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# Europe's Crisis Point

BY THOMAS MAYER

*Without changes, monetary union will inevitably collapse and the euro disappear.*

In the run-up to European monetary union, many economists warned that the single European currency would not survive if it were not backed by a single European state. When the treaty on monetary union was concluded, leading politicians therefore promised that political union would quickly follow. But agreement on political union proved elusive. EMU went ahead anyway. Developments at first seemed to prove the skeptics wrong. Since 2009, however, the deficiencies in the design of EMU have become apparent. Despite all efforts of governments, EMU would probably have collapsed already if the European Central Bank had not acted as its lifeguard. But the monetary order that has emerged in the course of the rescue operations for the euro is deeply flawed. For the euro to survive in this order, a proper state is needed to support it. But the emergence of a European state is not on the political horizon. Without a single European state as its guardian and guarantor, the euro must be reconstituted in a commodity money order, the order originally intended for it in the Maastricht Treaty. If this is not done, the question is not whether but only when EMU will collapse and the euro disappear.

## MONEY ORDERS ACCORDING TO EUCKEN

Walter Eucken, a key proponent of the German ordo-liberal school of economics, distinguished between commodity money and credit money systems. In the first system, money represents a commodity that has become a means of exchange and store of value by social

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convention. A pure form of a commodity money system is money fully backed by gold or silver. In the credit money system, money is lent into existence by private banks and hence backed by bank credit. Credit money can be created out of commodity money such as gold through fractional reserve banking, or it can be created on its own in association with fiat central bank money.

According to Eucken, existing monetary orders are mixtures of the pure systems, with one or the other system exerting the dominant influence. Today, our global money order is dominated by the credit money system coupled with fiat central bank money. There, money is created in a private-public partnership: Commercial banks produce book money via credit extension as private debt money, with the central bank managing the money production process and issuing central bank money to the public in the form of bank notes.

Already under the gold standard of the nineteenth century, when central bank notes were backed by gold and credit money was created through fractional reserve banking, the need for a lender of last resort to banks became apparent. Central banks, which originally were created as government funding agencies, assumed this role. In 1873, Walter Bagehot, a British economist, described the task of a lender of last resort: it should lend freely, but at a penalty rate and against good collateral. Bagehot's rule implied that the lender of last resort should only help solvent banks suffering from temporary liquidity crises. Those receiving assistance from it must have good collateral they can post as security and they must be able to afford high interest payments. If they cannot do this, they must declare insolvency and be wound down.

But the bankruptcy of a bank can have negative spillover effects on other banks when scared depositors want to exchange the book money banks created through credit extension against central bank money on a larger scale. To avoid bank runs, deposit insurance was introduced. In the United States, deposit insurance began in the nineteenth century at the state level. With the founding of the Federal Deposit Insurance Corporation, it was elevated to the federal level in 1933. In Germany, deposit insurance was introduced among cooperative banks in 1937. It was extended to private banks and moved to the federal level in 1966. Since the financial crisis of 2007–2009, deposit insurance has been fortified in the whole of the European Union. Today, common practice on a global scale is that the lender-of-last resort function of the central bank is complemented by a state-backed deposit insurance system so as to be able to deal with both liquidity and solvency crises in a banking sector issuing private debt money.

## Three Vital Reforms

First, insolvencies of banks would have to be made possible by either breaking up systemically important banks or, preferably, replacing fractional by full reserve banking. With full reserve banking (that is, money deposits at banks fully covered by central bank reserves), money would no longer be lent into existence by private banks but issued directly by the central bank. Thus, money could no longer be destroyed when banks fail. There would be no need for the central bank to act as a lender of last resort, nor would it be necessary for the state to provide a backstop for deposit insurance. Second, bankruptcies of states would have to be made possible by establishing a sovereign insolvency procedure. State debt would no longer be "sovereign debt" but become "credit." Hence, states would have to substantially reduce their outstanding debt. Third, the exit from EMU as a measure of last resort for a state unable to cope in a commodity money order would have to be allowed by introducing an EMU exit procedure. The possibility of exit is necessary to set strong incentives for policy discipline and to protect citizens and other states from serial defaults within EMU by reckless states.

*—T. Mayer*

*EMU would probably have collapsed already if the European Central Bank had not acted as its lifeguard.*

### THE EURO AS A QUASI-COMMODITY CURRENCY

Because of German insistence, the Maastricht Treaty of 1992, which laid the foundation for European monetary union, endowed the euro with a few features similar to those of commodity money. The European Central Bank was to steer the money supply with a view to achieving only price stability. It was banned from giving credit to governments or helping governments actively in pursuing the goals of growth and full employment. Governments were supposed to be responsible for their own fiscal affairs and banking systems, and they were not supposed to receive financial help from each other or from European institutions if they faced financial difficulties, even when threatened by bankruptcy. Thus, the institutional design for EMU had features similar to that of a gold-standard regime. However, for the euro to be established as true commodity money, the design left two key questions open. First, how could the default of an EMU member country be handled? And second, how could the exit from EMU of a country that was unable or unwilling to adjust to a commodity money regime be arranged?

From a German perspective, leaving these questions open could only be justified with the expectation that monetary union would quickly be followed by political union. In this case, the euro would lose its characteristics of a commodity currency again and eventually be constituted as credit money within a single European state. German Chancellor Helmut Kohl indeed promised political union as a follow-up to monetary union during the parliamentary debate on the ratification of the Maastricht Treaty. In a political union, a strong central authority could be expected to deal with financial difficulties at the lower levels of government, like the German federal government had dealt with financially troubled federal states. It would also act as a backstop for deposit insurance and deal with insolvent banks. Monetary policy would be left unperturbed by fiscal

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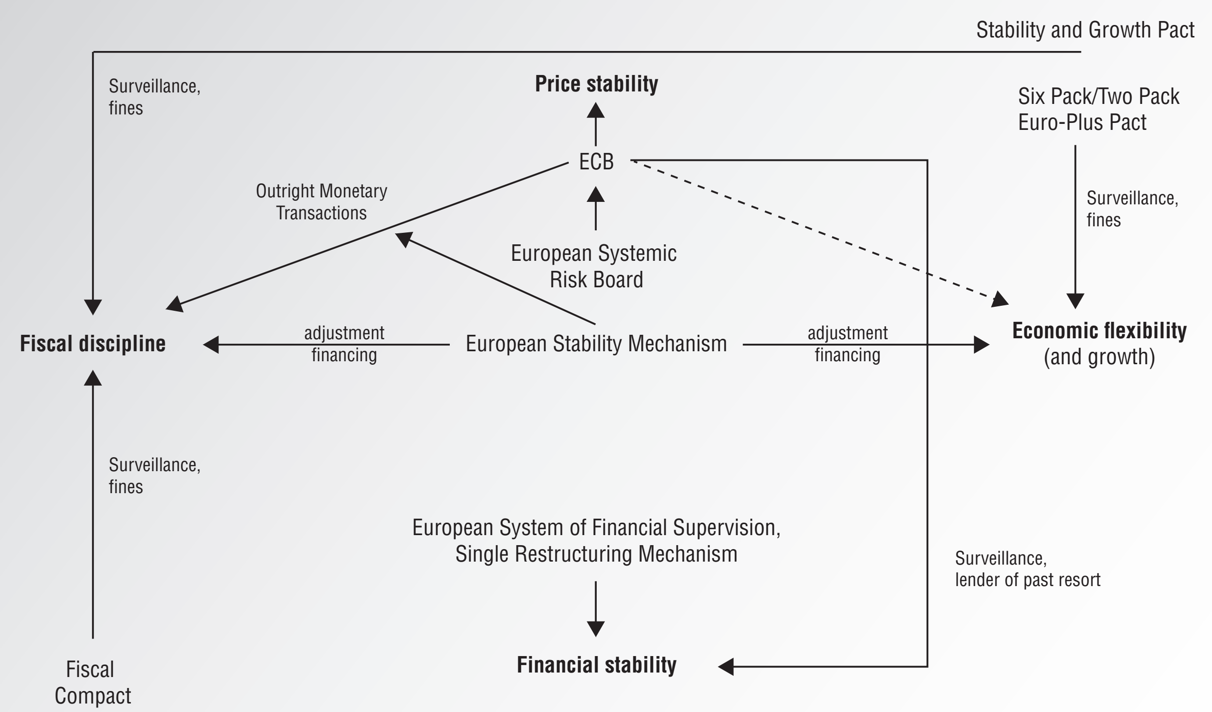
*After the Maastricht Treaty had come into force, it became quickly clear that political union was impossible.*

## The Shadow State for the Euro




Notes: Six-Pack describes six regulations aimed at strengthening procedures to reduce public deficits and address macroeconomic imbalances. Two-Pack stands for two regulations for the coordination and surveillance of budgetary processes. In the Euro-Plus Pact, EU member states promise political reforms with a view to improving their fiscal strength and competitiveness. In the Fiscal Compact, EU member states embedded budget and debt rules into national laws.

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policy and banking issues and could focus on pursuing the goal of price stability. For all practical purposes, exit from political and hence monetary union would be out of the question.

However, after the Maastricht Treaty had come into force, it became quickly clear that political union, ideally in the form of a European federation along the lines of the United States of America, was impossible. At this point, the Kohl government could have insisted on completing the commodity money regime for EMU by adding procedures for government insolvencies and exits, or on abandoning EMU. Kohl did neither, and EMU was launched with a flawed institutional design.

## CRISIS AFTER THE HONEYMOON

In its first decade, the institutional deficiency of EMU was papered over by cheap credit. During the upswing of the global credit cycle, governments unable to control their expenses and economies unable to preserve competitiveness by containing labor costs could fund their budget and external current account deficits with plenty of cheap credit. Cheap credit was the glue that held EMU together, and EMU became unglued when cheap credit disappeared after the burst of the global credit bubble.

*In its first decade, the institutional deficiency of EMU was papered over by cheap credit.*

The unanswered questions of how to deal with insolvent states and economies unable to cope in a commodity money order returned to haunt European policymakers. Just like Helmut Kohl had held the key for the birth of EMU, Angela Merkel now held the key for its survival. As so often in her political career, the German chancellor first marched in one direction, only to make a U-turn and go into the opposite direction thereafter. From the beginning of 2010 until the spring of 2012, she focused on retaining the nature of the euro as commodity money. Thus, her government pushed for the restructuring of Greek public debt on the premise that the state of Greece was indeed insolvent. When debt restructuring failed to stabilize Greek government finances and the Greek economy, she seriously considered the exit of Greece from EMU. However, a key characteristic of Merkel as a politician is her aversion to risk. Hence, when confronted with the risks of "Grexit," she reversed course in the spring of 2012: exit from EMU for any country was off the table and there would be no more sovereign debt restructurings. With this decision, the monetary order for EMU lost all resemblance to a commodity money order and changed to a state-backed credit money order. Yet political union, a state for the euro, had not come closer than it had been at the beginning of EMU.

## A SHADOW STATE FOR THE EURO

With bankruptcy and exit no longer available as sanctions for economic and financial misbehavior of EMU members, it was clear to German policymakers that other instruments had to be put in place to ensure economic and fiscal policy discipline. Consequently, they pushed for an enhancement of the Stability and Growth Pact (in the form of the so-called "Six Pack" and "Two Pack") and the conclusion of national pacts for fiscal policy discipline ("Fiscal Compacts"). The fiscal policy arrangements were complemented by a pact for structural reform to enhance competitiveness (the "Euro-Plus Pact"). At the same time, the role of the ECB was broadened with a view to supporting the European Stability Mechanism in crisis management (through an intervention program in government bond markets dubbed "Outright Monetary Transactions") and to supervising the banking sector (by assuming the role of the Single Supervisor in EMU).

The purpose of these arrangements was to limit national policy sovereignty of EMU member states so as to make their policies consistent with the pursuit of price stability by the ECB. Instead of the market, fines under the pacts and rules were supposed to ensure policy discipline. In the new governance system for EMU, the ECB's role as the guardian of price stability was extended to the buyer of last resort for government debt (in association with activities of ESM) and to the single supervisor of banks. With the threat of deflation increasing, the ECB also began to support government policies for the revival of aggregate demand.

The accompanying chart illustrates the new governance structure for the achievement of key policy objectives in EMU (shown in bold letters). I call this structure a shadow state, because it is supposed to be a substitute for a real state. It is a "state" because it imposes a supranational, state-like structure on national states. And it is in the "shadow" because it came into existence and is now operating without direct democratic approval by and accountability to the voters in these states. Parliamentary approval for the components of the shadow state was sought piece by piece, often in times of crises, exerting strong pressure for approval on members of parliaments and keeping them in the dark with regard to the eventual shape of the governance structure.

The restrictions to national sovereignty imposed by the euro shadow state are in conflict with the claim on national sovereignty maintained by most citizens and their parliaments in EMU member states. Restrictions could be imposed on smaller countries for a limited period of time under Troika-led adjustment programs. But they have been regarded as unacceptable by larger member states and by now are also resisted by the smaller states.

*The unanswered questions of how to deal with insolvent states and economies unable to cope returned to haunt European policymakers.*

With the shadow state unable to commit countries to policies ensuring fiscal and financial stability and promoting economic growth, the burden falls on monetary policy to pursue these objectives so as to hold EMU together. Monetary policy can prevent a collapse of EMU by temporarily providing monetary financing to member states or systemically important banks in financial distress, but it cannot create the economic and political conditions necessary for the survival of EMU in the long term. It is economic and fiscal policy that have to ensure the necessary economic flexibility and fiscal discipline for countries to survive in a monetary union, where the central bank is committed to price stability. However, when monetary policy is charged with sustaining countries in EMU that are unable to hold the fiscal and economic policy discipline necessary for membership in a hard currency union, it will inevitably adopt a weaker stance than warranted under its mandate for price stability. This stance will be inconsistent with the needs of stronger countries or even the monetary union as a whole.

If the weak country is as small as Greece, fiscal transfers from other countries may be politically just tolerable to keep it in EMU without compromising monetary policy. But if the weak country is as big as Italy, fiscal transfers are out of the question and a monetary policy backstop is essential. However, a monetary policy geared to the needs of Italy will almost certainly be inappropriate for the needs of Germany. Hence, when the costs of the inappropriate stance of monetary policy for either weak or strong countries exceed the perceived political and economic costs of their exit, EMU will break into pieces. In that event, the euro cannot survive as credit money without the backing of a central state authority.

## THE EURO AS COMMON COMMODITY MONEY

Only a few politicians, among them German Finance Minister Wolfgang Schäuble, seem to understand this. Hence, they push for full political union with a central European government leading a federation of European states. But there are no signs that the majority of their voters share this vision. To the contrary, since the crisis of EMU began, national and in some cases nationalist political forces have gained strength. In all likelihood, full political union of Europe will remain the utopia of a few.

To preserve the euro, the order of EMU would therefore have to be changed from the flawed credit money order it has assumed in the course of crisis management to the commodity money order originally intended. To this end, three measures would be needed: First, insolvencies of banks would have to be made possible by either breaking up systemically important banks or, preferably, replacing fractional by full reserve banking. With full reserve banking (that is, money deposits at banks fully covered by central bank reserves), money would no longer be lent into existence by private banks but issued directly by the central bank. Thus, money could no longer be destroyed when banks fail. There would be no need for the central bank to act as a lender of last resort, nor would it be necessary for the state to provide a backstop for deposit insurance. Second, bankruptcies of states would have to be made possible by establishing a sovereign insolvency procedure. State debt would no longer be "sovereign debt" but become "credit." Hence, states would have to substantially reduce their outstanding debt. Third, the exit from EMU as a measure of last resort for a state unable to cope in a commodity money order would have to be allowed by introducing an EMU exit procedure. The possibility of exit is necessary to set strong incentives for policy discipline and to protect citizens and other states from serial defaults within EMU by reckless states.

We should be under no illusion. The odds for a change in the present course of policy and reconstitution of EMU as a commodity money order for the euro are low. But, at the same time, without this change the question is not whether, but only when EMU will collapse and the euro disappear. ◆