



Policy Note

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EUROLAND'S ORIGINAL SIN

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From the very start, the European Monetary Union (EMU) was set up to fail. The host of problems we are now witnessing, from the solvency crises on the periphery to the bank runs in Spain, Greece, and Italy, were built into the very structure of the EMU and its banking system. Policymakers have admittedly responded to these various emergencies with an uninspiring mix of delaying tactics and self-destructive policy blunders, but the most fundamental mistake of all occurred well before the buildup to the current crisis. What we are witnessing are the results of a design flaw. 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.

For the past decade, many critics have focused on the policy of the European Central Bank (ECB), arguing that monetary policy was too tight. Others have argued that the Maastricht criteria, which ostensibly placed limits on member-government deficits and debt, were too tight. While both of these criticisms had some validity, they missed the main problem: Italy had become the equivalent of a Louisiana, but without the benefit of an Uncle Sam. The problem was not really that nations gave up “monetary” policy (interest rate setting) or that they agreed to overly tight constraints on budget deficits and debts. Over the past decade, ECB monetary policy was actually no tighter on average than the policy of the Federal Reserve (see Sardoni and Wray 2007).

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And in an important sense, the Maastricht criteria were too loose, given the ill-considered divorce of fiscal policy from monetary sovereignty—which is to say, given that euro governments are spending what is effectively a foreign currency. To the extent that they are users, rather than issuers, of a currency, eurozone member-states are in the same position as US states. But US states are held to deficit and debt ratios that are far more strict than the Maastricht limits, and a country like Italy cannot rely on a European version of an EU Treasury in the same way that a Louisiana can rely on the US Treasury in the event of a calamity.

Given the setup of the EMU, 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. 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 ECB to keep their interest rates down.

The second, much greater, problem was that individual nations had become responsible for their own banking systems. There was no hope that they would be able to bail them out without sinking their governments. This was part of the design of the euro system: 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 (imagine a US state being held responsible for resolving a run on a Bank of America or Wells Fargo that happened to be headquartered within its borders).

One of the goals of European integration was to free up labor and capital flows, removing barriers so that factors of production could cross borders. Indeed, that was a primary reason for adopting the single currency. Whether or not that was a good idea, and whether or not it worked, is another matter. What is important in the context of the crisis is that it enabled banks to buy assets and issue liabilities all over Euroland—which they did with abandon. The icing on the cake was the deregulation and desupervision of banking contained in the Basel Accords, which allowed European banks to partake in the same dubious schemes that Wall Street’s banks pursued.

This is, of course, what got Irish banks into trouble, as they ramped up lending across Europe, growing their liabilities to multiples of Irish GDP. Then, when their bets went bad, the Irish government had to bail them out, boosting fiscal deficits and government debt into uncharted territory. Again, 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. Warren Mosler (2001) warned from the beginning that individual EMU nations would not be able to deal with a financial crisis because of the setup of the currency union (with no clear line of responsibility back to the center).

Even more important to the current crisis in Euroland was the ability of bank depositors to costlessly shift euro deposits from one bank to another anywhere in the EMU. This is enabled by what’s known as the “TARGET 2” facility (Trans-European Automated Real-time Gross Settlement Express Transfer System). Any depositor of, let’s say, a Spanish bank can move deposits to a German bank. Such a shift requires that the central bank of Spain obtain reserves that get credited to the central bank of Germany. If deposits tend to flow from the periphery nations, their central banks go ever more deeply in hock to the ECB to obtain reserves that accumulate in the account of the Bundesbank. In 1998, Peter Garber wrote that the yet-to-be-implemented TARGET system and the structure of the ECB would create a “perfect mechanism to make an explosive attack on the system”; that the entire setup provided only the “costly illusion” of safety (Garber 1998).

That illusion is currently being dispelled before our very eyes. Euroland is now in the midst of a massive run on periphery bank deposits. Moving deposits to German banks is a sure bet: if Germany leaves the EMU, depositors will get appreciating marks, and if Germany remains in the EMU, depositors have the safest euro deposits available. Why take a risk that Italy or Spain or Greece will leave the EMU, default on euro-denominated deposits, and redenominate them in a depreciating currency? Even in the best-case scenario, the country that leaves the EMU will honor its euro debts only in domestic currency; in the worst-case scenario, it might not honor them at all. And while it is conceivable that Germany could refuse to honor euro deposits held in its banks by citizens of nations that leave the EMU, that would seem to be a low probability. After all, Germany will want buyers for its exports, so why not honor the

deposits, even if they must be converted to marks with the death of the EMU?

The bank runs should accelerate in coming days, as remaining periphery depositors decide to be neither fools nor philanthropists, and so continue to take the safest bet by shifting deposits to German banks. And if that does happen, TARGET 2 ensures that the ECB will be stuck with trillions of euros in uncollectible debts due to all the reserves it has been lending to central banks that have to finance the run to German banks. It all essentially comes down to an inadequately designed “reflux” system.

Part of the solution is to immediately adopt unlimited deposit insurance for all euro deposits in all EMU banks. But Chancellor Angela Merkel has declared that this would violate the German constitution. Deposit insurance would place an essentially unlimited liability on the ECB, which would be insolvent if Spain or Italy were to leave the EMU. And with no Uncle Sam standing behind the ECB, Germany would presumably get the bill. That’s a bill Germany will not accept; hence, probably no deposit insurance and no future for the EMU.

It is important to stress once again that this is a matter of institutional setup and political constraints. Governments whose fiscal policy has not been divorced from currency sovereignty are, for instance, not facing the same vicious cycles of exploding borrowing costs. Modern Money Theory (MMT) helps us to understand why. For the sake of simplification, and to separate genuinely economic from purely institutional obstacles, we can begin our analysis by consolidating the central bank and the treasury. This consolidated “government” spends by crediting accounts (by simple keystrokes) and taxes by debiting them. Deficit spending thus leads to net credits of bank deposits as well as bank reserves. Bond sales offer an interest-earning alternative to zero-earning (or low-earning) reserves.

This consolidated view of the government is not meant to deny the “internal” operations that go on between the central bank and the treasury, or the various operating constraints placed on the treasury. We know, for example, that most modern treasuries cannot sell bonds directly to their central banks; we know that the treasury must have “money in its account” at its central bank before it can cut a check; and we know that the US Congress, in its infinite wisdom, has imposed a debt limit on the US Treasury. But the consolidation of the Fed and Treasury balance sheets is a simplification that gives us a place to start the analysis.

In a recent presentation at the Levy Institute, Paul McCulley (until recently, senior managing director of PIMCO) observed that no one objects to consolidating the balance sheets of husband and wife. The “family balance sheet” is consolidated in the same way that we consolidate the “government balance sheet.” As with the government, there may be some preapproved hoops one family member needs to jump through before the money can be spent. McCulley called these hoops “prenuptials.” The central bank and treasury have entered into a variety of prenuptials, some of which are probably a good idea. But by mutual agreement, they can be changed. Both the US Treasury and the Federal Reserve are “creatures of Congress,” subject to the laws drafted by elected representatives and signed by the president. If the prenuptials get in the way of good public policy, they can be eliminated or changed.

This is why a United States or a Japan can run huge budget deficits that accumulate to high debt-to-GDP ratios with near-zero interest rates on short-term government debt and nearly historic lows on long-term government bonds. The market understands that there is no risk of involuntary default—Japan and the United States will continue to credit interest to their respective government debts. There is a very slight chance of a purely political voluntary default—for example, Congress could refuse to increase the debt limit, as it threatened to do last time around—but that risk is understood to be quite small because it requires entirely irrational behavior on the part of a democratically elected body. How long will US and Japanese rates remain close to zero? As long as their central banks want to keep them low. This is strictly a policy decision—and will continue until policy changes.

But given the way the EMU was set up, this is not a policy decision available to eurozone nations, some of whose borrowing costs are spiraling out of control even though their government debt ratios are much smaller than those of Japan. This problem was entirely foreseeable—and foreseen.¹ The EMU bank runs and the cascading solvency crises are all undergirded by a flawed banking structure compounded by a separation between fiscal policy and monetary sovereignty. EMU-wide deposit insurance, backed by the creation of a strong European federal treasury, would end the bank runs that are afflicting the periphery. Only a thorough reformation to unify fiscal policy and currency sovereignty will save the project of European integration.

The June 29 agreement that emerged from the EU summit does not go far enough in this direction. The agreement involves

using funds from the European Financial Stability Facility (EFSF) and the soon-to-be-created European Stability Mechanism (ESM) to directly bail out banks. The bank bailouts for Spain and Italy will not be added to each country's sovereign debt loads, but will be liabilities of the banking system and assets of the EFSF or ESM. In the case of Greece, however, the 48.8 billion euros for bailing out Greek banks were added to Greece's sovereign debt obligations. If it had received treatment similar to that of Spain and Italy, Greece's debt-to-GDP ratio would be improved (though still not serviceable); not to mention the fact that it would not be laboring under the crippling austerity conditions attached to its bailouts (conditions not included in the more recent rescue package for Spain and Italy). The discrepancy in treatment on display here can be attributed to the fact that Italy and Spain, because of their size, can blow the eurozone apart. But Chancellor Merkel seems oblivious to the message that is being transmitted by the markets regarding the instability generated by these inconsistent policy measures.

And beyond the inconsistency, the latest plan remains inadequate. EFSF-ESM funds are finite. Experience shows that anything less than a 100 percent guarantee of deposits will not stop a bank run; this is why it takes a sovereign currency issuer to stand behind deposits. No US state could offer a plausible guarantee of deposits (indeed, we experimented with such state insurance schemes in the United States, until the thrift crisis wiped them all out). No EMU member can guarantee bank deposits for this reason. And any limited funding source will not be seen as sufficient. 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.

Back in 2001, Warren Mosler wrote:

History and logic dictate that the credit sensitive euro-12 national governments and banking system will be tested. The market's arrows will inflict an initially narrow liquidity crisis, which will immediately infect and rapidly arrest the entire euro payments system. Only the inevitable, currently prohibited, direct intervention of the ECB will be capable of performing the resurrection, and from the ashes of that fallen flaming star an immortal sovereign currency will no doubt emerge. (Mosler 2001)

Note

1. This is not just ex post theorizing. Many affiliated with the Levy Institute saw this coming from the very beginning.

Wynne Godley (1997):

[I]f a government stops having its own currency, it doesn't just give up "control over monetary policy" as normally understood; its spending powers also become constrained in an entirely new way. If a government does not have its own central bank on which it can draw cheques freely, its expenditures can be financed only by borrowing in the open market in competition with businesses, and this may prove excessively expensive or even impossible, particularly under "conditions of extreme emergency." . . . [I]f Europe is not to have a full-scale budget of its own under the new arrangements it will still have, by default, a fiscal stance of its own made up of the individual budgets of component states. The danger, then, is that the budgetary restraint to which governments are individually committed will impart a disinflationary bias that locks Europe as a whole into a depression it is powerless to lift.

L. Randall Wray (1998, pp. 91–92):

Under the EMU, monetary policy is supposed to be divorced from fiscal policy, with a great degree of monetary policy independence in order to focus on the primary objective of price stability. Fiscal policy, in turn will be tightly constrained by criteria which dictate maximum deficit-to-GDP and debt-to-deficit ratios. . . . Most importantly, as Goodhart recognizes, this will be the world's first modern experiment on a wide scale that would attempt to break the link between a government and its currency. . . .

As currently designed, the EMU will have a central bank (the ECB) but it will not have any fiscal branch. This would be much like a US which operated with a Fed, but with only individual state treasuries. It will be as if each EMU member country were to attempt to operate fiscal policy in a foreign currency; deficit spending will require borrowing in that foreign currency according to the dictates of private markets.

Mathew Forstater (1999, p. 33):

Under the EMU, if investors are at all hesitant about any one member's debt, they can buy another member's debt without incurring currency risk, since there is no exchange rate variability among the currencies of member countries. Because member nations now are dependent on investors for funding their expenditure, failure to attract investors results in an inability to spend. Furthermore, should a member's revenues fail to keep pace with expenditures due to an economic slowdown, investors will likely demand a budget that is balanced, most likely through spending cuts. In other words, market forces can demand pro-cyclical fiscal policy during a recession, compounding recessionary influences.

Stephanie Bell (2002):

Countries that wish to compete for benchmark status, or to improve the terms on which they borrow, will have an incentive to reduce fiscal deficits or strive for budget surpluses. In countries where this becomes the overriding policy objective, we should not be surprised to find relatively little attention paid to the stabilization of output and employment. In contrast, countries that attempt to eschew the principles of "sound" finance may find that they are unable to run large, counter-cyclical deficits, as lenders refuse to provide sufficient credit on desirable terms. Until something is done to enable member states to avert these financial constraints (e.g., political union and the establishment of a federal [EU] budget or the establishment of a new lending institution, designed to aid member states in pursuing a broad set of policy objectives), the prospects for stabilization in the Eurozone appear grim.

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