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Europe: After the Crisis

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Abstract

The Eurozone could come to tatters temporarily. But the European ideal is so powerful that crisis and division will not permanently prevail. European leaders absorbed previous crises and bounced back to drive the European project forward. The same may happen again. This paper discusses how the political and economic underpinning of the Eurozone must change to avoid future crises.

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I. Introduction

Europe has moved forward in fits and starts, ever since it began coming together in the 1950s. Currently it is having a fit. It is hard to see quite how and when this will end, but we doubt if this crisis will end either swiftly or well. Europe, or rather the euro-zone within it, could easily come to appear in tatters, at least temporarily. But the European ideal has so much power that crisis and even division will not permanently prevail. There have been several prior serious set-backs, e.g. the break-up of the snake in the tunnel, the collapse of the Exchange Rate Mechanism, and each time the leaders of Europe absorbed what were thought to be the prior lessons and bounced back to drive the European project forward yet again. Thus the collapse of the snake in the tunnel led to the ERM, and the collapse of the ERM led to the single currency.

But the current crisis has been far more than just an economic crisis; it has been a political crisis also. This has been so for two reasons. First, and at a more superficial level, the crisis has been handled primarily by the political leaders of the major nations, notably Merkel and Sarkozy, supported by the Director General of the IMF, both of whom happened to be French. The leaders of the EU as a whole, van Rompuy and Barroso, had no money, little legitimacy (having been the place-men of the national leaders), and scant power. These two played, at best, a walk-on supporting role. Meanwhile the national political leaders each were subject to national political interests and constraints, which they had to balance against diverging views of the longer term future of the euro-zone. While all agreed to the end of saving the single currency, there was no agreement on the means. As a result, the political discussions often resembled a cacophony, with eventual, last minute compromise on the minimum necessary to hold the euro-zone together for the time-being; with the time-being measured in months, not years. Politics, if anything, has prolonged and worsened the crisis.

At the deeper level, this sorry tale has been a symptom of the failure of the elite to engage the mass public in the European project. This project has been driven forward by the elite. Apart, perhaps, from the population of Brussels, the primary allegiance of most of the public remains to their nation state, (or to their local region, e.g. Catalonia or Scotland). As a result national leaders are almost solely constrained by perceived national interests, and there is no counterbalance from Europe-wide political leaders, since the latter have no democratic legitimacy and no money. This latter lack of legitimacy was built into the working of the EU by having the President of the EC and the President of the Council of Ministers appointed by the cabal of national political leaders. In so far as there is an executive of the euro-zone, e.g. in the guise of the President of the European Commission, we, the people, have no more role in that appointment than in the case of an hereditary king or an elected Pope.

We do vote for Members of the European Parliament (MEPs). But the main role of a legislature is to hold the executive to account, and to constrain its freedom of action by limiting taxation, the power of the purse, 'no taxation without representation'. Since the voting public is not given any share in decisions about the (EC's) executive programme, and since there is hardly any purse to constrain (beyond the inflated administrative costs involved), voting for MEPs mostly becomes an extension of voting for the main national parties, with little real European dimension involved. To some limited extent national parties are thought to be more, or less, euro-phile, or euro-sceptic, and that influences a few votes; thus UKIP, the UK's Independence Party does much better in European than in national votes. But in the main, the election of MEPs is not actually about Europe at all!

If Europe is to become a democratic polity, this has to change. So the first proposal here is about reformulating the basis for appointing the President of the European Commission and the Commissioners, to be appointed by the President (not by national governments as now). Meanwhile money and power are intimately related. As has been exemplified in the recent crisis, it is problematical to try to issue money without the power to support that via taxation. Equally without access to money (notably via taxes), the power to undertake counter-cyclical, or cross-country,

stabilisation is limited. So, the second proposal is to revisit the exercise that was done, some twenty years ago, to assess what fiscal changes might be needed to accompany a single currency.

This latter exercise was turned down flat by the richer, Northern countries at that time (1993), partly because they saw it, (not entirely correctly), as a 'Transfer Union'. It is likely that the proposals advanced here will similarly be found to be 'ahead of their time'. So the question then becomes whether, and how, in the absence of more appropriate, and deeper, political and economic reforms, a single euro-currency could be made to function more effectively. The answer is that there is a set of such possible improvements, largely building on an overdue appreciation that the Maastricht criteria, and the Stability and Growth Pact, were badly designed. Better designs can be found, implemented and be made self-reinforcing.

II. Politics

The single most important political reform for the EU is to have the President of the European Commission elected by the voters, not appointed by the Council of Ministers. If she is to be elected, there needs to be a democratic contest, and, to understand what the candidate represents, each candidate should publish a manifesto of intended policies. How would a candidate for President emerge? One way would be to allow any Prime Minister, or set of Prime Ministers, representing more than, say, 75 million people to put a name in contention. Arrangements could be made to ensure that there were always at least two candidates, and for selecting a winner when there were more than two candidates, and none got over 50% of the votes.

In order to retain a proper EU balance, the same number of Commissioners would be appointed from each country as now. But the successful candidate for President would choose her own slate of such Commissioners. It would be expected that candidates, prior to election, would give an indication of whom they might have in mind for the more important of such positions. The Commissioners would, of course, support the policies set out in the manifesto. The period in office of the Commissioners would be coterminous with that of the President, perhaps five years with no renewal. Continuity would be provided by the Commission staff.

Elections to the European Parliament would be, intentionally, on a different cycle, say once every three years, so that, if the European voters were unhappy with the executive direction of the EC, they could elect a Parliament that would rein it back.

The purpose of the exercise is to construct a European polity, and power centre, that answers directly to the people of Europe, and is not simply an apparatus managed by national political leaders.

One of the key levers of power, and the main support for any currency, is the power to tax. With the EU being a different kind of political construct from the normal federal country, the power for the European executive needs to be greater than at present, but still tightly constrained. What such powers should be was considered at some length in the EC Report, on 'Stable Money – Sound Finances: Community public finance in the perspective of EMU', published in *European Economy*, No. 53, 1993, though most of the work on it was done several years earlier in 1990/91; this work was buttressed by Reports and Studies in *The Economics of Community Public Finance*, also published in *European Economy*, No. 5, 1993.

III. The Fiscal Counterpart to a Monetary Union

There is no need to reinvest the wheel. The above EC study remains the most comprehensive study of the complementary fiscal path, to accompany monetary union, that the euro-zone should have taken, and conspicuously failed to follow, with results that are now all too obvious.

Since this study was done some two decades ago, it will have skipped most memories. So it may be as well to recall some highlights of it. First, from some key paragraphs, in the Highlights section, pp 1 and 2.

“In the early years following the introduction of a single currency (i.e. in about 10 to 15 years) a small EC budget of about 2% of Community GDP is capable of sustaining economic and monetary union, including the discharge of the Community's growing external responsibilities (see Table 1). Such a budget should be composed of an effective interregional stabilization mechanism; reduced agricultural expenditure; an increased but still limited Community involvement in environment, R&D, trans-European networks and higher education; some further increase in expenditure for economic and social cohesion; and a strong rise in aid to third countries.

In economic and monetary union, the Community budget should be financed in a way different from the present one. European Central Bank profits are as convincing a candidate for new own resources. Other well-suited candidates are a tax on CO₂ emissions and corporate taxes.”

Table 1
EC Expenditure in the early years following the introduction of a single currency
and comparison with the 1992 budget

Expenditure categories	Indicative % of EC GDP	% share	1992 budget as % of 1992 GDP	% share in 1992 including EDF*
1. Agricultural expenditure	0.4 to 0.5	23	0.67	56
2. R&D, infrastructure, energy, education, environment	0.15 to 0.2	10`	0.06	5
3. Structural expenditure (including Cohesion Fund)	0.4 to 0.5	23	0.32	27
4. External aid (including EDF*)	0.5 to 0.55	27	0.07	6
5. Expected outlays under regional stabilization mechanism	about 0.2	12	--	--
6. Other	0.1	5	0.07	6
Total	1.75 to 2.05	100	1.19	100

* EDF = European Development Fund

Then from the Summary and Conclusions, pp 6-7.

“The central message of the report is that a small 'EMU budget' of about 2% of Community GDP is capable of sustaining European economic and monetary union, including the discharge of the Community's growing external responsibilities (see Table 1).

This is clearly contrary to much of the conventional economic wisdom, reflected in the MacDougall report as well as in the literature on economic and monetary union. Three distinctive features of this report compared to previous analyses explain the difference in the group's conclusions:

- (i) The principle of subsidiarity is applied rigorously.
- (ii) No explicit role is foreseen for the Community budget in Community-wide macroeconomic stabilization.
- (iii) While recognizing that strong political forces are at play and that the reduction of regional disparities is an important Community objective, the economic case for a permanent and substantial increase in interregional redistribution, as a direct consequence of EMU, is found to be weak.

Moreover, the group's confidence in this unconventional conclusion rests on one of its main findings. Inexpensive and effective mechanisms can be operated for assisting Member States hit by adverse economic developments (shock absorption) if they are explicitly designed for this purpose rather than

being the automatic implicit consequence of much larger budgetary flows serving mainly other purposes as in existing unions. Such a shock-absorption mechanism would provide a cushion against adverse developments in the Member States to a similar degree as automatic stabilizers do, for example, in the USA. For a shock absorption scheme based on changes in unemployment rates, the group estimates that the average annual expenditure might be of the order of 0,2% of EC GDP.

In addition to a cheap but effective specific stabilization instrument, no major new Community expenditure category would be necessary. However, the structure of expenditure should change significantly, leading to a drop in agricultural expenditure to about 25% of the total budget; an increased but still limited involvement (less than 0,2% of GDP) in expenditure on environment, R&D, trans-European networks and higher education; further strengthening of Structural Fund expenditure (including the new Cohesion Fund); and a strong increase in aid to third countries (including the integration of the European Development Fund into the general budget).

Here the following changes are advocated. New Community own resources should substitute, at least partially, for the present third and fourth resource, while at least maintaining proportionality, i.e. ensuring that poorer countries do not pay more and richer ones not less than their GDP shares. European Central Bank profits are as convincing a candidate for new own resources as customs duties. Other well-suited candidates are a tax on CO₂ emissions and corporate taxes.”

Finally, from Chapter 6, on *Stabilization support*, pp 73-75, the procedure for assisting countries in difficulties was discussed in more detail.

“As pointed out in Goodhart and Smith (1993), for a stabilization instrument to be pure and effective, it needs to respect the following three general principles:

(i) The instrument should be triggered following changes in economic activity but its intervention should be halted as soon as no further changes occur, irrespective of the level at which the economy has again become stable. Otherwise, the instrument would perform not only a stabilization function, but also play a redistributive role. Such an 'impurity' is typical for traditional fiscal policy measures, but should be avoided in the Community context as it may perpetuate adjustment problems and induce transfer dependency.

(ii) The instrument should make its impact during the decline in real economic activity, and not afterwards, when the economy has stabilized or is already recovering. If the intervention affects the economy too late, undesirable fluctuations around trend growth will be amplified by government action. As stressed in Friedman (1953), timing is critical to the success of stabilization policy, as well as hard to get right because downturns can be sharp yet relatively short-lived and any discretionary instrument is subject to the problem of recognition and policy implementation lags which can easily amount to more than half a year. Given the need for speed, the activation of the instrument should therefore be preferably linked to an indicator, whose fluctuations form a close proxy for variations in real output, and whose measurement is accurate and quick.

(iii) Stabilization is usually seen as arising through the effect of public financial transfers on private agents' incomes, and hence consumption. Ideally, a Community stabilization instrument should therefore, directly or indirectly, make a significant contribution on the margin to the income of individuals in the Member State(s) going through a recession.

On top of these requirements, a Community instrument to assist regional stabilization should reflect two additional considerations.

First, the instrument should only provide support inasmuch as the registered economic decline displays a clear country-specific dimension. As argued in Section 4.2, shocks affecting the whole of the Community should be responded to by fiscal policy coordination among the Twelve, the automatic stabilizers at national level, and, if the aim of price stability permits, the exchange rate and monetary

policy stance of the ESCB. Only when a country's slump distances it from the rest can EC assistance be forthcoming.

Second, in keeping with the reasoning that the abandonment of the exchange-rate instrument should be compensated for and recognizing that devaluation is not resorted to for each and every dip of real activity below trend, Community help should act as an insurance against grave economic difficulties. Accordingly, support should take place only in the event of major negative developments. The shock may be of a regional or sectoral nature but it should have clearly measurable significant macroeconomic repercussions. Moreover, in view of the objective of stabilization, neither the relative magnitude nor the likelihood of support should in any way be influenced by the relative prosperity of Member States. Each Member State should stand, in principle, an equal chance of being eligible for Community assistance.

As a final general remark, regional stabilization support should preferably take the form of Community grants rather than loans. For one thing, Community loans are scarcely appealing for Member States enjoying a strong credit rating on international capital markets. For another, Member States which, in EMU, need to offer a significant interest premium will in all likelihood be characterized by a high debt-to-GDP ratio. Community loans will raise the country's level of indebtedness, pushing it further into the 'excessive deficit' zone. Loans may thereby undermine the credibility of the latter concept, which is central to the Community's strategy in EMU to combat the public finance sources of inflation. Conversely, the existence of Community stabilization support would facilitate Member States' observance of the 'excessive deficit' constraint by tiding over economic downswings.....

The stabilization power one would wish the mechanism to achieve is ultimately a matter of political preferences, reflecting attitudes towards risk aversion. However, more important from the viewpoint of the present report is the finding that the proposed mechanism is highly efficient, i.e. it is capable of generating, at relatively low budgetary cost, a degree of stabilization that is not dissimilar from what has been observed for the federations of North America.”

IV. Revision of the Maastricht Criteria

This attempt to construct a minimalist federal fiscal reinforcement for a monetary union was rejected so rapidly and comprehensively by the richer Northern nations of the EU, at the start of the 1990s, that most people, even then, remained unaware that such a proposal had even been put on the table. Would it be politically possible to disinter it now? Such a proposal would obviously only relate to the euro-zone countries, and not to the out countries. This would remove the threat of a UK veto; indeed George Osborne (Refs August 2011) has indicated provisional support for such measures of fiscal mutual insurance amongst euro-zone countries.

But, despite the safe-guards against a permanent 'transfer union' built into the above proposals, the richer nations of the euro-zone could still see any safety-net fiscal measures as not only putting the euro-zone on the slippery slope to a 'transfer union', but also as replete with 'moral hazard'. So the likelihood of moving towards some fiscal counterpart to monetary union remains slim.

It was this gap, i.e. the absence of any central fisc to support the single monetary union, that the Maastricht criteria were meant to fill. These criteria were badly designed, not only focussing unduly on public sector deficits, rather than on current account deficits, but also having an incredible, and in the event unusable, set of sanctions. Let us start with the first shortcoming. There were a number of implicit, and incorrect, assumptions in those criteria. The first, and most important, was that a private sector deficit in any country, matched by a capital inflow (current account deficit), should not be potentially destabilising, because the private sector must have worked out how to repay its debts before incurring them. The second was that, in a single monetary system, local current account

conditions not only cannot be calculated, but do not matter. The third is that a public sector deficit, of a member country, is just as damaging when it is matched by a national private sector surplus, as by capital inflows.

Public sector debt can be redeemed in one of three ways, by a revenue surplus of tax over expenditures, by inflating it away, or by default. A monetary union prevents the member state from deploying the second option. But so long as the public sector debt is entirely domestically held, the choice between the tax burden and the default alternative is essentially internal. There will be indirect effects on other members of the monetary union, but so long as the domestic authorities choose the outcome with the greatest social welfare to their own citizens, that same choice will generally also be to the benefit of other members of the monetary union, (yes, one could construct artificial counter-examples, but are they realistically likely?).

In short, the concern of other members of a monetary union with the public sector finances of a member should relate directly to how far such debt is foreign held, and how far such deficits are matched by continuing capital inflows. Exactly the same analysis holds for external debt levels, and deficits, incurred for the provision of non-tradeable goods, such as housing, and many, but not all, services. In such cases the debt can only be paid off, current account deficits replaced by surpluses, if there is an incentive in future to shift into tradeable good production, out of non-tradeables. Such a shift is normally provided by devaluation, especially after a 'sudden stop' to capital inflows. But such devaluation is ruled out by a monetary union. Hence debts, and deficits, incurred as a counterpart to rising household debt levels, and non-tradeable construction, are just as potentially destabilising to a monetary union as public sector deficits. This was simply not recognized before the current crisis struck, especially not so in the cases of Ireland and Spain who had enjoyed a public sector surplus in the run-up to the crisis.

What this implies is the need for a wholesale reorientation of the stability conditions towards much more concern with external debt, and deficit, conditions and much less single-minded focus on the public sector finances. If a member country is in a Japanese condition with a huge public sector debt, but fully financed domestically, with a current account surplus and large net external assets, then its debt should entirely be its own concern, and not subject to censure or control by any outside body, whether in a monetary union, or not. Of course, such greater attention to external, especially current account, conditions needs to be more nuanced, since deficits, and external debts, incurred to finance tradeable goods production subsequently should provide the extra goods to sell to pay off such debts.

Belatedly the European Commission has been moving in this direction with its new Excessive Imbalances Procedure, (EIP), see M. Buti (2011, pp 5/6). Thus he writes:-

"In the decade preceding the crisis, macroeconomic imbalances in the EU and within the euro area increased considerably (European Commission 2010a). The warning signs were that current accounts of some member states increased to staggering deficits while for others current account surpluses built up. External imbalances can be problematic but not necessarily worrisome if deficits/surpluses are natural responses to changes in underlying fundamentals and the related saving and investment decisions of households or businesses. For instance, countries in the catching up phases often run current account deficits by investing in building up the stock of productive capacity. This, in turn, increases the prospects of future income and ensures their ability to repay the borrowed capital. Similarly, countries with ageing population may find it opportune to save today, i.e. run current account surpluses, to avoid a drop in consumption in the future (Obstfeld and Rogoff 1996).

However, high and persistent current account imbalances pose a policy challenge and need to be tackled if they are driven by market failures or inappropriate policy interventions. In this respect, external imbalances might reflect other types of imbalances such as excessive credit expansions or

asset bubbles. In these cases, the capital imported is not invested in productive activities that would enable the future repayment of today's incurred liabilities. Current account positions can also be a sign of an imbalance if they reflect weaknesses in domestic demand.

Indeed, the growing imbalances in the EU and particularly in the euro area reflected, at least in part, unsustainable macroeconomic developments. Some member states saw their price and cost competitiveness improve markedly, while others significantly lost competitiveness. Price and cost competitiveness indicators, such as Real Effective Exchange Rates, clearly document the increasing divergences in the EU and euro area. In addition, some euro area countries have shown a worrying gradual deterioration in export market shares.

The growing external imbalances were reflected in a build-up of domestic imbalances such as excessive credit growth in the private sector, housing imbalances as well as structural weaknesses of domestic demand and the inappropriate adjustments of wages to a slowdown in productivity. In particular, countries such as Greece, Spain or Ireland experienced rather fast rates of growth which were to an important degree driven by domestic demand booms and expansions in non-tradable sectors, notably, albeit not exclusively, construction.

As a result of this process, fuelled by low financing costs and increase in cross-border capital flow, resources were often channelled into unproductive uses. Figure 4 shows that the excessive credit expansions stimulated demand and pushed current account into deep deficits in some member states. Similarly, housing prices grew fast in many EU countries, in several cases developing into housing bubbles. Conversely, domestic demand in other member states appears to have been constrained, in part, due to existing rigidities in product markets. This, together with mispricing of risk in financial markets, resulted in increasing current account surpluses.”

The EIP should, one would hope, replace the old Maastricht criteria as the basis for euro-zone corrective policies. How might it work? Again Buti writes (*ibid*, pp 9/10),

“The procedure will have two key elements: (i) 'a preventive arm', focused on the early detection of macroeconomic imbalances through a regular monitoring and assessment; and (ii) 'a corrective arm', which kicks in when harmful imbalances are identified.

The preventive arm starts with an 'alert mechanism' to identify member states with potentially problematic levels of macroeconomic imbalances. The alert mechanism includes a scoreboard of forward looking indicators, which combined with an economic reading of results by the Commission services, could provide an early-warning of the emergence of potential imbalances. The aim of the alert mechanism is to identify those member states where 'in-depth' study is required to determine whether an imbalance is problematic or benign. It is the in-depth study, and not the scoreboard/alert mechanism, which is the central feature of the preventive arm of the EIP and which will be basis for any policy recommendations addressed to member states.

If the 'in-depth' study 'concludes that the imbalances are 'excessive' in that they, are severe or jeopardising the functioning of EMU, the 'corrective arm' of the process will be activated and the member state concerned will be subject to an 'Excessive Imbalance Procedure' (EIP). This will involve stepped-up surveillance centred around a remedial action plan put forward by the member state in response to more prescriptive country-specific policy recommendations issued by the Council. The action plan should detail the policy responses and their calendar and be agreed by the Commission and Council as an, *ex-ante*, sufficient policy response if well implemented. Strict progress reporting and implementation monitoring will accompany the process to ensure follow up.

In addition, if a euro area member fails repeatedly to act in compliance with the agreed action plan (or to put forward a sufficient plan) it will be subject to yearly financial sanctions until the Council

establishes that corrective action has been taken. If credibly enforced, the possibility to impose sanctions will be a crucial element. An important feature is that such sanctions should be voted, in the Council, with a reverse qualified majority. Unless a qualified majority is against, the sanctions will apply automatically. This major shift, which also applies to the proposed reforms to the SGP, will address one of the most widely criticised shortcomings of the existing surveillance arrangements.”

The ‘analytical, preventive’ arm is quite well designed, but, once again, the ‘corrective’ arm, involving enforcement and sanctions is not.

As described by Buti, the suggested sanction still take the shape of a financial penalty to be imposed on the wayward government, albeit now quasi-automatically. There are several major objections to this. If the financial penalty is small, it would not have much effect. If large, it would worsen public sector finances, just when these are likely to be weak. For example, would it make sense under current circumstances to fine Greece and Portugal for running a current account deficit? Again for a sovereign country, the standard response to a persistent current account deficit is devaluation. When a country voluntarily gives up its ability so to do as a member of a monetary union, is it appropriate for that same monetary union to fine a member country facing current account problems? Finally such pecuniary fines are likely to inflame anti-European political sentiment in the country at the receiving end.

Indeed, the persistence of the EC in seeking to apply such fines as a sanction is evidence of lack of analytical imagination, especially where there may be better alternatives at hand. A much more suitable sanction would be an enforced credit rating downgrade, whenever external debt/current account deficit was matched by a combination of public sector and household debt/deficit. Certainly the details and numerical thresholds would be complicated, but it would relate the sanction, (worsening credit rating), directly to the problem, i.e. the likelihood of default with cross-border spill-over, externalities. The aim would be to downgrade the credit ratings of countries getting into unsustainable external positions well before this threatened the financial stability of both creditor and debtor countries in the euro-zone.

A valid criticism of the credit ratings agencies has been that, under political pressure, they have downgraded the ratings of (important) sovereign countries far too late in the course of the current crisis; that relates as much to the USA as to the euro-zone. In view of the fact that the EC has been so focussed on public sector debt/deficit, it has been both weak-kneed and short-sighted of them to play along with the self-interested complaints of national governments that such downgrades were premature and unjustified, whereas in reality the reverse has been the case.

What this implies is that sanctions, in the guise of credit downgrades, have to be embedded in rules agreed ex ante. Leaving it to the discretion of the authorities ex post, to act as judges in their own case, is to guarantee the failure of such a system. The rules could be based on a ‘comply or explain’ procedure, perhaps giving the EC the capacity to explain why the downgrade rule should not be applied in some special circumstance, (which explanation should also be agreed by the European Parliament). The frequently advanced proposal to develop an European rating agency is generally ridiculed as a self-serving mechanism for maintaining artificially high ratings. The only European ratings agency that would have any real value would be one that was required by transparent ex ante rules to be manifestly tougher and more rigorous than the present lot of CRAs. That would be a good idea. Might it happen? Perhaps when the present euro-crisis has been analysed in more depth, the case for it may become better understood, but again the chances are slim.

V. Banks and Governments

The euro-zone crisis has been much complicated by the interaction between national governments and their domestic banks. In federal unions, sub-sovereign member states can, and do occasionally,

go bankrupt without devastating results. This is largely because their failure does not automatically entail the collapse of their own financial system, since the latter has become dominated by federally diversified financial intermediaries. But a euro-zone country cannot default, except to a strictly limited degree, without bringing down its own banks, and insurance companies, (and vice versa, the main banks of such a country cannot default without bringing down the finances of the public sector of that country). A country can go on operating, more or less, if public sector expenditures have to be reined back to such levels as current receipts allow. But a country cannot function if its banks and payment system close. Ultimately foreign banks might take over, but the lags involved would seem to those affected like an eternity. The most pressing and immediate threat to the maintenance of the euro has always been a bank run, or bank failure, that the rest of the euro-zone (ECB) cannot, or will not, check; under such circumstances a national government has little alternative but to leave the monetary union, and to save its own banking system by resort to a reconstructed printing press (plus exchange controls).

This problem would be ameliorated if the main banks in the member states were all very large cross-border euro-banks, so that they were so diversified that the default of a (small) member state would not cause their own subsequent failure. But this would not be likely when a larger member state was at risk, or one with a particularly large debt. Moreover it causes another problem. Larger cross-border banks are likely to be large relative to the size of the fisc in their own head-quartered country. Their cross-border activities may be too large to save for their home country; and no good way to handle the burden of the failure of a cross-border bank amongst the countries involved has yet been found.

So much of the problem of preventing public sector crises from breaking up the monetary union transmutes into the related question of how to cope with potential banking crises. There are three ways (at least) with coping with the burdens/losses of bank crises. These are not mutually exclusive.

The first is to try to prevent them by requiring much higher equity ratios, reinforced (and this is necessary) by credible intervention in the guise of temporary public ownership whenever such equity capital should fall anywhere near a danger area, (as measured by market, as well as by accounting, values). The draw-back of this is that bank management, upset by falling Returns on Equity (RoE) results and declines in equity prices, might respond by deleveraging and seeking ever more keenly to find loopholes in regulation to manipulate in order to maintain RoEs. One answer to this transitional problem would be to restrict dividends, and perhaps increases in executive compensation, until not only were the capital ratios achieved but also the starting level of bank assets were re-attained. While this could most easily be done by increasing holdings of government debt, rather than lending to SMEs, such a course would not be very profitable, especially during periods of deflation and low official interest rates, and would raise interest rate risk. Moreover, such intervention would be widely perceived as draconian and inconsistent with a capitalist system.

The second is to place the burden on creditors, by requiring banks to issue co-cos, and to make the bonds issued by both banks and governments subject to bail-in, whereby the bank/government remains in operation but the loss gets absorbed by the bond holder in reverse order of seniority. If bank/government failures/crises were random, or idiosyncratic, events, this would be the way to go. Unfortunately the serious crises are systemic in character. The likelihood of a bail-in (co-co) trigger getting pulled in one instance is likely to close the primary market for new bail-inable issues for any other bank/country with even a remote chance of meeting the same fate. Faced with such an inability to raise such new bond finance, banks would be forced to sell assets, thereby worsening the downward spiral. Because most analysts think only in terms of the effects on the individual bank/country, the proposals for co-cos/bail-ins are getting much more support than they deserve as an antidote to systemic problems. Rather than worry about the effects of the first bank/country to face default, proponents of co-cos/bail-ins need to address the question of how these arrangements would affect the prospects of all the others in difficulties at the same time. When one tries to design a system proof against failure, contagion should be the main concern.

The third approach is to have some kind of insurance fund to meet the loss burden and to prevent forced closure of systemically important banks. The next question is who meets the cost? There is no good way to assess the premia that each bank should pay ex ante, though it could be related to equity ratios. If the latter, one reverts to the problem of bank management's focus on ROEs. There is also a concern about moral hazard, though this should be prevented by employing a combination of both risk-weighted and simple leverage capital asset ratios.

If the insurance cost is to be met ex post by the surviving banks, it runs into several problems. First, the tax, being ex post, has no beneficial effect in encouraging more prudent bank behaviour ex ante. Second it imposes a greater burden on surviving banks just when they are most fragile and need profits most desperately to rebuild their strength. The cynical might conclude that such support as the industry gives to ex post, over ex ante, bank taxes is partly due to the expectation that the manifold disadvantages of such an ex post tax would cause its imposition to be deferred or lightened in the event.

That, of course, leaves the taxpayer as bearing the brunt of any such bail-out. We have seen the political and economic limitations of that route. The current cry is for a massive increase in some European fund, a major extension to the EFSF. But this is, in effect, and so perceived to be, a contingent claim on the German taxpayer, and as such is not likely to be accepted. Perhaps a more realistic proposal, which harks back to the suggestions put forward in Section III, would be to build up, ex ante, an insurance fund, financed for example from seignorage from euro note-issue. This fund would need to be mainly invested (when not required) in non-euro-zone assets so that sales (i.e. to buy equity in euro-banks in difficulties) would strengthen euro values. Such a fund would have the characteristics of a euro-zone sovereign wealth fund. One can argue that it is not just oil-rich countries which need a sovereign wealth fund as a protection against systemic future crises.

VI. Conclusions

- 1) There is a need to revisit the political and economic underpinning of the euro-zone. A monetary union does need some minimal centralisation of powers to work. We need to review what such minima may be. A look back at the EC 1993 exercise on 'Stable Money – Sound Finances' would be a good starting point.
- 2) The new EC Excessive Imbalances Procedure correctly shifts the focus from public sector deficits/debts towards external deficits/debts.
- 3) But the enforcement/sanctions component of the EIP is misguided. The problem with the ratings agencies has been that they have downgraded sovereign ratings far too late, not too early. Can a mechanism be found to establish rules to rectify that?
- 4) The most severe euro-zone problems have arisen from the interaction between bank and public sector debt. There is no really good way to resolve this. Enthusiasm for bail-ins of bond holders is over-done. Bank taxes have numerous disadvantages. There is a case for building up a sizeable euro-zone sovereign wealth fund for use in emergencies.