate for shocks to economic activity as effectively as the tax-transfer mechanism between the central budget and the states. Flexibility of real wages in European Member States is typically lower than elsewhere but it also differs widely. Some small and/or open economies do well, some were among the first in serious trouble. But nobody would therefore suggest that ‘northernness’ is an OCA criterion; after all, Germany is not more northern than Ireland. The lack of labour market flexibility is invoked *ad nauseam* by analysts of the crisis, yet labour markets had nothing to do with any conceivable cause of this crisis. Ireland should not be in trouble if conventional labour market flexibility would have helped, the Spanish labour market has proven frighteningly flexible as far as firms’ shedding of their workforce is concerned while Germany has done well out of its massive subsidies of labour hoarding. Even a lack of competitiveness cannot

2 See also De Grauwe (1975) who formalized this argument in a simple Phillips curve framework.

3 Another Chicago boy (and LSE lad), Harry Johnson (1969), sensed the absurdity of the thought experiment to see a ‘problem’ of optimization in the existence of currency areas.

be invoked so easily because an economy with low labour productivity is simply poor but not bankrupt without somebody financing the current account deficits over some time. Only Kenen's criterion of a fiscal transfer mechanism held up in my view, although it may be unnecessary at this stage.⁴

In any case, the latest popularized formulation of OCA theory was the so-called 'endogenous' version. It started from the insight that had taken hold since the mid-1970s that economic mechanisms change under the impact of policies applied to them, for instance because economic actors anticipate these policies. In the case of a currency area, this would be the expectation of exchange rate stability. In its most optimistic guise, this endogenous version promised that the monetary union would become an ever better currency area simply by forming one. This is mainly because of closer trade integration that leads to more synchronized business cycles or more similar production structures if intra-industry trade dominates, which is usually the case between OECD countries (Frankel and Rose, 1998). The underlying mechanism is that most mature economies engage in intra-industry trade (sell cars to each other rather than cars against wheat, the latter being inter-industry trade). As all expand trade with each other, all develop equally diversified production structures that are susceptible to similar cyclical swings and external shocks (say a rise in the oil price); exchange rate adjustment thus becomes ever less relevant.

This endogenous theory can provide an explanation for the crisis only in the pessimistic version of Krugman (1993). His 'lessons of Massachusetts for EMU' tell us that a currency area could also become endogenously sub-optimal. Integration may lead to geographical concentration of certain economic activities, which could make regions more vulnerable to asymmetric shocks. However, the US dollar should then also be in trouble, yet the drama of California is quite different from the tragedy of Greece (Henning and Kessler, 2012: 12–15).

Finally, there was an instrumental version of OCA theory that could be used to justify certain policy processes of the EU, in particular Luxembourg and Cardiff. This version conceded that EMU may not be an OCA but suggested that it could be optimized through structural reforms of labour and product markets. The original Mundell argument, of real wage flexibility as a precondition for an OCA, was thus turned on its head: rather than being an OCA at the beginning, Member States must implement deep institutional reforms in order to become an OCA. The Europe 2020 strategy and the Euro Plus Pact invoke exactly this logic of monetary integration as a reform lever.

But again, labour and product markets, reformed or not, did not cause the euro area crisis. This cannot be changed by European summits reiterating the mantra of more structural reform or newspapers quoting repeatedly Eurogroup President Juncker that governments ('we') know exactly what to do but don't know how to get re-elected once they've done it. The reforms that governments have engaged in over the last two decades are concerned with the ongoing modernization of welfare systems and restraining their own dynamic of social expenditure, rather than with governing EMU. This was revealed by then French and EU European Council President Sarkozy who in one of his first big speeches after the collapse of Lehman Brothers declared the introduction of Sunday opening hours to be of crucial importance for adjusting to the crisis. It became obvious to voters that his government did not know what to do and he did not win re-election.

To sum up, OCA theory in whatever form is in my view useless for understanding the big issues facing EMU. The theory gives no relevant guidance on the economic governance of a real currency area in contrast to a mythical OCA and it provides no explanation for the specifics of the euro area crisis.

4 We come back to Kenen's criterion and why it holds up in the section on policy coordination.

Monetary integration as benevolent tying of governments' hands

The second theory underpinning EMU is optimal control theory, better known as: 'the advantage of tying one's hands'. This is the memorable title of an article by Giavazzi and Pagano (1988) on why Italy joined the European Exchange Rate Mechanism. The path-breaking articles of Kydland and Prescott (1977) and Barro and Gordon (1983) thus found their European destination and application.

The phrase nicely sums up what was arguably the idea underpinning much of the policy framework of EMU: governments committed strongly and ostentatiously to price and exchange rate stability in the macroeconomic management of national economies even though most of them were not able to sustain such stability before. The theory suggests that such commitments are self-enforcing because in a world where electorates know the preferences and constraints of their government, an administration cannot gain from pump-priming the economy into inflationary growth. To be precise: it is part of the model that stimulus programmes of governments can only lead to inflationary growth and hence it is also part of the rational expectations of the electorate. Voters therefore do not believe any statements according to which the government is committed to price stability, as long as the administration (including the central bank) can manipulate its constraints on policy-making, in these models represented by the expectations-augmented Phillips curve. In other words, this manipulability of the constraint on policy-making is what creates inadvertently a credibility problem in optimal control theory. Delegating monetary policy to an independent supranational agency or subjecting oneself to fiscal rules were ways for euro area Member States to credibly commit to the 'sound finance-sound money' paradigm underpinning the monetary union.

In contrast to OCA theory, this rationale for EMU gives rather precise instructions on how economic governance of a currency union should be operated.⁵ It also provides a possible explanation for why EMU is now in crisis: the Stability and Growth Pact is seen as a grand failure because its headline figure of any deficit ratio above 3 per cent being excessive was broken early on by its champion Germany, thus fatally undermining its status as a nuclear deterrent to profligacy. Nor has the Pact prevented Greece or Italy from pursuing budgetary policies that made them vulnerable to sudden capital flow reversals.⁶ Moreover, the proponents of a disciplinarian policy framework would see the ECB's bond buying under the Security Markets Programme as succumbing to exactly the pressure that the no-bailout clause in the Maastricht Treaty was meant to prevent: the central bank bought the bonds of delinquent fiscal authorities from banks in order to stabilize the euro. The Fiscal Compact that was drawn up to harden the Pact is obviously taking its clues from this diagnosis, for instance with a debt brake that is hard-wired into domestic law or even constitutions. It is an attempt at tightening the fiscal rules, at making fiscal surveillance even more intrusive and sanctions quasi-automatic, in order to prevent that the ECB will ever again be put in a situation where it has to replace the missing fiscal authority for EMU as a whole.

5 One might argue, as one astute referee of this article did, that the instrumental version of OCA theory and this optimal control theory are related. Both theories commit governments to institutional changes although they look at very different institutions. Both also blame failure to stick to these commitments as causes of the crisis although it is failure to reform labour and product markets in one and failure to comply with fiscal rules in the other theory. There are scholars who subscribe to both theories although I wonder how consistent it is to support social engineering as in instrumental OCA theory and nurture deep suspicion of governments as in optimal control theory simultaneously.

6 In Italy, the problem was not so much the annual budget deficit – its primary balance tended to be in surplus – but extremely short-term financing of public debt so as to pay lower interest rates.

At least in one respect the architects of the original Pact and now the Compact (more precisely: the fiscal part of the so-called Treaty on Stability, Coordination and Governance) deviate from the theory in that they never trusted in the self-enforcing nature of fiscal rules and added the threat of pecuniary sanctions. What this lack of confidence in rational expectations means is that the EMU architects cannot invoke fiscal rules as viable governance instruments in a decentralized union of budgetary authorities. Without rational expectations that make market actors punish governments reliably and predictably, the fiscal rules turn into instruments of hierarchical, quasi-federal governance. This amounts to an attempt at creating a divisive political union without fiscal union. Yet, as long as there is no *quid pro quo* in terms of budgetary rewards to the sub-federal entities, compliance problems will abound. Domestic budget politics can then easily bring about an EMU crisis. The Netherlands provided a glimpse into this brave new world of close fiscal surveillance in April 2012 when a coalition government collapsed over disagreements on an austerity budget. It brought even this traditionally compliant polity to the point of openly defying EMU rules although a newly formed coalition prevented this from occurring (van Daalen and Mock, 2012).

The diagnosis of optimal control theory of what caused the euro area crisis is less in line with the facts than the constant references to it suggest. It ignores that EMU has delivered exactly what the proponents of this credibly stability-oriented framework wanted it to deliver, namely price and exchange rate stability in the context of moderate growth. The proponents should therefore explain why meeting the magic thresholds of 3 per cent deficit and 60 per cent debt ratios would have made all the difference. Belgium has met neither of these rules over recent years and is left alone by financial markets almost three years after the downgrading of Greek government bonds in December 2009. The proponents should further explain why low inflation overall but price flexibility in fast-growing parts of the Union did not work the wonders of efficient markets. Price and wage stability was their sole focus while nothing in this macroeconomic theory would alert us to the problem of regional asset price bubbles even in a low-inflation environment, furthered by the pro-cyclical movement of real interest rates. Finally, one would like to know how it is possible that countries with above average inflation rates experienced high real growth over several years if any inflation rate above the ECB's 2 per cent target is so detrimental. The crisis can hardly be interpreted as an indicator that markets finally woke up to this problem: severe crises have befallen those with high growth (Greece, Ireland, Spain) and those with low growth (Portugal, Italy), those with prudent fiscal positions (Ireland, Spain) and those with unsustainable ones. All this should not happen nor play any role if all that was needed for a viable monetary union was credibly constraining fiscal authorities.

Monetary integration as mutually beneficial policy coordination

The third rationale of EMU is that governments wanted to gain additional degrees of freedom for macroeconomic stabilization. The currency union eliminated the exchange rate as a constraint on national policies and coordination itself can be seen as an additional instrument for domestic stabilization. This theory goes back to a flourishing literature on international macroeconomic policy coordination after the breakdown of Bretton Woods (Hamada, 1977).⁷ A current account balance is easier to correct for each country if other trading partners adjust as well; an orderly devaluation of a currency easier to achieve if the central bank of the main creditor country assists and buys some of the currency under pressure. Given that this theory was developed when exchange rate instability

7 For an overview and application to EMU see Hughes Hallett et al. (1999).

became a serious policy concern, the exchange rate is not a priori taken as an effective instrument of macroeconomic policy. It is seen as an asset price that itself may have to be stabilized, reliably so only with the help of other currency areas (Schelkle, 2001: 117–138). The literature on speculative currency attacks that started with Krugman (1979) drove home this message that is ultimately the result of a somewhat esoteric evolution in the conceptualization of exchange rates, namely from a (relative) price of traded goods to an asset price of another currency or a currency portfolio. The theory of policy coordination can explain why governments were ready to give up the exchange rate: it was not a cost but a benefit of EMU. Mundell himself suggested that in a largely unknown paper that Paul De Grauwe (2006) made accessible to a wider community.

In contrast to optimal control theory, this conceptualization assumes that governments want to strengthen their hands through monetary integration, that is, pool policy resources so as to stabilize the domestic economy more effectively. This does not necessarily require the assumption of enlightened government. But it seems plausible to assume that governments try to avoid taking responsibility and blame for outcomes with high downside risks that they cannot fully control; inflation and unemployment are outcomes of this kind. Nor do they want to be seen to be dominated by other countries' policies. Macroeconomic outcomes are not least determined by spillovers from currency markets, changes in the exchange rate that affect interest rates and the trade balance. Ever since the breakdown of Bretton Woods, coordinated European exchange rate stabilization can be seen as an attempt to institutionalize cooperation between self-interested national administrations, not least to strengthen their hands vis-à-vis protectionist interest groups at home. Currency unification was the endpoint of these attempts.

A monetary union based on this reasoning and this view of government would look very different from the one we have got. It acknowledges interdependence not only in the negative sense of spillovers from reckless fiscal behaviour but interdependence originating in the relatively small size of most economies relative to the size of international financial markets. The idea is to provide an insurance arrangement in the sense that a member country that experiences relatively hard times is compensated by other members (Schelkle, 2005). Such compensation need not imply an insurance payment in the form of cash transfers from a central fund, as the original Kenen criterion for an OCA envisaged it to work. In the first instance (and in normal times), stabilizing compensation could be achieved by other members adjusting their policies to make it easier for the country in difficulty to get its economy back on track. An illustration would be fiscal stimulation by partner countries or encouragement of higher wage settlements that creates higher demand for the unfortunate member's exports. Alternatively, the central bank could reduce interest rates with a view to the member in the doldrums, knowing that these rates may be too low for the other countries, which obliges them to exercise countervailing fiscal restraint. More generally, forming a monetary union *alias* pooling policy resources raises the question of which policies have to be coordinated how closely: just fiscal policies, or fiscal and monetary policy, or fiscal and monetary and coordinated wage settlements? As regards the latter, the public sector wage bill can be thought of as a policy tool.

The new Scoreboard for monitoring macroeconomic imbalances can make sense in this context (see below). The 10 indicators do not invite hard and fast assessment of compliance but an analysis of diverse country cases with a view to how the adjustment of each country affects others.⁸ The

8 However, the letter of the ('six-pack') reforms in which the Scoreboard and an Excessive Imbalances Procedure was introduced suggests that a country may eventually be fined if it fails to comply with the threshold values; this follows the logic of optimal control theory that blames governments for everything that goes wrong in the economy.

data for 2012 show that there is not a single country that would not have some shaded cells, i.e. a value of the particular indicator that may point to a potential problem as noted in the row 'Thresholds' (Table 1). Nor are there simple patterns of problem countries, for instance even a country with severe imbalances, such as Greece (EL), does not perform badly on every indicator as defined. There are as many countries with more than 160 per cent of private debt to GDP as there are countries with more than 60 per cent of public debt, both considered to hint at an imbalance. The indicators have to be read in conjunction with each other and cannot be used for prompt disciplinary measures; and one policy instrument only, such as the budget balance, will not do. The exercise of drawing up this Scoreboard is worth the effort if only for driving home this message.

There is also the obligation or idea of symmetric intervention in the case of current account imbalances although the European Parliament had to insist on this symmetry against the resistance of current account surplus countries. This acknowledges the need for policy coordination, namely that adjustment has to come from both sides, from those who buy too much for sustainable debt levels and those who sell too much for sustainable credit levels. But it will remain a political struggle to realize this idea: in the Scoreboard for 2012, the threshold (4.6 per cent) means that for a current account deficit the ratio that raises attention is 4 per cent of GDP while that for a current account surplus is 6 per cent (with Germany, incidentally, managing a projected 5.9 per cent surplus).

Quite apart from the difficulty of reaching political agreement, a major technical difficulty of policy coordination consists of the various lags that hamper timely implementation. As in national fiscal policy, automatic stabilizers provide a solution. An example of automatic policy coordination is contained in a study that the Council commissioned in the early 1990s when discussions about the exact implementation of the euro were still in full swing. The question that the Council put to the Commission and a team of outside economists was how a stabilization mechanism could be devised that delivers a similar amount of insurance as the US fiscal federation. In the United States, about 25–30 per cent of a state's drop in GDP relative to the average is compensated through lower tax revenue the unfortunate state pays when its tax base shrinks and some transfers that it is entitled to receive, possibly for food stamps. Alexander Italianer, then Director-General of Directorate-General for Economic and Financial Affairs (DG ECFIN), and his distinguished collaborators devised a mechanism that follows insurance principles (European Commission, 1993). Because it would not work through a tax-transfer union but a tailor-made stabilization mechanism, it would be much cheaper than US fiscal federalism, costing approximately 1 per cent of EU GDP, roughly the same amount again of the EU budget.

The mechanism would be triggered by a condition that a government cannot manipulate and that should ideally be a leading indicator of the business cycle.⁹ An example is the following: whenever the unemployment rate of a country rises more than 1 per cent above the EU average increase, a Member State would get access to stabilizing funds for a limited time, say two years. So the mechanism would help a country with adverse changes in its macroeconomic data temporarily; it would not help a country with high levels of unemployment permanently or just because it has low income. This is the difference to Kenen's transfer union which envisages even closer policy coordination than stabilization strictly requires. The Italianer et al. scheme would provide automatic stabilizers, in the absence of a federal budget with Europe-wide income taxes and unemployment benefits.

⁹ This is another technical difficulty as the unemployment rate, used in the following example to illustrate the principle, is actually a lagging indicator of a recession.

Table I. Macroeconomic Imbalance Procedure Scoreboard 2012^a.

Year 2010	External imbalances and competitiveness					Internal imbalances				
	3-year average of current account balance as % of GDP	Net international investment position as % of GDP	% change (3 years) of real effective exchange rate with HIPC deflators	% change (5 years) in export market shares	% change (3 years) in nominal ULC	% year on year change in deflated house prices	Private sector credit flow as % of GDP	Private sector debt as % of GDP	Public sector debt as % of GDP	3-year average of unemployment
Thresholds	-4.6%	± 35%	± 5% and ± 11%	-6%	9% and 12%	+6%	15%	160%	60%	10%
BE	-0.6	77.8	1.3	-15.4	8.5	0.4	13.1	233	96	7.7
DE	5.9	38.4	-2.9	-8.3	6.6	-1.0	3.1	128	83	7.5
EE	-0.8	-72.8	5.9	-0.9	9.3	-2.1	-8.6	176	7	12.0
IE	-2.7	-90.9	-5.0	-12.8	-2.3	-10.5	-4.5	341	93	10.6
EL	-12.1	-92.5	3.9	-20.0	12.8	-6.8	-0.7	124	145	9.9
ES	-6.5	-89.5	0.6	-11.6	3.3	-4.3	1.4	227	61	16.5
FR	-1.7	-10.0	-1.4	-19.4	7.2	3.6	2.4	160	82	9.0
IT	-2.8	-23.9	-1.0	-19.0	7.8	-1.5	3.6	126	118	7.6
CY	-12.1	-43.4	0.8	-19.4	7.2	-6.6	30.5	289	62	5.1
LU	6.4	96.5	1.9	3.2	17.3	3.0	-41.8	254	19	4.9
MT	-5.4	9.2	-0.6	6.9	7.7	-1.6	6.9	212	69	6.6
NL	5.0	28.0	-1.0	-8.1	7.4	-2.9	-0.7	223	63	3.8
AT	3.5	-9.8	-1.3	-14.8	8.9	-1.5	6.4	166	72	4.3
PT	-11.2	-107.5	-2.4	-8.6	5.1	0.1	3.3	249	93	10.4
SI	-3.0	-35.7	2.3	-5.9	15.7	0.7	1.8	129	39	5.9
SK	-4.1	-66.2	12.1	32.6	10.1	-4.9	3.3	69	41	12.0
FI	2.1	9.9	0.3	-18.7	12.3	6.6	6.8	178	48	7.7

^aThe shaded cells in the table mark values that fall outside the Scoreboard thresholds.
Source: European Commission services.

Charles Goodhart, one of Italianer's collaborators, has repeatedly drawn attention to these studies, most recently in a generally accessible blog (Goodhart, 2011; see Schelkle, 2001: 306–313). But the European Council shelved these studies immediately when they came out because a number of influential governments vetoed the creation of any common fiscal capacity. With hindsight we can see that their refusal then has forced the ECB into a quasi-fiscal role now. European financial integration spread the crisis of a small open economy with unsustainable public finances, leading to a renationalization of the bond markets for euro area members in the process.

In this view, the most important reason for the present crisis is an insufficient integration of public debt management that could back up the ECB as a lender of last resort. This is a crucial difference between California and Greece. Such a back-up is necessary not only in the case of a sovereign debt crisis but more typically in a systemic financial crisis when some banks do not merely have a liquidity problem but are insolvent. The own capital of any central bank is too small to deal with solvency problems of the banking system, it either has to force the banks themselves to sort out the problem through mergers and acquisitions or leave it to fiscal authorities.¹⁰ In a situation of general vulnerability of the banking system that rules out the first solution, De Grauwe and Moesen (2009) have therefore proposed a Eurobond that addresses the immediate need for providing emergency liquidity but also gives reassurance to bondholders that when a country is frozen out of markets, its bonds can still be honoured. The proposal foresees that the share of each country in the Eurobond issue is identifiable, so national interest rates would have to be paid. This is a precaution against moral hazard when bonds are jointly guaranteed since interest rates would presumably rise for a government that is seen as free-riding on the joint liability by issuing more debt.

Moral hazard is a concern that has so far stopped governments from agreeing on integrated public debt management and it is a strength of the De Grauwe and Moesen proposal in political terms that it addresses this concern. But addressing this concern in the extreme, treating abuse by a rogue government as the standard scenario, must also not destroy the insurance benefits for all. A common interest rate is an insurance mechanism against the pro-cyclical tendency of markets to push economies already in recession into even deeper recession by asking for higher interest rates, and to cause booming economies to overheat even more (Mabbett and Schelkle, 2010). A common interest rate but no guaranteed share in the overall issue could deal with moral hazard as well and incentivize ongoing cooperation of governments in the public debt management for the euro area as a whole.

Concluding remarks

The proponents of the euro were keen to show that currency unification and forming a monetary union with hardly any fiscal integration was good economics. This article has looked at three possible economic rationales for this historically singular experiment. With the benefit of hindsight, I have argued that two of the three theories of monetary integration were misleading or setting the wrong priorities, both in terms of what was necessary to build a viable union and in terms of what needs to be done to stabilize a union which at the time of writing is in existential crisis.

The optimal currency area approach, in its instrumental form, supported a focus on structural reform of labour and product markets while financial markets were completely out of the picture.

10 In principle, the own capital of a central bank is not really a constraint as a central bank has the exorbitant privilege of being able to print its own assets and thus generate profits in the form of seignorage that, if retained, could act as own capital. In order to restrain this privilege that could destroy a currency, mature monetary systems constrain a central bank from doing this legally, seignorage is owed to the fiscal authority and own capital has to be granted by parliamentary approval.

The theory has a lease of life even now for reasons that arguably have to do more with domestic political priorities than with good economics. Similarly, the optimal control approach supported a focus on restraining fiscal policy in Member States even though such restraint would have led to a complete meltdown of developed economies in the financial crisis of 2008–09 and a lack of restraint was in each case not the reason for national bonds being shunned in panicking markets. However, the theory still casts its spell over the crisis management of the Council because for some influential Council members it is rather convenient to fight as a sovereign debt crisis in some countries what is a latent national banking crisis in debtor and creditor countries alike. Other than national fiscal policy, there are also no other stabilization instruments over which the Commission has some authority. This seems to make the Commissioner for Economic and Financial Affairs exceedingly keen to regulate the conduct of national budgetary policies in ever more detail. Again, it is political interests rather than good economics that can account for the reliance on the disciplinarian approach in the EU's crisis management even though this has failed to calm markets for several years now.

I have argued in favour of a rationale that sees currency unification generically as a form of policy coordination, namely one that revolves around a unified monetary policy. But the experiment of forming a monetary union without a minimum of budgetary integration has arguably failed. The question is now whether governments and their electorates find the euro so worthwhile that they would be ready to break this last taboo of European integration. The emergency funds that have been created are still a liability for each and every Member State according to its share, not a joint liability. They are funds that signal fiscal capacity but also the limits of this capacity. This means, first, that every sovereign is constantly under scrutiny for the sustainability of its liabilities and, secondly, that markets resume panic mode whenever the funds could conceivably run out – and make a run on them. A Eurobond, by contrast, is a way of integrating public debt management and thus creating a non-finite source of funding without a joint budget. The basics of a banking union, like a deposit guarantee scheme and a bank resolution facility paid for by the financial industry over time, is another component of policy coordination that has proven to be essential.

So while I think that monetary integration seen as a form of policy coordination is good economics, it is unfortunately also bad politics. It requires a lot of trust between administrations which has been destroyed by subsequent governments in Greece and the temporary popularity of a figure like Berlusconi in Italy. It is unpopular with voters who do not see compelling reasons to enter in such close integration with other polities of which they know little. Also, taxpayers have understandably no inclination to pay for the failures of parts of the financial sector, not even in their own countries. All these considerations weigh heavily on elected politicians and constrain their space for solutions. It is easy for academics, professional euro watchers and outright Europhiles to dismiss them and ask for bold action. But the viability of the euro is not merely a matter of finding the right economic solutions but also the politically palatable ones. The latter is outside the realm of economic theory.

Funding

This research received no specific grant from any funding agency in the public, commercial, or not-for-profit sectors.

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