



## Forgotten Lessons for the Eurozone

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A Monetary Union is one where there is a single fiat currency with a single monetary authority (a central bank). It also has a single interest and exchange rate, and a single legal entity responsible for issuing that currency across a geographic area. This combination of features required for a true monetary union suggests that many previous monetary unions, including the Latin Monetary Union (LMU) and the Scandinavian Monetary Union (SMU) were not proper monetary unions as such, while the Austro-Hungarian Monetary Union (AHMU) *was* and the Eurozone *is*.

The SMU, at least before 1901, was similar to the LMU in being largely a common standardization of weights and measures; after 1901 it came closer to being a monetary union, although the currencies of Sweden, Denmark and Norway still existed in distinct forms and there was no common interest rate.<sup>1</sup>

The article discusses the most recent problems for the Eurozone, namely the Greek crisis and the conduct of the

European Central Bank, which could lead to considerable difficulties for a stable Eurozone. I will examine some lessons from the three historical monetary unions relevant to the current Eurozone crisis. Although there is a vast historical gulf separating these late-nineteenth-century monetary unions from the present, they provide ‘food for thought’ for policymakers and commentators attempting to think through the complications facing the Eurozone.<sup>2</sup>

### Historical Lessons for the European Monetary Union

Luca Einaudi has warned that comparisons between earlier monetary unions and the European Monetary Union (EMU) are ‘misleading to some extent’, since ‘technical aspects of money and political background have changed radically’<sup>3</sup>. Unlike in the nineteenth century, we are now in a world of fiat currencies, of tighter European political

and institutional integration, and of a vastly different system of national central banks. Despite this, a few lessons can be gleaned for the contemporary EMU from the memory of the LMU, the SMU and the AHMU. The most important, overarching lessons that can be taken from the nineteenth-century European monetary unions' discussion in this article are:

**(1) The fragility of monetary unions.** One lesson from the historical record on monetary unions is recognition of the fragility of such arrangements, especially in the absence of other levers for fostering economic convergence and formal coordination of member states' economies. The LMU, the SMU and the AHMU all disappeared for reasons often connected with a lack of coordination or too difficult financial circumstances – and in particular with the First World War.

**(2) The importance of economic convergence for a viable monetary union.** Another lesson from the historical record is the issue of economic convergence and whether an Optimal Currency Area (OCA) is an essential condition. The SMU provides, perhaps, the most potent example of this factor, considering the Scandinavian nations' lack of economic convergence throughout their experience of monetary union. This

helped to put pressures on the SMU, which eventually aided in its dissolution. *Ceteris paribus* economic convergence is an important element in a well-functioning monetary union. On the other hand, the United States is an example of an OCA that was weak but which, despite the Civil War and the currency collapse in the 1920s, has become a robust single currency. What is perhaps remarkable about the euro is that, despite the great divergence across the EU's economies, it was first of all established and, second, has actually survived the most serious threat to its existence with the 2008 financial crisis. This suggests that certain key conditions have changed, particularly those dealt with under (3) below.

**(3) The importance of institutional safeguards to curb moral hazard and to ensure deeper coordination.** Another difficulty in monetary unions, highlighted by the examples of the LMU and the SMU, in particular, is that of moral hazard. It is important that monetary unions create institutional safeguards to prevent moral hazard and free-riding problems. Furthermore, the continuing existence of national interests in previous unions meant that it was difficult to coordinate fiscal and economic policies across the member states.

**(4) The relevance of ‘national’ interests.**

An important lesson, however, may be drawn in the comparison between the nineteenth century and the late twentieth and early twenty-first centuries: this is the changing role of the nation state and of national governments. The early period was actually the heyday of nation-state nationalism, but this had considerably diminished by the last quarter of the twentieth century. The drive towards EMU was possible only because the EU’s member states were willing to surrender certain aspects of sovereignty to the supranational institutions. The EMU became, therefore, a much more deeply integrated union than was possible, at least across different countries in the earlier period. In fact, it was only possible in a federation such as the United States or Canada because there was a willingness to create a new overarching entity. Although the EU is not yet a federation, it is developing into something quite similar. This has been borne out by the progress made in devising institutional responses to the crisis and the willingness to use it as a means of deepening integration even further.

**(5) Finally, there is the challenge of creating representative and strong centralised institutions in a monetary union.** Such institutions ought to be both (a) representative and (b) able to battle issues of moral hazard. The experience of the AHMU, in which Hungary was able to extort highly

favourable terms through threat of exit, points to the importance of political institutions in the creation of any tenable monetary union. The current arrangement of the ECB, in fact, seems poorly suited to this task at hand, in part because of precisely the sort of misalignment of power seen in the AHMU.

**Greece: Eurozone sovereign debt restructuring necessary, but Troika clung to austerity**

The Eurozone has followed a self-destructive strategy for too long. The single currency zone was driven towards an unnecessary crisis and Greece into meltdown before serious consideration of the alternatives. Forcing Greece to exit would be damaging for Greece in the short to medium term, but it could be far more painful for the Eurozone.

Any scenario for how to tackle the Greek debt crisis will have to be considered based on the fact that there is no chance whatsoever of Greece repaying its debts.

Only the creditor nations of Europe’s economically stronger northern region refuse to acknowledge this reality. The current set-up is completely unsustainable. There is no reason why Europe cannot recognise this and make the necessary adjustments. In spite of historical experience that indicates fiscal

consolidation during recessionary periods is harmful, Europe, under German leadership, opted for austerity policies in the aftermath of the global crisis of 2008, thereby making a bad situation even worse.

Greece will not be able to recover from its current crisis without a significant haircut for the official sector debt holders. The country's public debt-to-GDP ratio has increased substantially under the so-called 'bailout' programme. Growth in the Eurozone has stagnated and future prospects for sustainable growth are highly unlikely without a major shift in the economic policies of the present, including the emphasis on austerity and balanced budgets. The debate over the treatment of Greek debt is still a major issue for the Eurozone.<sup>4</sup>

Pisani-Ferry, Sapir and Wolff<sup>5</sup> have argued that the Troika of the European Commission, the European Central Bank (ECB) and the International Monetary Fund (IMF) should have entertained debt reduction during the first five months of 2010. The IMF<sup>6</sup> ex post evaluation of exceptional access under the 2010 Greek stand-by arrangement reaches a somewhat ambiguous conclusion: 'Upfront debt restructuring was not feasible at the outset. While the IMF began to push for Private Sector Involvement (PSI) once the programme went off track in early 2011, it took time for the stakeholders to agree on a common and coherent strategy.' Barry

Eichengreen,<sup>7</sup> a long-time advocate of debt reduction in sovereign financial crises is unambiguous: 'The country's sovereign debt should have been restructured without delay,' writing down its debt burden by two-thirds.

Generally, as argued by the IMF, debt reduction is too little and too late. Without a dramatic change in the collective approach to public sector involvement, which was not on the cards in May 2010, early debt reductions would almost always be too small and would need to be repeated, which was a good reason to wait. Without an outright Greek default or suspension of payments, which in May 2010 would have been economically and financially complicated for Greece and for the viability of the Eurozone, Greece could not have achieved the two-thirds reduction in face value of its debt that Eichengreen argues was appropriate.<sup>8</sup>

The IMF, in a 50-page report, produced a concise analysis of what went wrong in the Greek rescue programme. The IMF expressed regret that it took an excessively long time to agree a debt restructuring for Greece.<sup>9</sup> The IMF deserves credit for being publically self-critical about its handling of the Eurozone crisis. How long will we have to wait for a similar self-analysis of the ECB's role in this affair?<sup>10</sup>

It is now clear that the IMF management and staff were right not to include debt reduction as part of the May 2010 Greek programme,

but it was a mistake to wait until March 2012 to implement debt reduction for the country, because the delay at that point weakened the commitment of the Greek authorities to implement their reform programme. The delay in implementing a debt restructuring had a serious cost for European taxpayers and was very damaging to the Greek economy. It cost European taxpayers money because private Greek creditors were repaid in full for two years, with the money coming from European taxpayers and the IMF.<sup>11</sup>

After Greece accepted the Troika bailout, members of the ECB Executive Board regularly gave speeches depicting a potential Greek default as provoking ‘an economic meltdown’ across the Eurozone.<sup>12</sup>

Neither then-IMF boss Dominique Strauss-Kahn – who was a potential socialist candidate for the French presidency at the time – nor German chancellor Angela Merkel, nor finance minister Wolfgang Schäuble, would countenance that at the time, arguing instead they had to rescue the German, French and European banking system. What they wanted to avoid, of course, was any losses for their respective banks.

One thing Greece’s creditors can do to help resolve the crisis as speedily as possible is to offer significant debt relief. With the IMF’s Debt Sustainability Analysis published on 26 June 2015, the economic case for providing

such relief is beyond doubt. Finally, after a prolonged standoff with the Greek government through the first half of 2015, the IMF publicly stated that Greece’s official debt was unsustainable and a large chunk needed to be written off. But the Fund *still* refused to back off on austerity. Even Blanchard supported the IMF’s insistence on further fiscal consolidation.<sup>13</sup>

The alternative approach – pushing Greece towards a euro exit – is probably the strategy that will ultimately minimise the return of money to its creditors. The moral and economic case for debt relief is there.<sup>14</sup> Now it just requires the political courage of Europe’s leaders to admit their past mistakes and stop pretending Greece is going to pay back all the money.<sup>15</sup>

### **The European Central Bank rules the democratic void**

On 4 February 2015, the ECB unexpectedly and suddenly cancelled acceptance of Greek bonds as collateral for liquidity funding unless Greece obeyed the Troika agreement. The ECB’s irresponsible and incompetent actions call into question their respect for the Greek government’s attempts to resolve its debt crisis in a sustainable way. The ECB may or may not have good reasons to cut off Greece – depending on your point of view – but it is clear that such a move would be political. A central bank that is supposed to be the lender of last resort and guardian of

financial stability would be taking a deliberate and calculated decision to destroy the Greek banking system. The ECB is now seen in some quarters as arrogant, unaccountable and authoritarian.

The ECB has an unfortunate tendency to act with delay and without creativity. Not only was the ECB slow to cut interest rates, it acted first against the tide and raised them twice in 2011. It then took more than half a decade longer than the US Federal Reserve or the Bank of England to get round to quantitative easing, which means the central bank buying assets, usually government bonds, with money it has printed or created electronically and pumping this extra money directly into the financial system. Most damagingly of all, European policymakers insisted on austerity programmes that resulted in still weaker growth and even higher levels of unemployment. Yet any form of accountability is strongly missing.

The euro, although ‘a currency without a state’, is backed by significant political and even state-like commitments. That the euro must be saved at all costs is an imperative suggested not only by Mario Draghi, the technocrat, but Angela Merkel, the statesman. Political elites, particularly in Germany, have staked their legacy on its success.

But there is a growing mismatch between the monetary and fiscal sides of the Eurozone

governance system and this has led to a number of problems. The main problem is that, while we may not find it easy to live with the ECB, we cannot live without it. Yet, when we look at the Greek bailout programmes, it is easy to conclude that they have failed. The Troika has imposed austerity, which has led to a severe contraction of output and highly adverse welfare effects. This was intended, in a way, to punish Greece for its profligacy rather than serve as a way out of the crisis.

The ECB is far more independent than the US central bank, the Federal Reserve, whose legal status is far weaker and which is directly accountable to Congress and the government. The ECB was supposed to be like the German central bank, the Bundesbank. The ECB, however, has failed to emulate the distinctive attributes that made the Bundesbank successful, such as accountability and interdependence with other democratic institutions. The Maastricht Treaty, which defines the role of the ECB, says that the ECB has a primary mandate to maintain stable prices. It also says that, ‘where it is possible without compromising the mandate to maintain price stability’, the ECB will also support the ‘general economic policy of the EU’, which includes, among others, ‘steady, non-inflationary and environmentally friendly growth’ and ‘a high level of employment’. However, the emphasis is explicitly on price stability. The ECB can

justly claim to have held together a poorly designed system in difficult circumstances. But the mission creep is its own responsibility.

The ECB, in fact, is the least accountable central bank among advanced nations.<sup>16</sup> There is no democratic accountability when the ECB strong-arms governments into policy actions that go well beyond any reasonable interpretation of its mandate.

Not only is the ECB shielded from politicians, ECB statutes have also placed it beyond the reach of democratic rules on bad behaviour. The ultimate control politicians have over a central bank is the power to change its statutes and the power to appoint governors. For example, in the case of Germany, a simple majority in the Bundestag can change Bundesbank law. This procedure is absent in the Eurozone. The statutes of the ECB can only be changed by revising the Maastricht Treaty, which requires unanimity of all member states. The ECB today argues that the only institution that has the right to limit its power is the European Court of Justice, which has an activist Europhile interpretation of European treaties. The crisis has given the ECB governing council such an increased power that no national government or national institution can match it.

The project of European integration was not designed democratically, or at least not in the way democracy is traditionally conceived in

terms of placing ultimate law-making authority in the hands of the people or their elected representatives. It is not even meant to be democratically responsive in the way that term is usually understood. Any democratic deficit that the EU suffers seems to many observers a deliberately constructed one. So how could we control the ECB in the future? It needs to be placed under a stricter and more direct supervision by democratically elected politicians. One of the institutions the president of the ECB puts himself in front of, the European Parliament, does not inspire anyone to believe that the ECB is being held accountable. This very independence means that democratic governments now have no way to keep the ECB accountable if it starts to violate its mandate.

A revised treaty, Maastricht mark two, would need to look at a proper oversight of ECB activities. One possibility is a supervisory committee composed of members of national parliaments and European Parliament who should also have the ability to dismiss particular members of the ECB Governing Council before the end of their terms. This should be the case if the majority of the supervising board considers the respective member of the Governing Council to have failed at its job. Unlike today, the council members would be accountable to democratically elected politicians. It may be important for other Eurozone countries to emulate the German constitutional court

model with its potential to hold the ECB to account.

## Conclusion

The Five Presidents report summarizes the debate on the Deep and Genuine Economic and Monetary Union (EMU).<sup>17</sup> The debate was launched by publication of the European Commission's Communication on 'A Blueprint for a Deep and Genuine EMU' in November 2012.<sup>18</sup>

In comparison with the 2012 Communication, the Five Presidents report is less ambitious but, at the same time, less ambitious because it does not contain proposal of debt mutualisation presented in the 2012 Blueprint. It would further undermine fiscal discipline on national level, already compromised by several bail-outs of the troubled countries and continuous breaching of fiscal criteria established by the Treaty on Functioning of the European Union (TFEU) and the Stability and Growth Pact (SGP).

All measures, which are to be adopted in the Stage 1 (between July 1, 2015 and June 30, 2017) as 'Immediate Steps', do not require changes in the EU Treaties. They can be implemented through either EU secondary legislation or the Commission's own decisions. This cannot be said about the Stage 2 ('Completing the EMU Architecture')

that will require changes in the Treaties although the time horizon proposed (until 2025) makes this potentially feasible (if accepted by all EU member states).

The Five President's Report anticipates the Eurozone having a treasury, with tax and debt-raising powers and powers to spend. Such a treasury function would clearly require political oversight. And indeed there is now an ongoing discussion about the establishment of democratic accountability mechanisms within the eurozone.

The Eurozone, in its relatively short time of existence, has successfully overcome a number of crisis periods. As the political landscape is changing, it will be difficult to develop more constructive and proactive solutions for the Eurozone crisis, such as debt restructuring, than was the case with the 'muddling-through' approach that has characterised the Eurozone crisis strategy in the last few years, especially in Greece. The ECB epitomizes that perceived 'democratic deficit' run by an unaccountable bureaucracy that poses serious problems for the future of the Eurozone.

EMU has been a considerable achievement. Yet it also remains fragile because of a flaw in its governance. This flaw is linked to the non-existence of a European government with the power to spend and to tax, which would be independent from national governments,

which entails the absence of a minimal degree of budgetary integration and of political unification. The five historical lessons for the EMU outlined above have not been addressed by Eurozone policymakers.

If mutualisation of at least a part of member states' debt issuance were to happen, the Eurozone would be taking a big stride towards a large, liquid, integrated bond market like that of the United States, which makes the dollar such an attractive key currency. As such, it would partly address the complaint that the euro is a currency without a state and so by definition lacks the independent fiscal capacity that is a fundamental characteristic of a reserve currency.<sup>19</sup>

The Eurozone and the EU will have critical decisions to make when dealing with the possible Greek exit from the euro, the possibility that the United Kingdom will vote to leave the EU on 23 June 2016 and the ongoing migrant crisis. While those challenges play out, the survival of the EMU hangs in the balance.<sup>20</sup>

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<sup>1</sup> ‘Historical Monetary Unions. Lessons for the current Eurozone crisis?’ (with John Loughlin), *Studia Diplomatica*, Vol. LXVII, Issue 4 (2014): *Various shades of federalism: Which responses to the rise of populism and euroscepticism?*

<sup>2</sup> There is an increasing interest on the part of financial stakeholders and policymakers in early monetary unions, which is perhaps best evidenced in reports for the Swiss bank UBS by Paul Donovan et al. (2010) and Stephane Deo et al., (2011).

<sup>3</sup> Einaudi, L. (2000). ‘From the Franc to the “Europe”’: Great Britain, Germany and the attempted transformation of the Latin Monetary Union’, *Economic History Review*, Vol. 53, No. 2, pp. 284-308.

<sup>4</sup> Ryan, J. (2011). ‘After a Greek Default – Restructuring by 2012 for the Irish economy?’ *European Integration working papers* 2011/Number 2, German Institute for International and Security Affairs.

<sup>5</sup> Pisani-Ferry, J., A. Sapir and G. B. Wolff. (2013). ‘Financial Assistance in the Euro Area: An Early Evaluation’, *Bruegel Blueprint*, Bruegel.

<sup>6</sup> IMF (2013a). ‘Greece: Ex Post Evaluation of Exceptional Access under the 2010 Stand-By Arrangement’, Washington: International Monetary Fund.

<sup>7</sup> Eichengreen, B. (2013). ‘Lessons of a Greek Tragedy’, *Project Syndicate*, June 2013.

<sup>8</sup> Ibid.

<sup>9</sup> IMF (2013b). ‘Sovereign Debt Restructuring: Recent Developments and Implications for the Fund’s Legal and Policy Framework’, Washington: International Monetary Fund.

<sup>10</sup> Whelan, K. (2013). ‘Sorry Olli, The IMF Were Being Nice About Europe’s Role in Greece’, *Forbes*, 10 June 2013.

<sup>11</sup> IMF, ‘Sovereign Debt Restructuring: Recent Developments and Implications for the Fund’s Legal and Policy Framework’, Washington: International Monetary Fund, 2013.

<sup>12</sup> Bini Smaghi, L. (2011). ‘Private sector involvement: From (good) theory to (bad) practice’, at the Reinventing Bretton Woods Committee, Berlin, 6 June 2011.

<sup>13</sup> Ashoka Mody, “Saving the IMF”, *Project Syndicate*, 9 April 2016.

<sup>14</sup> Mohamed A. El-Erian, “Time for Debt Reduction in Greece”, *Project Syndicate* 22 April 2016

<sup>15</sup> Yves Smith, “Leaked Memo Reveals IMF (Still) Wants Out of Greece Bailout and Plots to Pressure Germany to Act”, 3 April 2016, [nakedcapitalism.com](http://nakedcapitalism.com).

<sup>16</sup> Werner, Richard A. (2006). ‘A comparative analysis of the independence of the ECB, the Bundesbank and the Reichsbank’, *International Finance Review*, 6, 1-16.

<sup>17</sup> Juncker, J.C. (2015) ‘Five Presidents Report: Completing Europe’s Economic and Monetary Union: Report by: Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi and Martin Schulz (Brussels: European Commission), 22 June 2015

<sup>18</sup> European Commission: *A Blueprint for a Deep and Genuine EMU. Launching a European debate*, Communication from the European Commission, 28 November 2012.

<sup>19</sup> Barry Eichengreen & Charles Wyplosz, “Minimal conditions for the survival of the euro”, [Voxeu.org](http://Voxeu.org), 14 March 2016.

<sup>20</sup> “Greece’s state cash is rapidly drying up again”, [ekathimerini.com](http://ekathimerini.com), 25 April 2016.