The insurance potential of a non-optimal currency area

Book section

CHAPTER X

The insurance potential of a non-optimal currency area

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Does the Eurozone have to be an optimal currency area to survive?

The crisis of the Eurozone has revived the theory of optimal currency areas (OCA) formulated more than 50 years ago (Mundell 1961). It is an economic theory that takes the perspective of the nation state as a unitary actor, contemplating the costs and benefits of joining a union that is optimal only if made up of homogeneous parts. OCA theory can tell us why the euro project must fail: it claims that a monetary union must be forged through convergence, be it in terms of similarly flexible labour markets, a similar degree of industrial diversification, or synchronized business cycles. Only then will member states not be affected by region- specific shocks to which exchange rate adjustment would be an easy and quick response. Yet, convergence was insufficient before the crisis and it is presumably not happening fast enough now.

This economic version of OCA theory can easily be dismissed, despite its popularity since the Eurozone crisis broke out in 2010. Even its major proponents, Robert Mundell (1973) and Peter Kenen (2003), distanced themselves from the original theory they helped to canonize, notably because it had no role for financial markets and exchange rate instability. Even a brief reflection alerts us to the difficulty that on this account hardly any major currency area should exist. More detailed studies have shown that in the Eurozone's favourite comparator, the United States, labour markets are not flexible and mobility not high enough to bear the brunt of adjustment; instead, a common budget and regional asset diversification primarily do the job of income and consumption smoothing (Asdrubali, Sørensen, and Yosha 1996). In addition, the homogeneity required for optimality prevails only in small city states, which, however, face prohibitive transaction costs from using their own currency. Most importantly, the original understanding of the exchange rate, namely to be an effective tool of economic policy, does not correspond with any modern exchange rate theory. The exchange rate is now conceptualized as an asset price[1], thus heavily influenced by expectations about future income streams and therefore susceptible to speculative attacks. Rather than being a reliable tool of stabilization, it needs stabilization. This removes the basis for the cost-benefit analysis of when to give up the exchange rate as there is apparently no cost of giving it up. Yet this cannot be true either. Economic OCA theory is a dead end for thinking about monetary integration (De Grauwe 2012: Chapter 2; Schelkle 2013).

[1] This is in contrast to understanding the exchange rate as a relative price of goods, either of export goods in terms of import goods or of traded goods in terms of non-traded goods.

But two eminent political economists, Peter Hall (2012) and Fritz Scharpf (2011, this volume), recently diagnosed the Eurozone crisis in terms of a variation on OCA theory that cannot be so easily dismissed. Here the Eurozone is a non-optimal currency area in the sense that it is made up of incompatible varieties of capitalism subjected to a Germanic model of running an economy. The way European monetary union has been set up, notably with an independent central bank obliged to prioritise price stability and by tying governments' hands through fiscal rules, imposes convergence on Southern European members for whom this is an alien policy regime. Specifically, the determination of wages is deeply embedded in the social compact around which national welfare states are built. In its simplest form, the social compact can support two models of economic growth. The Nordic one is based on exports of high quality goods that justify high wages in an environment of macroeconomic stability. The Southern one is based on domestic demand driven by inflationary finance of state expenditures and asset market booms, which requires occasionally a rapid downward adjustment of production costs, above all wages. The loss of an exchange rate that can devalue and thus lower production costs dooms the South to permanent austerity and low growth. The most disturbing political implication of this diagnosis is that creating a monetary union requires suppressing national and social democracy in Southern Europe.[2] For instance, trade unions must be bashed, the seniority model of employment rights abolished, and the traditional way of providing social security – with the family as its main pillar -- unsettled.

While this diagnosis of a North-South divide at the heart of the crisis is compelling, it also makes the entire project of monetary integration utterly incomprehensible. Why did anybody ever want to forge a union between the incompatible? We get an answer with two variants: It was a purely political project that ignored the economic realities on the ground. This was either a manifestation of French political will power that exacted the price of Economic and Monetary Union (EMU) from Germany, in return for rapid unification (Hall). Or it was the sheer arrogance of political and business elites who benefitted from integration (Scharpf). Both explanations are hard to reconcile with the fact that Europe is made up of democracies that are sovereign in their decision to enter such an arrangement. Why did so many others join in, from Finland to Greece? How could the pro-integrationist elites win over those who were bound to lose power under the new arrangements? In other words, where were institutional inertia and the obstructionism of veto players that usually claim prominent roles in this type of political economy analyses? The historiography of 'great men do great things' (read: Delors managed to outmanoeuvre the Bundesbank) does not work for an institutionalist explanation. There must be more compelling reasons that allowed this sea-change in European integration to happen.

An alternative needs to address the nagging question underlying these pessimistic accounts: can the Eurozone survive, given its diversity, without suppressing democracy in some member states? My

[2] See Crum (2013) for a systematic discussion of this point.

contribution contrasts the OCA perspective with an insurance view of monetary integration. It does not answer the question of why EMU came about, but rather of what can be its enduring economic basis. This is important for the union's political legitimacy because, as Fritz Scharpf rightly stresses, the EU has to justify its existence primarily by generating beneficial outputs rather than by arriving at procedurally acceptable collective decisions. The insurance view starts from the idea that currency unification has created, more by default than by design, a risk pool and an insurance mechanism. The notion of insurance, used broadly here as forms of risk-sharing, implies that diversity is a potential source of benefits from pooling sovereignty: only entities that are exposed to different risks can insure each other.

A lot depends on how exactly the insurance arrangement is devised, however. The single currency provides some insurance by default and recent innovations triggered by crisis management, such as the European Central Bank's (ECB's) unconventional measures or the creation of an emergency fund, can be seen as the extension of insurance. Yet, the insurance potential is far from realised in the present operation of EMU. The most effective shock absorbers, a joint tax system or joint public debt management, are missing. Moreover, monetary integration may generate risks of its own, for instance a common interest rate accentuates business cycles in member states rather than smooth them. The emergence of endogenous risks, that is, volatility that is generated by monetary integration itself, is the main reason why monetary integration has costs.

The limitations of existing insurance arrangements are not evidence for the suppression of national democracies but, on the contrary, for the assertiveness of national democracies. It alerts us to the deficits of national democracies that international monetary systems try to address, rather than to their alleged democratic deficit (Hix, this volume). Before the crisis, peripheral countries claimed their right to catch up with the EU average even if this meant destabilizing the union, for instance through tax competition and procyclical deficit spending. Ireland is an economically successful example of this, Greece an unsuccessful one. In crisis times, it is above all Germany, the Netherlands, and Finland that are concerned with limiting their exposure even if this comes at the cost of foregone stabilization. Limited provisions of insurance and negative externalities of national action are problems of policy coordination among sovereign but unequal actors generally, as the concept of hegemonic stability told us long ago (Kindleberger 1973; Eichengreen 1987). Thus, the failure of providing the public good of international stability is not unique to EMU. Unfortunately, this does not make it less pressing or easier to overcome politically.

The chapter proceeds as follows: the next section outlines the insurance view of monetary integration and summarizes what kind of risk-sharing the existing monetary union managed to provide *because* of its diversity. Section 3 explains the Eurozone crisis in terms of instability created by integration itself and moral hazard thanks to the relaxation of the current account constraint, neither of which was

tackled. The conclusions spell out that EMU is not the outcome of political voluntarism clashing with sensible economics but is rather an ongoing attempt to maintain economic stability and social security in a world of financial markets that have become very big relative to national economies, whatever their growth model is.

How can monetary integration support risk-sharing between members?

The insurance view of monetary integration originates in the political economy literature on policy coordination and the economic literature on risk-sharing. The coordination strand acknowledges interdependence with other economies as a challenge and as an opportunity for domestic economic stabilization (Kindleberger 1973; Hamada 1985). This makes for a fundamental shift in the perspective as it sees currency unification as one form of managing interdependence in the international monetary system. The collective action problem involved, namely that sovereign nation-states want to benefit from stability but are reluctant to contribute to it, requires either hierarchy (a hegemonic power) or institutionalized cooperation (e.g. an IMF) to solve it (Eichengreen 1987). The crucial public goods that need to be provided are liquidity in an internationally accepted currency and an orderly procedure to write down debt when solvency is the problem.

The risk-sharing strand explores how interdependence created by market integration contributes to smoothing consumption and income in comparison with a central budget (Atkeson and Bayoumi 1993; Asdrubali, Sørensen, and Yosha 1996). This literature held the prospect for EMU that markets can do part of the job that a federal budget would normally do. It could easily be underestimated as a partial contribution to OCA theory, in that it explored the role of capital mobility in regional or national economies adjusting to shocks. But it is of wider relevance, in a way that speaks to the concerns of political economists about the compatibility of different social market economies. Analytically, we can see the link by noting that an individual's wealth is a portfolio of assets, which comprise typically some real assets (homeownership), financial assets (cash deposits, life insurance, and shares) but also the present value of future earnings. These assets have different risk-return profiles that are determined by the degree of market integration with other regions or countries.

Risk-sharing and (social) insurance is used here in a wide sense, not just for contribution-based schemes that pay out in the case of an accident or shock. They comprise five mechanisms that could insure income and smooth consumption in EMU.[3]

[3] Insurance and risk-sharing as used here can be both: ex post redistribution from the lucky to the unlucky (smoothing) and ex ante redistribution from the rich to the poor (narrow redistribution). Strictly speaking, smoothing means only to dampen the volatility of consumption and income around a trend, not to change the trend which is the role of redistribution in a narrow sense. Credit is a way of smoothing income while transfers are redistribution in the sense of increasing the income of a beneficiary. Hix (this volume) calls the new

1. *Financial market integration* allows for diversification of property claims, access to credit, and to insurance for domestic assets. Household wealth typically becomes more diversified because banks, pension funds, or insurance firms against which households have claims become more diversified. A decline in rates of return in one market segment may thus be compensated by higher returns in another (Kalemli-Oczan, Sørensen, and Yosha 2004: 5-6).
2. *Goods market integration* allows for income and consumption smoothing. When domestic demand grows more slowly than in trading partners, an export surplus can stabilize and stimulate domestic employment and income. Although this is conventionally seen as a benefit of the Single Market, it also requires financial market integration. In fact, a current account imbalance can only occur if there is lending and borrowing (Christev and Mélitz 2011: 28). A single currency allows this to happen more easily as it eliminates exchange rate risks between members of a monetary union.
3. *Fiscal institutions* lower taxes and/or increase transfers for individuals and regions when they fall on hard times. This is typically provided by a central budget but more targeted insurance mechanisms such as a supplementary unemployment benefit could provide income smoothing as well (Italianer and Vanheukelen 1993; Dullien 2007).
4. A *central bank* can act as lender of last resort and provide liquidity to financial institutions if the cash flow problems of some threatens to lead to a run on all. In a severe crisis, it may also comprise sovereign borrowers. This insurance mechanism is particularly valuable if banking in the union is transnational and most trading takes place between members.
5. Finally, *labour market integration* allows the diversification of sources of earnings and thus the maintenance of the present value of future earnings when job opportunities at the place of residence dry up. In a union of welfare states like the EU, labour mobility entails more than the permission and ability to take up a job elsewhere. The EU integrates labour markets through a form of rights-based social policy. For instance, it assures EU citizens of their right to move while retaining their acquired welfare entitlements, notably the portability of public pensions across borders. This is a risk-sharing mechanism of the Single Market that has been triggered by the euro area crisis.

Individuals and regions benefit from portfolio diversification to the extent that business cycles are not fully synchronized and shocks are specific to a jurisdiction. This is directly contradicting OCA theory: diversity can make monetary integration actually an attractive proposition for domestic stabilization, not only but especially when the exchange rate is not a reliable policy instrument. The literature on interregional and interstate risk sharing has estimated first two insurance effects of financial integration (cross-border claims from portfolio investment and current account imbalances) with

emergency funds (EFSF and ESM) transfer mechanisms but, in economic terms, they are smoothing mechanisms as programme countries are expected to pay the credit back.

respect to output shocks and compared financial integration with the insurance effect of a central budget. The most recent study before the crisis, with data ending in 2000, found that the susceptibility of member states' output to country-specific ('asymmetric') shocks declined even though regional specialization has increased. Moreover, this (declining) output asymmetry did not cause as much idiosyncratic fluctuations in member states' incomes as it did previously (Kalemli-Oczan, Sørensen, and Yosha 2004). Hence, the study concludes that further financial integration in the euro area will lead to more income and consumption smoothing, analogous to the US where this process is also still evolving.[4]

Unfortunately, this is too optimistic an insurance story, and one that begs the question of why we do not see more currency unification. Monetary integration does provide additional insurance mechanisms in an uncertain world and removes a major source of risk to social welfare, namely exchange rate instability. But while it may absorb ('exogenous') shocks, it also creates ('endogenous') risks. As soon as we shift the OCA perspective from one member state that has fallen on hard times to the risk pool thus created, we realise that integration intensifies interdependence. This makes every member more susceptible to shocks abroad, if only because they are the lucky members of an insurance scheme who have to bear the cost of compensating the unlucky ones.

Moreover, market integration may lead to the realization of other, unanticipated types of shocks. Notably, some members may become vulnerable to financial excesses that were unknown before. This can either be due to the insurance market failure of adverse selection, that is, hidden information about risks that then come to the fore. Or it can be due to moral hazard, that is, hidden behavioural changes after entry into the union. Note that not all behavioural changes, namely more risk-taking due to the insurance provided, are undesirable. The higher risk is typically rewarded by a higher return.[5] For instance, greater specialization in the international division of labour and thus more trade, thanks to less vulnerability of businesses to exchange rate instability, entails the promise to increase income. However, such productive risk-taking becomes undesirable moral hazard if the additional down-side risk has to be largely borne by those who do not share in the reward, namely the general taxpayer. It is in this sense that there can be too much insurance.

These caveats amount to saying that the insurance benefits from monetary integration can be offset by the losses from increased interdependence that monetary integration generates, yet leaves uninsured. Christev and Mélitz (2011) find that in EMU about 65 per cent of output volatility translates into consumption volatility. But their analysis of whether – in the absence of a central budget -- the

[4] Note that these studies do not even take into account the cost of speculative currency attacks or overshooting that modern exchange rate theory now considers being an inherent feature of exchange rates. Eliminating this source of instability is a major advantage of currency unification but it is not merely risk-sharing; it *removes* risk.

[5] As Sinn (1995: 507) put it: 'Under the protection of the welfare state, more can be dared.'

remaining 35 per cent have been compensated by capital market integration fails to find such a direct effect on consumption smoothing. The authors note that the insurance that portfolio diversification provides in response to an output shock can be offset by the destabilizing effect of asset price shocks on consumption. Relevant in this context is US research that found a 'Great Moderation' of aggregate output fluctuations since the 1990s but also more volatile household incomes at the individual level, that is, when households became heavily invested in homes and stock markets (Gottschalk and Moffitt 2009; Dynan 2010). This suggests that the net insurance effect is determined by financial market integration, rather than the euro per se. But only further research can tell.

The Eurozone crisis from an insurance perspective -- what went wrong?

An insurance view of monetary integration, as outlined in the last section, guides us to a number of reasons for what may have gone wrong with the management of interdependence in EMU. The financial risk-sharing literature asks us to give financial markets a prominent role in the diagnosis, in contrast to OCA-type analyses that are fixated on labour and goods markets.

First of all, some economic outcomes may have become more volatile due to monetary integration. While this is not true of output, income, and consumption, it has certainly been observed with respect to asset markets and exchange rates (Reinhart and Rogoff 2009). In EMU, the procyclical movement of real interest rates has now been identified as a main culprit. In fast-growing member states such as Ireland, Greece, and Spain, ensuing bottlenecks and the bargaining position of organised labour are likely to lead to above-average price and wage increases. If nominal interest rates have converged as they should in a monetary union, this leads to below-average real interest rates, thus fuelling these overheating economies further. Low financing costs and healthy nominal growth make private and public debt look sustainable even if it is growing fast, leading to asset market booms. And vice versa for an economy with below-average growth, such as Germany in the first few years of EMU, that will find it harder to revive growth due to a relatively high real interest rate.

This procyclical real interest rate effect of a unified monetary policy was noted as such in the mid-1980s, by the British economist Alan Walters, a chief economic advisor to Margaret Thatcher. He thus criticized the European Exchange Rate Mechanism although his critique equally applied to the British monetary union. The Bank of England maintains an interest rate that, before the Great Recession, tended to be too low for the overheating service economy in South England and too high for the industrial North where production is more dependent on credit. Unsurprisingly, the response of UK politicians and advisors was not to propose abandoning this monetary union with its one-size-fits-none (nominal) interest rate. The deindustrialising North became a target of regional policies instead.

The Walters effect is simply a feature of all monetary unions with specialized regional economies. It alerts us to the need for additional economic policy instruments to counteract it. But more effective

than regional policies are macroeconomically relevant policies like coordinated wage bargains that can exercise restraint in overheating economies before they are forced by rising interest rates and unemployment. The problem is that this asks too much of organized labour and employers who, like all market actors, must set high prices when times are good and exercise modesty when they are bad. Even in the supposedly coordinated market economy that is Germany, wage restraint was implemented in the midst of a prolonged recession, in the first half of the 2000s, with the Hartz reforms reinforcing this procyclical wage moderation. Another and possibly more promising route is now taken with macroprudential financial regulation, that is, the imposition of credit restraint on banks with a view to systemic stability. In integrated financial markets, this requires cooperation among supervisory authorities. The Countercyclical Capital Buffers that the Basel Committee on Banking Supervision created in 2010 do exactly that. They require that a financial intermediary lending into a jurisdiction must fulfil the capital requirements in that jurisdiction, even if the intermediary is not located there. Banks can no longer circumvent national regulations by financing the business from one of their offices abroad. The Spanish authorities tried to impose such macroprudential instruments since 2000, given annual rates of credit growth of almost 20 per cent, forcing banks to put about 15 per cent of net operating income into countercyclical loan loss provisions. Yet, they failed on a purely national basis and under pressure from government.[6] Fiscal measures, such as countercyclical property taxation, would also help by targeting overheating housing markets. But national governments have found this an electoral landmine. The recent failure of Mario Monti's technocratic government has been attributed not least to an unpopular property tax.

Moral hazard is a popular explanation for the crisis, especially in the version that blames the availability of cheap credit for behavioural changes in Southern European countries. They started to live beyond their means as shown by ever increasing current account deficits and thus became reckless debtors.[7] This version raises the immediate objection that every market transaction has two sides: there must have been careless exporters and reckless lenders at the other end. The moral hazard therefore was also with those who thought that in EMU they can hand out ever larger amounts of credit to run ever bigger surpluses.

The literature on financial risk sharing can tell us that this blame game is too simplistic, though. Moral hazard, that is, risk behaviour endogenous to the insurance contract, was actually a desirable feature of EMU. Access to credit without the fear of disruption from self-fulfilling currency attacks held the promise for middle-income countries in EMU to catch up more quickly, in return for them giving up on infant industry protection or other measures to privilege national producers. Productive risk-taking

[6] See Alberola, Trucharte, and Vega (2011) for a thoughtful assessment of the Spanish experience.
[7] Taking advantage of cheap credit was not confined to Southern Europe, or we would have to redraw the map for Ireland and the non-euro countries in Central and Eastern Europe; the latter also had high current account deficits fuelled by high private debt.

in Europe's emerging markets created a profitable market opportunity for slow-growing mature economies. The problem with this is that there is no inherent tendency to turn this into a cycle by which the former deficit countries become the new surplus countries and vice versa, mainly because the successful export nations do everything to maintain the imbalance. Crisis is inevitable, though, If the same member states run continuously current account deficits and surpluses, respectively. The debt service on a rising stock of debt/ claims feeds on the deficit or surplus itself: interest paid on foreign debt constitutes an import of capital services in the current account, interest received on foreign assets an export of services. The ensuing dynamic of foreign debt and current account deficit means that it becomes ever harder to reverse a current account imbalance. A drastic recession can help to gain price competitiveness and depress import demand, but interest payments do not respond to a recession. It becomes actually harder to service debt out of a shrinking income, economically and politically. The availability of an exchange rate does not help either since devaluation increases the value of foreign-denominated debt. Governments usually fall over the attempt to adjust, and the IMF, now troika, has to be called in.

Current account imbalances have a tendency to accumulate and concentrate risk, rather than diversify them. In contrast to the usual current account and exchange rate crises, the risks in the Eurozone materialised in national banking crises that quickly turned into sovereign debt crises. Banks held predominantly the claims and liabilities of their national exporters and liabilities of their national importers. They survived the preceding financial crisis of 2007-09 reasonably well, thanks to resolute lending of last resort by all major central banks. But the ECB was not allowed to extend its insurance to sovereign debtors in the Eurozone which meant that their source of financing stimulus and rescue measures were banks. This prepared the ground for the deadly embrace of failing banks and sovereigns. The deep recession and EU governments' reluctant recapitalisation of banks meant that a second Lehman moment was in the offing. The management of the Eurozone crisis prevented banks from failing and allowed those that held claims against deficit countries to exchange them for claims against the European emergency funds or the ECB. Needless to say, this was mainly an advantage for banks in surplus countries and for truly international banks, notably from France and Spain. Those concerned about moral hazard should point not to the origin but the management of the crisis and how it benefitted the financial system and the surplus countries disproportionately, shifting the costs on all (not only German) taxpayers in the Eurozone.

Those familiar with the history of international monetary systems should not be surprised. The moral hazard problem of banking and the ability of creditor nations to force the debtor nations into one-sided adjustment is a feature of the world economy since the gold standard (Eichengreen and Temin 2010: 19). It was again a British economist, John Maynard Keynes (1936: ch.23), who noted the deep mercantilist tendencies of capitalist democracies that are up against the inherent tendency to underemployment. External demand is then a welcome source of stimulating domestic economic

activity. Yet, Keynes was also aware of the depressing effects on employment in those countries that lose out in the competition. In negotiating the Bretton Woods institutions, Keynes tried to convince his counterpart Harrison Dexter White to add an adjustment mechanism that would force creditor nations to symmetric adjustment. But to no avail, as the US was the export champion of the world then. The new Macroeconomic Imbalances Procedure of the EU rests on insights that we owe to the Keynes-White debate: current account imbalances are treated as part of macroeconomic imbalances, not merely as a problem of wage costs[8]. The adjustment requested is formally symmetric, thanks to the European Parliament's insistence against the Council. But threshold values for worrying current account deficits (4 per cent) are lower than those for worrying surpluses (6 per cent). The White position still dominates, although it is now the German finance minister for whom the notion of excess surpluses is anathema.

Why do we never hear about macroeconomic imbalances in the United States? In fact, we do not even know what the current account balances of US states are. It is very likely that the poorer states (or their poorer regions within states) have current account surpluses because firms use them as production sites for goods consumed elsewhere and do not reinvest all their profits but transfer the income to firm owners living elsewhere. It is this difference between production and absorption of income that makes for an export surplus, not some conscious act of saving. Such a poor state may struggle with retaining (well-paid) jobs and therefore its tax base. But banks that finance these imbalances operate nation-wide and are therefore more diversified, hence can absorb a crisis of state finances that do occur in the US occasionally. Finally, public policies make a difference: states in the US are allowed to use public procurement aggressively to favour local industries, a practice that would be banned under state aid rules in the EU (Schelkle 2012: 38). And there is, of course, a federal government that can help to restructure failing banks and failing states (Henning and Kessler 2012).

What role is thus left for adverse selection as an explanation of the crisis? In my view: not much. The insurance view can make sense of the Maastricht process that placed great emphasis on ex ante screening of club members, putting every applicant for Eurozone membership into 'purgatory' (Buiter 2004). But the relevant information on Ireland, Italy, Portugal, and Spain was not hidden: national authorities did not know systematically more than everybody else. Greece is the exception that proves the rule. Its shambolic public finances were a case of hidden information and a bad risk one would not like to add to a pure insurance pool.[9] But the previous analysis of endogenous volatility and moral hazard gives us the necessary and sufficient conditions for why the Eurozone got into

[8] For instance, it is generally acknowledged that Portugal did not have a problem of high wage costs but of high mark-ups that their public enterprises charge, driving prices and profits to the detriment of competitiveness. In Ireland, rising unit labour costs were the consequence, not the cause, of rising costs of living, notably for housing.

[9] One may still admit a member for reasons of solidarity, though, and a more comprehensive treatment along the lines of 'The politics of social solidarity' (Baldwin 1990) can include this motivation into the insurance view of economic integration.

crisis. It was not Greek public debt that led to the crisis but the fragile state of the international financial system as well as current account imbalances from different growth dynamics, driven by procyclical real interest rates. Moral hazard can explain why crisis management was so lenient with banks and so harsh on debtor countries. A focus on Greece diverts from the fact that better ex ante scrutiny would not have prevented the Eurozone crisis: there are mechanisms at work and insurance arrangements missing in EMU that make the union prone to crisis, with or without Greece. Greece was simply the weakest link that broke first; adverse selection can only explain the weakness of this link.

How can Eurozone members live with their interdependence?

The insurance view of monetary integration interprets the Eurozone crisis as a systemic problem of EMU, not as a problem of some country or types of countries. Not diversity but new and more intense forms of interdependence are the issues that EMU must tackle. The insurance view also makes us see the generic features of the Eurozone crisis (Eichengreen and Temin 2010), such as the governance problems of any international monetary system, the mercantilist proclivities of capitalist democracies struggling with the curse of underemployment (be it through outright protectionism or the undervaluation of exchange rates), and the potential as well as the failures of financial markets to provide insurance.

The intensification of interdependence came from a common interest rate policy that accentuated divergent growth and price dynamics in member states. When the Eurozone crisis erupted in 2010, just as the world economy experienced in the early 1980s (the Latin American debt crisis) and the late 1990s (the Asian crisis), the regime extended too much insurance to transnational banks and very little to sovereigns. The consequence is the 'fragility of an incomplete union' (De Grauwe 2012: Chapter 5): as outlined above, the ECB played an effective role as a lender of last resort to the financial system but is constitutionally constrained in providing this insurance to sovereigns, even in an unprecedented crisis. National governments are therefore on their own when trying to stabilise their economies, not least the financial system since 2008. Deteriorating public finances make bond market investors reconsider the riskiness of their bond holdings, sell them and thus drive up the yields on bonds. Credit rating agencies typically follow (although they should lead) with downgrading government bonds, which forces institutional investors, like pension funds, to sell more bonds as regulation requires them to hold a less risky portfolio. This deterioration of the investment quality of government bonds then feeds back on banks that hold a high share of (now impaired) government bonds: they are seen as risky investments and must pay a higher price for refinancing their activities. They are likely to reduce their exposure to other risky business, that is, credit to firms and households, and shore up their

balance sheets with even higher high liquidity reserves. This is the liquidity trap and the credit crunch that the Eurozone is in ever since the crisis broke in 2010.[10]

Crises in EMU are bound to emerge as sovereign debt crises because banks have the ECB as a lender of last resort – but this does not mean governments are the cause of a crisis. Greece is the exception that proves the rule. The vicious circle just outlined jeopardizes welfare not only in the deficit but also in the surplus countries. If the debtors are pushed into a situation where they cannot pay, the creditor loses. Interdependence cannot be ignored or wished away. Rather, it must be managed.

The maxim of completing the union does not have to be suppressing these different growth dynamics as they help Southern and Eastern European member states to catch up. This is the promise of EMU on which they entered and low interest rates as well as assured access to liquidity are the essential instruments to keep this promise. Preferences for low interest rates and for low inflation are perfectly compatible, they are two sides of the common coin. What is not compatible is the running of permanent surpluses and deficits by fiscally sovereign members of a union: a current account crisis will then sooner or later erupt in the guise of a banking crisis. Such banking crises can be dealt with by the ECB's liquidity provision but when this becomes a solvency problem of national banks, it will emerge as a sovereign debt problem which the ECB is not meant to deal with. Strong export nations like Germany and the Netherlands, can run surpluses of their manufacturing sectors but they must also run sectoral deficits of, say, their public or other services sector. France is a good example of such a combination of strong export sectors without running a permanent export surplus. The same, namely that sectoral surpluses and deficits vis-à-vis other Eurozone countries must roughly match in the medium term, holds for Southern European countries: they have strong service sectors, in tourism, transport and, indeed, finance.

The running of growth models is, contrary to its technical image, not at the disposal of any one actor or institution. It requires policy coordination, not only between member states but also between policy areas within member states. Fiscal policy has as instruments more or less generous public sector pay and more flexible taxation[11], the setting of minimum wages and cash transfers for the consumption of domestic (care) services. Labour market parties can use sectoral and regional wage bargains, financial regulators can now use macroprudential instruments to combat regional and sectoral overheating. The riskiness of permanent current account balances must be priced in by exporters, importers and their banks.[12] Short of that, the Eurozone will sooner or later need orderly insolvency procedures for

[10] For a more general treatment see De Grauwe (2012: Chapter 5).
[11] Examples for such innovations are counter-cyclical property taxes or 'fiscal devaluation', that is, reducing taxes on labour in favour of taxes on consumption – and vice versa for fiscal revaluation.
[12] For instance by charging differential interest rates on what the European System of Central Banks considers to be excess Target2 balances or by imposing higher reserve requirements on banks with large exposures to deficit countries.

sovereign debtors, an innovation in the international monetary system that is long overdue (Gianviti et al. 2010).

The limited political support for the project of completing the union warrants this to be a minimalist exercise. But further steps cannot be avoided for the very reason that concern Peter Hall, Fritz Scharpf, and everybody who is critically sympathetic to European integration: the output legitimacy of EMU depends on it being seen to benefit, not to jeopardize, social welfare and security of its members. Completing the union is legitimate if the incomplete monetary union is itself responsible for destabilising tendencies that led to the crisis, above all the procyclical real interest rate and incentives for banks to extend credit in an unsustainable way. This legitimacy is based on reciprocity that underpins the social market economies of the union's members: if one wants individuals to take risks in their economic choices, for instance acquire specialist skills, they have a legitimate claim to safety nets that protect them against catastrophic outcomes. If one wants member state economies to integrate in a monetary union without recourse to protection, they have a legitimate claim to insurance against systemic instability.

Some of the ingredients for turning EMU into a mutually beneficial insurance arrangement are now in the pipeline: lending of last resort to sovereigns and a banking union with some public debt mutualisation. As soon as a single supervisory authority is established, the agreement was that the ESM would be allowed to recapitalise systemically important banks directly rather than through the respective sovereign having to take on more debt. The problem is that main guarantor countries, most importantly Germany, seem to renege on this agreement by mid-2013. They behave like the lucky members of an insurance scheme who want to leave it once the risks have materialised and they know that they have been the lucky ones. This is moral hazard, too.

The banking union would entail a resolution fund for insolvent banks. It should be a vehicle to write down public debt that was incurred in the botched crisis management of EMU, when banks were allowed to offload their bad debt onto sovereigns and the ECB, ultimately European taxpayers. This will require some form of mutualisation of public debt, Eurobonds for short, because in a systemic crisis the funds paid by the industry may not be big enough – and in fact, they should not be too big as they invite gambling. This fiscal back-up requires less than a full-fledged budget. From an insurance point of view, such a full-fledged central budget would not even be necessarily desirable. Decentralisation and devolution of budget responsibilities makes sense as an insurance arrangement that insures its members only against catastrophic risk, not minor damages. It fosters diversity and therefore diversification of risks, it limits interdependence and thus contains the spread of minor casualties, and it also reins in moral hazard of authorities who try to pass on the responsibility for their mistakes. But the separation of responsibilities works only if there is a crisis resolution mechanism in cases where there is a systemic crisis, contagion, or a shock beyond any member's control.

Without some progress on the banking union, the Eurozone will remain in a state of virulent crisis, stagnating at best under its burden of debt. Such a Japan scenario may be sustainable for EMU in economic terms, but it is doubtful that its constituent democracies can live with a paradox of exceptional politics in permanence (White, this volume). To avoid this, the raft of measures to tighten fiscal surveillance -- from the Six Pack and Two Pack of the EU to the Fiscal Compact among member states -- must be combined with institutionalised risk pooling. A fiscal back-up for the resolution fund is one such device of risk pooling, as are the emergency funds or the possibility of the ECB buying bonds directly from countries under a programme. Closer fiscal surveillance is then protecting the facilities from abuse. But without such risk-sharing arrangements, the tightening of fiscal surveillance is actually destabilising. It signals to the markets that every sovereign is meant to fight for itself and whenever a government is not able to comply, speculation against the country may set in, especially since the EU is obliged to exercise sanctions that push countries in fiscal difficulties into more fiscal difficulties. This is the opposite of insurance.

The defenders of the status quo point to the moral hazard that any risk sharing entails. The logic of this argument implies that there should be no car insurance, indeed no welfare state. But moral hazard is an inherent feature of all insurance and requires precautions like co-payments or rewards for not using the insurance -- it must not prevent giving any insurance.

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