

Waltraud Schelkle

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Unity in diversity: the unfulfilled promise of the euro

Waltraud Schelkle

Creating the European monetary union between an ever expanding number of diverse and unequal nation states is arguably one of the biggest social experiments in history. It is still not well understood. How can we explain the attempt, the success of which is so far not assured? In whose interest is this experiment? Do we have any precedents for a monetary union of such diverse member states? Can it work?

Many regard the experiment as failed. The Harvard economist Robert Barro, writing for the *Wall Street Journal* in January 2012, expresses the verdict shared by many U.S. observers: “Despite some scale benefits from having larger countries, the cost of forcing heterogeneous populations [...] into a single nation could be prohibitively high. [...] The euro was a noble experiment, but it has failed.” The quote contains a couple of tacit assumptions. First, a monetary union must be part of a country, read: a political union. And, second, a nation is defined by its homogeneous population. But neither of these assumptions applies to the United States. The greenback was created precisely to force a divided country into one (Frieden 2015: 49-103): in 1863, after the Southern slave states had declared their secession from the union, Congress introduced the first national currency without the representatives of the secessionist states present. It was the currency of the victorious North over the defeated South and the gold-based currency remained contested for several decades. The agrarian states wanted a monetary regime in which it was easier and cheaper to get credit. In the Barro sense, the U.S. experiment has failed as well. The dollar area remains a union of heterogeneous populations and diverse political-economic geographies. IT services-oriented California and oil-dependent Texas are no less different than Germany and France.

Many political economists dispute even that the euro was a “noble experiment” (see the contributions in Matthijs and Blyth 2015). They see the common currency as the expression of a neoliberal policy consensus that served the interests of international business and the ideology of political elites. Their principal criticism of the euro venture is that neoliberalism ignores differences in institutional arrangements, particularly for wage bargaining, across the euro member states. They argue that labour market institutions have to become alike so that they can achieve wage moderation in line with Germany. Otherwise, the loss of competitiveness pushes these countries into current account crises (Hancké 2013, Johnston and Regan 2015). These points deserve more debate than is possible in this short article. But wage fixing institutions in Germany have changed substantially since unification: the country now has a dual labour market that resembles more the liberal model of low protection and competitive wage determination. Economic institutions seem not to be so fixed after all.

My approach starts from the historical evidence that European governments and their advisors have tried to coordinate, harmonize and eventually unify their monetary policies ever since the late 1960s (Dyson and Featherstone 1999: ch.3). They did so conscious, not ignorant, of the differences between their political economies. These differences concerned their vulnerability to social conflicts feeding inflation and budget deficits as well as their abilities to contain current account imbalances and currency crises, subjects of constant debate. The timing coincides with the increasing strains in the fixed-exchange rate system of Bretton Woods that were fuelled by permanent current account imbalances, notably Germany's and Japan's surpluses and corresponding deficits of the U.S., but also of France, Italy and the UK. The dollar-parity system collapsed in August 1971. The efforts to replace it included the so-called Werner plan to introduce a common currency among the six original European Community members by 1980. Financial instability in the aftermath of the liberalization of banking and capital markets renewed these earlier efforts after the mid-1980s and it succeeded this time with a larger membership than initially projected.

Efforts at European monetary integration were about sharing risks from monetary and financial instability between states that have a political bond and complementary economic interests. Risk sharing between states can be achieved through various channels.¹ It can take place through closer financial market integration that leads to cross-border shareholding, lending and borrowing. So if the domestic economy experiences a downturn, household consumption can draw to some extent on these international sources of income and credit; and vice versa if in an upswing. For most households except the wealthy, this smoothing happens indirectly through the revenues of their pension funds, insurers and international banks investing household savings in an international portfolio and thus steady the return on these savings, at least in theory. Other risk sharing channels include common policies towards migrants which allow citizens and their families to move, find work and integrate into the welfare system of another member state. But while this may be valid insurance for individuals, it is not clear that regions can be insured in that way: regions that experience a shock lose their young mobile workforce and are thus additionally disadvantaged. Risk sharing can also come from interstate emergency funds, such as aid or the recently created European Stability Mechanism which gives bilaterally guaranteed credit on non-commercial terms. This last channel is the small equivalent of a common budget in a fiscal federation like the United States.

The potential for mutually beneficial risk sharing rises with the diversity of the risk pool (Imbs and Mauro 2007). But the paradox is that the more diverse countries are, the less likely it is that they share the political bonds needed to overcome the mistrust, justified or not, which is necessary to activate and exploit the opportunities for risk sharing. Diversity makes it more likely that members are not hit by the same shocks or not in the same way.

¹ The contribution of various channels of inter-state risk sharing was first systematically explored by Asdrubali et al (1996) for U.S. states and Sørensen and Yosha (1998) for OECD countries, which generated a large literature.

The member economies that are less hard hit or even benefit from a shock² can then smooth income and consumption of those hit hard, through cross-border share holdings, credit, job opportunities and fiscal transfers. But whenever the veil of ignorance is lifted and the risks have materialized, the lucky members of an insurance scheme tend to see the unlucky as at least partially responsible for their mishap (“moral hazard”). This can then easily serve as a pretext for reneging on commitments. The political capacity to overcome such opportunism sets practical limits to inter-state risk sharing.

A review of estimates covering phases between 1960 and 2007 shows that the aforementioned channels compensate the following fractions of a (100%) shock to output in EA member states (Schelkle, forthcoming):

- capital markets (cross-border share holdings) compensate between 6 and 14 percent of a national output shock;
- credit markets (cross-border lending and borrowing) between 24 and 43 percent;
- labour migration and fiscal channels do not contribute significantly to risk sharing between EA members;
- 51-61 percent of an output shock remains uncompensated and translates into consumption volatility.

This literature is a good starting point but it has some limitations. One is that only shocks to output are considered (Mélitz and Zumer 1999: 155-156). Yet financial market volatility may generate shocks to consumption: the subprime crisis in the U.S. led to more pessimistic expectations about house prices across the OECD world; when prices fell, households felt poorer and reduced their consumption, thus hitting producers. The estimates above are therefore too optimistic as they do not capture this reverse causation from financial integration.

Nor does this literature capture that the risk sharing channel of financial markets can also act as a transmission mechanism for shocks. The initial trigger of defaulting mortgage loans, taken out by low income households in the U.S., was amplified by fire sales of assets and capital flight (into the U.S. dollar!) by European banks, invested in these toxic products. From then on, the crisis took its fatal course: governments guaranteed national banks’ obligations and relieved them from their worst assets, not only to rescue the banks but also the savings of households. By 2010, however, financial investors turned the table and attacked sovereign borrowers in bond markets. Greece was a fiscal disaster waiting to happen but this cannot be said of Ireland and Spain. Markets panicked them relentlessly into pro-cyclical fiscal retrenchment (“austerity”) and the measures they took were then codified in adjustment programmes prescribed by the troika of IMF, European Commission and European Central Bank.

² An example is unusually rainy weather which hurts regions with a concentration of tourism while it benefits regions with industries producing water-proof clothing, umbrellas etc.

But still, there was some risk sharing. The dog that did not bark in this epic saga was a payments crisis. This is the problem of not being able to make a payment even though the two contracting parties have agreed on the underlying transaction. In international economic relations, it is known as a sudden stop of trade finance. The conspicuous absence of a payments crisis is noteworthy, given the credit crunch in Ireland and Southern Europe as well as the capital flight from these countries. The EA's cross-border payments system, TARGET2, played a pivotal role. Mistrust between banks could have led to a complete breakdown of commerce; this was prevented. Banks could offload their claims against each other (which they normally incur in their transactions with importers and exporters) to their respective central banks. This became visible in large TARGET2 imbalances; in particular the German Bundesbank accumulated large claims against the TARGET system. These imbalances indicated that the insurance mechanism against a sudden stop of trade finance worked and not that something is wrong, as yet another political campaign of Hans-Werner Sinn insinuated.³ Even banks outside the EA, in particular UK banks, benefitted and could hedge against a break-up of the EA. This was another insurance service of TARGET, although probably not one it was designed for.

TARGET is an excellent example for how risk sharing in a union of diverse members can work, economically and politically. Economically, it is analogous to universal social insurance: it is the same insurance against the vagaries of disrupted payments for all participants, whether traders or speculators; and the insurance is provided as a public good, the usage of which is non-excludable. This non-discrimination makes it financially robust and technically efficient. Politically, it is important that the insurance has no visible ex ante distributive effect: net importing as well as net exporting nations benefit from it. In fact, the balances do not even correspond closely to current account balances. In previous years, the Bundesbank had a negative balance while the Bank of Italy had surpluses. Only if a member leaves the EA can there be a loss to the insurance pool. To take the obvious example: if Greece exits, the claims against the Bank of Greece would be distributed according to a member state's share in the paid-up capital of the ECB, not according to the current stated balances of each national central bank in TARGET. So the loss allocation spreads the risk of a euro exit fairly in the sense that it takes the different economic size of member states into account. But it also gives everybody a stake in the payments union and an interest in keeping all members in the insurance pool.

TARGET thus illustrates how an insurance mechanism can make the diversity of countries compatible and mutually beneficial. The cross-border payments mechanism removed the foreign exchange constraint on trade between member states, a constraint that had triggered financial panics in the pegged exchange rate system of the past. Trade, uninterrupted by the difficulty to process a payment beyond the contracting parties' control, is beneficial to diverse countries. It removes an important obstacle for emerging

³ Sinn (2012) contains a set of alarmist contributions and two articles by central bankers that explain TARGET imbalances (Bindseil et al 2012, Ulbrich and Lipponer 2012).

markets' catch-up growth (Portugal, Spain) and it keeps open a source of growth for countries with too little domestic growth dynamic (Belgium, Germany).

But did this insurance not prevent adjustment and/ or enable too much risk taking? Possibly, yet this is not all bad. Insurance is meant to give time for adjustment if the disturbance is not temporary; and more risk taking such as economic specialization or innovation is usually gainful. A payments mechanism cannot prevent permanent trade imbalances. Imbalances make those that accumulate debt vulnerable: a slight rise in interest rates can render the servicing of debt too burdensome. They also make those that accumulate the corresponding claims take too much risk: the absence of exchange rate fluctuations seems to have created the false impression that country risks have gone for good but bond markets can suddenly create country risks by attacking the sovereign's debt issue. Still, this does not invalidate the insurance potential of a heterogeneous monetary union for its membership: it just says that insurance of risks to orderly payments is not enough.

From a risk-sharing perspective, European currency unification was not a triumph of political will over economic reason. Undeniably, political motives drive the integration process. For better or worse, this limited the extent to which risk sharing could occur. Political elites are not cohesive: they mistrust each other and have problems realizing the benefits of collective action. In the euro area, this mistrust established a taboo on fiscal integration. Whether self-inflicted or not, fiscal difficulties have to be solved nationally. In the financial crisis, this shifted the risk of market instability on those with the weakest capacity to bear it, namely the emerging markets inside EMU (Greece, Ireland, Portugal and Spain). And so they broke first, even though each had rather different weaknesses.

To summarize the answers to the opening questions: The longstanding attempts at forming a European monetary union can be understood as the search for ways to manage the risk of monetary and financial instability. It makes sense as a regime that reduces the risk of exchange rate instability and spreads the risks of payments imbalances. This is in the interest of trading business and their financiers, first and foremost, but the byproduct is a genuine public good. Yet no OECD country has so far succeeded in reining in destabilizing capital flows; this is not a specifically European problem and diversity at least prevents that all suffer at the same time from their effects. It is the fiscal taboo of the EA, refusing all joint liability, that shifted the risks disproportionately on those most likely to suffer pro-cyclical capital flows. The U.S. dollar area is a precedent to the EA, in that it founded a monetary union before it re-established its political union. And it is still a heterogeneous union. 'Unity in diversity' and not 'uniformity' is the promise of monetary integration here and there. But, as Peter Hall (2014: 1239) said, "the future of European integration will depend on Europe's capacity to give substance to that slogan".

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