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EUROPEAN MONETARY UNION DOOMED BY FLAWED STRUCTURE THAT SEPARATES SOVEREIGN CURRENCY FROM FISCAL POLICY

New Levy Study Says Creation of European Federal Treasury and EMU-Wide Deposit Insurance Is Vital to Address Debt Crisis

ANNANDALE-ON-HUDSON, N.Y. — With leading financial policymakers meeting in Europe this week in an effort to reduce borrowing costs in Spain, it is clear the European Monetary Union (EMU) debt crisis is far from over. A new study from the Levy Economics Institute of Bard College says that the policy efforts to address the crisis thus far—primarily bailouts tied to austerity measures—have been inconsistent and inadequate, and argues that the EMU must address a fatal design flaw in its structure: the attempt to separate fiscal policy from a sovereign currency.

The EMU bank runs and cascading solvency crises are all undergirded by a flawed banking structure compounded by a separation between fiscal policy and monetary sovereignty," write Levy President Dimitri B. Papadimitriou and Senior Scholar L. Randall Wray in the policy note *Euroland's Original Sin*. "When individual nations like Greece or Italy joined the EMU, they essentially adopted a foreign currency—the euro—but retained responsibility for their nation's fiscal policy. This attempted separation of fiscal policy from a sovereign currency is the fatal defect that is tearing the eurozone apart."

Given the setup of the EMU, the authors write that it was inevitable that individual euro nations would face two problems. First, "if a deep recession hit, their budgets would automatically move to deep deficits," they write. "The problem would not be the Maastricht criteria (since, after all, almost all euro nations persistently violated those criteria), nor even just the cyclical process by which recessions shrink revenue and increase safety net spending; but rather that markets would raise risk premia on their debt, which would cause interest rates to explode in a manner that would further increase deficits in a vicious cycle. With no 'Uncle Sam' to come to their rescue, they would have to rely on the charity of the [European Central Bank] to keep their interest rates down."

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The second major problem in the structure of the EMU, the Levy scholars contend, is that by making individual nations responsible for their own banking systems and freeing up labor and capital flows—one of the primary goals of European integration—they became responsible for the debt of their private banks, which the EMU enabled to buy assets and issue liabilities all over Euroland. When the crisis hit, “there was no hope that they would be able to bail them out without sinking their governments,” Papadimitriou and Wray write. “There was no Uncle Sam in Brussels to come to the rescue of governments burdened by the debts run up by private banks, debts that could easily be orders of magnitude greater than total government spending or taxing.”

As an example, the authors point to Ireland, where banks ramped up lending across Europe, growing their liabilities to multiples of Irish GDP. “When their bets went bad, the Irish government had to bail them out, boosting fiscal deficits and government debt into uncharted territory,” they write. “This was a design feature of the EMU and the European Union (EU) more generally: banks were freed to run up massive debts that would ultimately need to be carried by governments that, because they had abandoned currency sovereignty, were in no position to bear the burden.”

To conclude, Papadimitriou and Wray argue that the June 29 agreement to use funds from the European Financial Stability Facility and soon-to-be-created European Stability Mechanism to directly bail out banks does not go far enough. “Only a thorough reformation to unify fiscal policy and currency sovereignty will save the project of European integration,” they write. “What is needed is an open-ended, unlimited deposit insurance system from the center to back up all euro deposits in the banks of all EMU members. . . . Unless the June 29 agreement represents the first step on the way to such a system, the EMU will be left with the same defective structure that doomed it from the start.

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Policy Note 2012/8: *Euroland’s Original Sin*

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