Harold James
Professor
Princeton University

Central Banks and Financial Stability: The Problems of Designing an Institutional Framework in Europe

The changing tasks, and the governance issues, of modern central banks are best thought of in the framework offered by the analysis of targets and instruments. What are the goals of a modern central bank? They may conflict with each other, and such conflicts strain the governance mechanism of the central banks. In particular, central banks aim at:

1. Price stability
2. Exchange rate stability
3. Financial stability

In the European setting, there is a long history of exchange rate objectives conflicting with price stability objectives. The European answer to the exchange rate issue adopted in the 1990s with creation of the monetary union was the radical one of simply abolishing exchange rates within Europe. That action left, however, the question of whether there were circumstances in which the requirements of preserving financial sector stability would run counter to the price stability objective. That potential conflict is the theme of this paper.

How can financial instability be dealt with in a currency union? In a domestic setting, we usually think of better regulation and supervision as the answer to financial instability. Resolution of failed institutions is much more problematical and raises questions about cost and burden sharing when undertaken in a cross-national setting. How much fiscal firepower is required in resolution? The answer clearly depends on the magnitude of the financial system.

The ex ante danger to financial stability is also greater in a cross-border setting. Is the threat of financial instability more pronounced when it occurs in an international setting in which (as in the gold standard) there is no possibility of changing exchange rates and financial flows thus constitute a fundamental threat to and distortion of monetary policy? Was the inability in the early 1990s to decide whether Europe was more like an international policy regime or more like a domestic regulatory framework the fundamental design flaw of Europe's unique experiment in producing a supranational currency?

This paper examines the history of the discussion of the financial regulation issue and its implications for the current debate about solutions to the euro area crisis. If the only logical solution to the threat of financial stability lies in substantially controlling cross-border flows and confining banks to a national context in which they would

be regulated by a national regulator, and bailed out if necessary by a national fiscal authority, that would constitute a fundamental change of the international system and a rejection of the kind of financially driven globalization that has evolved over the past thirty years.

Monetary Union and the Broader Context

It is often claimed – especially but not only by American economists that the travails of the euro show that it is impossible to have a monetary union in the absence of a political union. Thomas Sargent used the bully pulpit of the Nobel Prize Acceptance speech to tell Europe to follow the U.S. example in

the aftermath of the War of Independence and assume the debts of the individual states. Assumption for Hamilton was "the powerful cement of our union." Paul de Grauwe has recently stated the case quite simply: "The euro is a currency without a country. To make it sustainable a European country has to be created."[1] The Presidents of the ECB seem to endorse this advice. Accepting the Charlemagne Prize in Aachen, Jean-Claude Trichet said: "In a long term historical perspective, Europe – which has invented the concept and the word of democracy – is called to complete the design of what it already calls a Union." Mario Draghi has been even more dramatic, spelling out the logic of the various steps and demanding "the collective commitment of all governments to reform the governance of the euro area. This means completing economic and monetary union along four key pillars: (i) a financial union with a single supervisor at its heart, to re-unify the banking system; (ii) a fiscal union with enforceable rules to restore fiscal capacity; (iii) an economic union that fosters sustained growth and employment; and (iv) a political union, where the exercise of shared sovereignty is rooted in political legitimacy."[2] This advice seems appallingly radical to many, since almost every politician denies that there is any real possibility of creating a European state, and almost every citizen recoils at the prospect. Hence, we would face the dark night of the European soul.

Is it possible that the flaw in the euro's construction is less radical, and that it lies in the failure to inaugurate what is now generally referred to as macroprudential supervision in an effective way? That is a flaw that should in theory be easier to resolve politically: but there is a problem too, as in every regulatory setting, including the USA and the UK, the implementation of macroprudential supervision is fraught with uncertainty.

[1] *Sargent, T. 2011.United States Then, Europe Now. Nobel Prize speech 2011: www.nobelprize.org/nobel_prizes/economics/laureates/2011/sargent-lecture.html (retrieved on 10 July); Grauwe, P. 2012. The Eurozone's Design Failures: can they be corrected? November 28, 2012, LSE lecture: http://www2.lse.ac.uk/publicEvents/pdf/2012_MT/20121128-Prof-Grauwe-PPT.pdf (retrieved on 10 July).*

[2] *Trichet, J. C. 2011. Building Europe, building institutions. Speech by Jean-Claude Trichet, former President of the ECB on receiving the Charlesmagne Prize 2011 in Aachen. 2 June 2011; Remarks by Draghi, M. 2012. Treasury Talks. A European strategy for growth and integration with solidarity. A conference organised by the Directorate General of the Treasury, Ministry of Economy and Finance – Ministry for Foreign Trade. Paris, 30 November 2012. See also Mario Draghi in: Die Zeit. August 29, 2012: www.ecb.int/press/key/date/2012/html/sp120829.en.html (retrieved on 10 July).*

The Choice for State or Non-State Money

In choosing a "pure" money in the 1990s, free of any possibility of political interference and simply designed to meet the objective of price stability, Europeans were taking an obvious risk. They were obviously and deliberately flying in the face of the dominant modern tradition of thinking about money. The creation of money is usually thought to be the domain of the state: This was the widely prevalent doctrine of the 19th century, which reached its apogee in Georg Friedrich Knapp's highly influential *State Theory of Money*. Money could be issued by the state because of government's ability to define the unit of account in which taxes should be paid. In the *Nicomachean Ethics*, Aristotle explained that money owes its name to its property of not existing by nature but as a product of convention or law.[3] Greek coins usually carried depictions of gods and goddesses, but the Romans changed the practice and put their (presumed divine) emperors on their coins. Christ famously answers a question about obedience to civil authorities by examining a Roman coin and telling the Pharisees: "Render unto Caesar the things which are Caesar's."[4]

The design of the euro makes the novelty clear. Unlike most banknotes and coins, there is no picture of the state or its symbols – no Caesar – on the money issued and managed by the European Central Bank. This feature sharply distinguished the new money from the banknotes that had circulated before the common currency and that were carefully designed to depict national symbols. Especially in the 19th century, the formation of new nation-states was associated with the establishment of national moneys, which gave the new polities a policy area in which they could exercise themselves. European leaders in the late 20th century were self-consciously stepping away from that tradition – in large part because of a widespread sense that national money had been subject to political abuse with inflationary consequences.

The Current Account Dilemma

Europe's monetary order emerged as the outcome of global debates about currency disorder. It was primarily designed to tackle a problem about current accounts rather than issues arising specifically out of financial sector imbalances. European monetary integration appeared urgent in the late 1960s, as the Bretton Woods regime disintegrated, and in the late 1970s, when US monetary policy was subject to big political pressures and the US-dollar collapsed. The most decisive push for a European solution to a global problem occurred in different circumstances. When the dollar was soaring in the mid-1980s, when American manufacturing was threatened and when there appeared to be the possibility of a protectionist backlash, the finance ministers of the major industrial countries pushed for exchange rate agreement. At the G-7 finance ministers Louvre meeting in 1987, they agreed to lock their exchange rates into a system of target zones. In practice, nothing came of that global plan, but then Edouard Balladur, the French finance

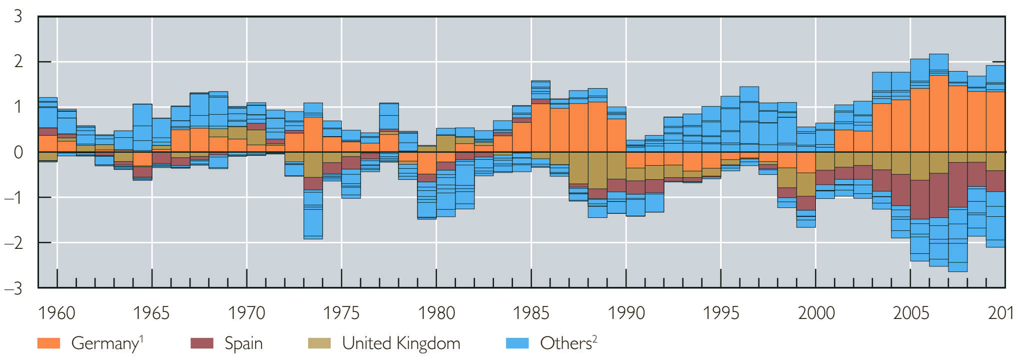
[3] *Aristotle. Book V: "Money has become by convention a sort of representative of demand; and this is why it has the name 'money' (nomisma)-because it exists not by nature but by law (nomos) and it is in our power to change it and make it useless."*

[4] *Matthew 22: 21.*

Chart 1

Sum of Current Account Balances of Deficit and Surplus Countries

As a percentage of GDP



Source: OECD Economic Outlook, European Commission, Annual Macro Economic Database.

[1] *From 1991 the balance of payments statistics also include the external transactions of the former German Democratic Republic.*
[2] *Including Belgium, Denmark, France, Greece, Ireland, Italy, Luxembourg, Netherlands and Portugal.*

minister who had largely been responsible for the Louvre proposal, came up with a tighter European scheme. When German foreign minister Hans Dietrich Genscher appeared sympathetic, Europe's central bankers were asked by the president of the European Commission, Jacques Delors, to prepare a timetable and a plan for currency union.

Monetary union was conceptualized as a way of simplifying politics. This had been a feature of European arguments from the beginning. Robert Triffin in 1957 had shown how a problem could be reduced to its most basic level: "The significance of monetary unification, like that of exchange stability in a free market, is that both exclude any resort to any other corrective techniques except those of internal fiscal and credit policies."[5]

For most of the long postwar period, current accounts were driven primarily by divergences in fiscal stances, and the appropriate corrective techniques were thus fiscal. That posed some painful political dilemmas. Deficit countries were faced by the prospect of austerity and deflation in order to correct deficits. This alternative was unattractive to the political elite, because it constrained growth and guaranteed electoral unpopularity. Their preferred policy alternative was thus expansion in the surplus countries, and that usually meant Germany. This course was unpopular with a German public worried about the legacy of inflation and was opposed by the powerful and independent central bank, the Deutsche Bundesbank. These issues were at the center of a politicized debate until the 1990s, when they faded, as fiscal policy no longer seemed very useful as a stabilization tool. It was cumbersome, had large time lags built in, and was consequentially regarded as largely ineffective.

By the 1990s, things were changing, and the expansion of capital markets and bank lending generated large private sector flows. Current account imbalances were apparently sustainable for much longer periods – though not forever. The effects of movements in capital in allowing current account imbalances to build up to a much greater extent, and ensuring that corrections,

[5] *Triffin, R. 1957. Europe and the Money Muddle. London. p. 289.*

when they occurred, would be much more dramatic, was already noticeable in the late 1980s and early 1990s, before the move to monetary union. Indeed, those large build-ups in the imbalances were what convinced Europe's policy-makers that a monetary union was the only way of avoiding the risk of periodic crises with currency realignments whose trade policy consequences threatened the survival of an integrated internal European market. The success of the early years of monetary union lies in the effective privatization of current account imbalances, so that the problem disappeared from the radar screen of policy debates. It would only reappear when the freezing up of the banking system after 2008 required the substitution of public sector claims for private claims: with that the old problem of the politicization of current account imbalances immediately reappeared. At that point also the problem of the appropriate corrective instrument came back: Should it be fiscal policy? Or should it be policy directed at maintaining financial stability (what Triffin had called "credit policy").

Negligent Planning?

How solid was the plan of Delors? Did the participants sincerely want to get committed to a real marriage – the analogy that came to be increasingly used to describe the new sort of commitment? What basis was there for agreement?

It has become fashionable to say that the move of the early 1990s were undertaken in a mood of carelessness (*Sorglosigkeit*), in Otmar Issing's phrase, or that Chancellor Kohl was neglectful (*leichtsinnig*) – according to Hans Peter Schwarz's monumental new biography.[6] Kohl promised a political union: On November 6, 1991, he told an ecstatically applauding German parliament that "one cannot repeat it often enough: political union is the indispensible counterpart of the economic and monetary union." But when the governments negotiated a few weeks later in Maastricht, there were very concrete plans for the monetary union, and for the political union – none at all. Does that really mean that everyone was just unbelievably careless, and that, in the same way as the British empire was allegedly acquired in a fit of absent-mindedness, the European dream was wafted on a post-unification euphoria?

In fact, the planning for monetary union was unbelievably sober and meticulous, even far-sighted. In the debates of the central bankers' group that Delors chaired in 1988-89, before the fall of the Berlin Wall, two really critical issues were highlighted and they were the ones that really mattered:

The first concerned the fiscal discipline needed for currency union. An

[6] *Schwarz, H.-P. 2012. Helmut Kohl: Eine politische Biographie. Stuttgart: DVA, 2012; Issing, O. 2012. Europa in Not – Deutschland in Gefahr. Frankfurter Allgemeine Zeitung. June 11.*

explicit discussion took place as to whether the capital market by itself was enough to discipline borrowers, and a consensus emerged that market discipline would not be adequate and that a system of rules was needed. The influential Belgian economist from the BIS, Alexandre Lamfalussy, a member of the Delors Committee, brought up cases from the USA and Canada as well as from Europe where cities and regions were insufficiently disciplined. Jacques Delors himself at this time appropriately raised the prospect of a two speed Europe, in which one or two countries might need a "different kind of marriage contract."[7] There is a tendency for fiscal policy to be pro-cyclical, particularly when the cycles are

driven by property booms, in that enhanced fiscal revenue from real estate exuberance prompts politicians to think that the increase in their resources is permanent. But the pro-cyclical fiscal element may be magnified in a currency union.

In the lead-up to the Maastricht Treaty, a paper prepared by the Committee of Central Bank Governors stated the critique quite explicitly: "Article 21.1 will *not suffice* to exert as much discipline as is needed to avoid excessive budget deficits, or to induce markets to correctly set interest rates on public debt. On the one hand, public entities may still enjoy a privileged access to financial markets as a result of national fiscal, banking, and prudential regulation. On the other, markets may expect that governments will ultimately be bailed out when encountering difficulties in refinancing their debt, and governments may expect the same. Finally [.°.°.] Article 21.1 would not prevent budget deficits from leading to pressure being exerted on the ECB to pursue a more accommodating monetary policy."[8]

The need for fiscal discipline arising from spillover effects of large borrowing requirements is a European issue, but it is clearly not one confined to Europe alone. In emerging markets, this problem was identified after the 1997/8 Asia crisis, and the problem of major fiscal strains became primarily one of the industrial world – and especially of the United States. An appropriate response would involve some democratically legitimated mechanism for limiting the debt build-up, as in the Swiss debt brake (*Schuldenbremse*) which was supported by 85% of voters in a referendum.

The second flaw in the European plans identified by the central bankers as they prepared monetary union was much more serious. The penultimate draft of the Delors Report specified in paragraph 32 that the "system would participate in the coordination of banking supervision policies of the national supervisory authorities." But in the final report, "national" was deleted, leaving the implication that the supervisory

[7] *In the second meeting of the Delors Committee, October 10, 1988. See James, H. 2012. Making the European Monetary Union. Cambridge Massachusetts: Harvard University Press.*

[8] *CoG, 3.4/1–7. Economic Unit. June 19. 1991. Monetary Financing of Budget Deficits in Stage Three.*

authorities would be European. In the original version of a plan for a central bank that would run a monetary union, the central bank would have overall supervisory and regulatory powers. That demand met strong resistance, above all from the German Bundesbank, which worried that a role in maintaining financial stability might undermine the future central bank's ability to focus on price stability as the primary goal of monetary policy. There was also bureaucratic resistance from existing regulators.

It would be reasonable to assume that the central bank issuing a new currency would take over the functions normally associated with existing national central banks. But assumptions about central banks' operations – and their willingness to state clearly what the objectives were – varied significantly from country to country. In particular, the Germans worried about the moral hazard implications of central bank regulation of the financial sector. Before the First World War, the German Reichsbank had been widely viewed as providing the ultimate support of the financial sector. Its origins lay in a response to the severe financial crisis of 1873, and the big German banks saw the central bank as a backstop. But the experience of hyperinflation in the 1920s led to a new approach, and a feeling that unlimited support for the financial system contained a danger to monetary stability; and in consequence, the idea of a central bank as a lender of last resort had much less support in the late 20th century Germany than in the Anglo-Saxon world, where Walter Bagehot's treatise of 1867, *Lombard Street*, was still widely regarded as the paradigm for modern central bank behavior.

There was thus considerable uncertainty about the wording of the statute on financial sector regulation. In the initial draft of the ECB Statute produced for the Committee of Central Bank Governors by the alternates, the "tasks" of the ECB included "to support the stability of the financial system"; and Article 25 on "Prudential Supervision" included the following tasks for the ECB, which were placed in square brackets to indicate that they were not yet consensual:

> 25.2. [The ECB may formulate, interpret and implement policies relating to the prudential supervision of credit and other financial institutions for which it is designated as competent supervisory authority.]
> 25.3. [The ECB shall be entitled to offer advice to Community bodies and national authorities on measures which it considers desirable for the purpose of maintaining the stability of the banking and financial systems.]
> 25.4. [The ECB may itself determine policies and take measures within its competence necessary for the purpose of maintaining the stability of the banking and financial systems.]

The Bundesbank wanted to avoid references to an explicit role for the ECB in supervising banks, "especially in the context of maintaining the stability of the banking and financial system and the delicate question of moral hazard. These two Articles could be misinterpreted as a lender of last-resort function." As a consequence, the items in square brackets were in the end excised from the Governors' draft. The former Vice-President of the Bundesbank Hans Tietmeyer provided a neat encapsulation of the German philosophy of regulation: "This did not mean from the view of the Board of the Deutsche

Bundesbank that the ECB should not support the stability of the financial system, but that it should never be written down; this would be moral hazard."[9] The question of resolution and its fiscal cost later became a central part of academic discussion of the policy response to financial crisis, but was not treated very directly in the official discussions. Nevertheless, it was clear that bailouts and rescues after a financial crisis might be problematical if large cross-border banking developed, as a consequence of the reluctance of national authorities (and their tax payers) to bear the financial burden of bailing out depositors or creditors in other states.[10]

The pushback to the idea of the central bank having financial regulation as a major task came from the political authorities, which feared losing control of their national banking systems. In February 1990, at the Monetary Policy Committee meeting in Brussels, where governments as well as central banks were represented, there was complete agreement that the different national rules regarding bank regulation should be left in place.[11] Commission President Jacques Delors was unwilling to force the pace on this issue, and stated that the European Commission approached the issue of banking supervision with an "open mind": the ESCB should simply "participate in the coordination of national policies but would not have a monopoly on those policies."[12]

The Governors' draft referred to the possibility that the ECB would take over banking supervision and regulation functions, but by the time this proposal was included in the Maastricht Treaty provisions on monetary policy (Article 105, section 6) it was accompanied by so many provisos that it looked as if the hurdles to effective European banking supervision could not be set higher.[13] The intrusion of politics had thus resulted in a fundamental flaw in the new European monetary order. The ECB was thus never given overall supervisory and regulatory powers, and until the outbreak of the financial crisis in 2007-2008 no one thought that was a problem. It is, however Article 105 that presents the legal basis of an extension of the ECB's function in the light of a recognition that the monetary union does indeed require an element of coordinated supervision of the financial sector – or what is now referred to as a banking union.

The Financial Crisis and Its Aftermath

By 2010, it had become clear that there was a very big problem. This is a worldwide phenomenon – after September 2008 and the collapse of Lehman, it is clear that central banks anywhere cannot ignore financial stability. Then there is a particular European problem. There had previously been a stream of private sector money from north to south in Europe, with capital flows driving current account imbalances. The flows of capital had important effects on wage rates, differential inflation levels, and hence on the position of competitiveness. In the monetary union, there was

[9] *CoG, Committee of Alternates, October 16, 1990.*

[10] *Goodhart, C. and D. Schoenmaker. 2006. Burden Sharing in a Banking Crisis in Europe. Sveriges Riksbank Economic Review 2 (2006). 34–57.*

[11] *HADB, B330/24112, February 22, 1989, Report on Monetary Policy Committee.*

[12] *CoG, Meeting 243, March 13, 1990.*

[13] *Kenen, P. B. 1995. Economic and Monetary Union in Europe: Moving beyond Maastricht. Cambridge: Cambridge University Press 33.*

no policy tool to limit inflation through a national monetary policy, and hence in the borrowing countries (now often referred to as the periphery), interest rates were lower than they should have been had a Taylor rule been practiced. Indeed Ireland had negative real rates for substantial periods of the 2000s. After the financial crisis, the sustainability of the flows was threatened by banking crises in the periphery, and the long-developing competiveness positions now looked like an argument that the debt levels (private or public) were unsustainable. Growth prospects that looked brilliant before the crisis no longer existed; so there was a debt servicing problem. That in turn seemed to endanger the banks, including particularly big north European banks that had already taken losses on US sub-prime investments. Funding dried up as US money market funds no longer wished to buy paper issued by European bank borrowers. One of the most obvious lessons of the first phase of the financial crisis was that the failure of big banks would have disastrous consequences. That mantra of the policy technocrats produced its own pushback among many voters and politicians: Shouldn't the banks bear some of the burden. At Deauville in October 2010, Chancellor Merkel and President Sarkozy agreed that there should be Private Sector Involvement (PSI).

Far from reassuring markets, the move to make private lenders bear some of the cost of past mistakes made for greater nervousness – much more so, indeed, as Jean-Claude Trichet of the ECB had insistently warned. For a decade, markets had interpreted the no-bailout clause of the Maastricht Treaty as making default impossible. It now seemed to be encouraged by the official sector. After Deauville an unhappy mechanism was created which increased the potential for large bank losses and heightened market nervousness. The official sector put in more money, in effect a substitution for the absent private sector flows of the pre-crisis era; and as that occurred and as the public credit was given seniority, the problems of the private sector debt increased rather than diminished.

Who ultimately is to absorb losses from very large banking sector problems? Do states, which rely on borrowing because they cannot increase taxes, have the capacity to do that when the financial sector is failing? It looked as if only monetization of debt by the central bank could solve the problem in the short run, but in the long run that threatens to mean writing off of debt by means of an inflationary process. So the fiscal problems generated by big financial sector problems pose a challenge to the design of monetary policy.

A New Vision

Central banks in a financial crisis take on a different function: in normal times, their task is primarily concerned with price stability, but in response to financial crisis, they have a new function of restoring financial stability. In the global financial crisis after 2007, central banks became rock stars. They knew they should respond decisively and innovatively to problems that could not easily be tackled by governments, finance ministries and politicians. In the aftermath of the collapse of Lehman Brothers in September 2008, the US administration and the Congress were paralyzed by the upcoming presidential election, and consequently the government lacked the authority to act. But the Federal Reserve System could be very decisive. It injected liquidity into the banking system. The New York Fed intervened in a very unorthodox way to prop up a systemically vital financial institution whose collapse would have destroyed the global financial system: it lent AIG USD 85 billion in return for 80% of its stock, as well as providing USD 20.9 billion in the commercial credit program and a USD 38 billion facility providing liquidity for the company's securities. Federal Reserve Chairman Ben Bernanke was explicit

about how a historical lesson drove the policy response. As he put it: "History teaches us that government engagement in times of severe financial crisis often arrives late, usually at a point at which most financial institutions are insolvent or nearly so."[14] The theoretical point is that monetary policy can shift expectations about future and hence current asset values. That affects the question of the solvency or insolvency of agents. In a world of multiple equilibria the central bank can in the short term bring agents back into a good equilibrium, and they appear as very powerful mechanisms to restore growth prospects in the short run.

The debate about central bank capacity focuses more and more on unconventional monetary policy, and on macroprudential issues. Both involve discrimination between particular sectors and types of credit (such as housing finance or car loans or student loans or SME credits). The central bank needs to decide which segment of the market needs cooling down, and where reanimation is required. Such decisions have distributional consequences, and hence look political. Making these decisions tests the independence of a central bank, for which there is a very solid case when it is simply a question of monetary policy oriented toward price stability.

The euro story is about the breakdown of governance mechanisms in the face of enormous financial claims generated in the absence of adequate financial sector supervision, and about the proper way of managing a policy response when policy moves away from a concern with price stability and toward the broader goals of financial stability and macroeconomic performance. The story holds broader lessons, also for other non-European countries, which do not simply apply in the peculiar case of currency unions.

(1) Mega-finance is a danger to fiscal stability, because first it permits the easy financing of deficits, but also the development of local bubbles and divergent competitiveness. The breakdown

[14] *Hetzel, R. L. 2012. The Great Recession: Market Failure or Policy Failure? New York: Cambridge University Press. p. 282.*

then requires large government funded rescues and raises the problem of fiscal sustainability. A solution involves the capacity to provide regionally differentiated monetary policy.

When the EC Committee of Central Bank Governors began to draft the ECB statute, it took two principles as given: Price stability as the primary objective of the central bank; and the indivisibility and centralization of monetary policy. This would not be "in contradiction with the principles of federalism and subsidiarity."[15] But in fact the second assumption was not really justified either historically or in terms of economic fundamentals.

Think first of the gold standard. A critical part of the gold standard was that individual national central banks set their own interest rates, with the aim of influencing the direction of capital movements. Incidentally the same differentiation of interest rates also occurred in the early history of the Federal Reserve System, with individual Reserve Banks setting their own discount rates. The euro area is now moving to a modern equivalent, driven by a new concern with macroprudential regulation. Bank collateral requirements are being differentiated in different areas. This represents a remarkable incipient innovation. In the aftermath of the crisis, some policymakers are beginning to see that a monetary union is not necessarily identical with unfettered capital mobility. Recognition of diverse credit quality is a step back into the nineteenth-century world, and at the same time forward to a more market-oriented and less distorting currency policy.

(2) Fiscal sustainability in the long run requires some sort of politically negotiated agreement. That needs to be rule-based, but also to establish rules that permit flexibility as part of a strategy of immediate crisis response. Rules do not often constrain governments, so it is better to run stabilizers through non-government institutions. A better way of discussing transfers within a large and diverse political order is to think of them as individualized or personalized. In particular, a European-wide social security system would not only be a logical completion of the labor mobility requirements of the single European market.

(3) Without increased flexibility sovereign bankruptcy becomes a disastrous and destructive event that uncontrollably generates contagion.

Though all the underlying problems have been around for a long time, there is always a temptation to do what Europeans did until the financial crisis: merely hope that with time the problems would vanish.

The management of cross-national problems and the containment of crisis-driven nationalistic quarrels certainly need technical fixes, including improved macroprudential surveillance and a new approach to capital requirements. But a real solution to the crisis clearly also requires something more. A politically legitimate mechanism for solving the problem of international adjustment was the unsolved problem of the twentieth century. In Europe and elsewhere it generated enormous conflict. Fixing that issue is a European but also a global agenda for the 21st century.

[15] *James, H. 2012. Making the European Monetary Union. Cambridge Massachusetts: Harvard University Press.*