

From divorce to a union of unions: too much of a good thing

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1 The paradigm shift in the GEMU reports

The Four and Five Presidents' reports constitute a paradigm shift in how the monetary union should be governed. While the old paradigm was based on an "unprecedented divorce between the main monetary and fiscal authorities" (Goodhart, 1998: 410), the paradigm outlined in these reports on a Genuine Economic and Monetary Union (GEMU) envisages a "union of unions". This is progress as it acknowledges that non-state money, issued by a central bank without fiscal backing, needs some risk sharing mechanisms between member states. Otherwise, financial markets will shift the risks of financial instability onto the weakest members that are least able to bear them. It is exactly what happened: Vulnerable member states were drawn into a negative feedback loop between deteriorating government balances, weakened by rescue measures for their oversized banking systems, and deteriorating bank balance sheets, weakened by falling asset prices including government bonds that they held as "safe assets".

Since May 2010, the member states that were financially less exposed had to ride repeatedly to the rescue of these crisis countries. This was in their own interest as sovereign defaults would have dealt a fatal blow to many of their domestic banks as well and possibly led to the end of the euro area. But the uncertainty of when support will be forthcoming and how much of it has made crisis management very costly and politically divisive.

What was the problem with the old paradigm? The original architecture was meant to contain the moral hazard inherent in monetary integration: member state governments were expected to become more reckless in running deficits, given that financial markets might not punish a government that issues more euro-denominated debt as each debt issue constitutes only a small share in a vastly expanded market for euro-denominated bonds. The threat to be left to one's own devices in a crisis was made explicit by the notorious bail-out clause. The ECB was not allowed

to buy bonds directly from the issuer, not even under the extreme circumstances of a systemic financial crisis: panic had to force the central bank's hand before it could intervene in secondary markets.

The separation principle means effectively that banks can count on being bailed out swiftly and directly while sovereigns get a bailout only under the most onerous conditions. Those obsessed with moral hazard should also worry about the incentives for future risk-taking that this creates in the financial system. The separation principle also ensures that instability is allowed to spread, as a kind of punishment for the alleged perpetrator of fiscal sins. Neither Ireland nor Spain should have fallen from grace on that account, however.

The lesson, perhaps too obvious and therefore ignored, is this: integration – monetary, financial, and economic – makes members more interdependent and the crises of some can easily become a crisis of many. It is in the self-interest of every member to prevent this, irrespective of whether they are cause, victim or collateral damage of market panic. The GEMU reports have now acknowledged this and propose welcome ideas for doing something about it. But the union of unions may be too much of a good thing.

The Five Presidents' report proposes three big steps towards the ultimate union of unions (Juncker, 2015: 4): In the short term, a banking and capital markets union should provide the mechanisms for private risk sharing when a shock hits any of its members.¹ This would give time to economies and governments, in the medium term, for their "economic structures [to] converge towards the best standards in Europe"; convergence would finally prepare the ground for public risk-sharing "through a mechanism of fiscal stabilization for the euro area as a whole." Eventually, political-fiscal union would embrace economic and monetary, banking and capital union.

2 The economic limitations of the paradigm shift

This phasing-in model of risk-sharing in the Four and Five Presidents' reports is firmly based on a literature from the second half of the 1990s (Asdrubali et al. 1996, Sørensen and Yosha, 1998). It modified the standard approach to monetary integration in that it argued that members of a monetary union do not have to converge economically before they can form an "optimal currency area"; to the extent that shocks were idiosyncratic and not common, they could insure and compensate each other to mutual benefit. If households have, directly or indirectly through their banks and pension funds, access to financial markets in other member states, a

¹ An element of fiscal union is thrown in as well, with the foundation of an independent Fiscal Board, but I regard this as a complete side show. There is no need to have even more oversight powers than DG Ecfm already has.

downturn of domestic income can be compensated through capital income or credit from other member states.

The methodology measured how much of an output shock is compensated by various channels of inter-state risk sharing, absorbing its transmission into consumption volatility. Especially between U.S. states, the bulk of output shocks was apparently absorbed by capital and credit markets, while the federal budget and labor migration combined contributed less than 20%. Later studies in this tradition found increasing risk sharing of output shocks between OECD countries and in particular the euro area members that could be attributed to closer financial integration (e.g. Gerlach and Hoffmann, 2008; Christev and Méltz, 2011: 27–29). This literature could show that a monetary union of diverse member states is not a problem but provides the opportunity for mutually beneficial risk diversification.

But this literature also has limitations. They are quite serious if used in a blueprint for the future of the euro area. The methodology can deal with exogenous output instability only and excludes, by assumption, the destabilizing influence of demand volatility on output. This may explain why the estimates for the contribution of public risk-sharing are so low (Dullien, 2012: 59). The methodology does not grasp endogenous risks arising from financial integration itself. An example is the leveraging of private balance sheets and an ensuing asset bubble, both fueled by cross-border capital flows. The prime channels of private risk sharing, capital and credit markets, can thus never become the source of risks to macroeconomic instability, for instance a credit crunch for investing firms and wealth effects on consumption (Christev and Méltz, 2011: 29). The economic literature on which the Five Presidents' report bases its recommendation was firmly based on the belief that financial markets are efficient and imperfect largely because of regulatory-political segmentation.

This is hardly a tenable view of the world in 2015. The North-Atlantic financial crisis since 2007 and the euro area crisis since 2010 have not been caused by too little financial integration. What made markets seize up was the interdependence of banks in advanced economies that had taken too much and poorly understood risks on their books, not an output shock like a sudden rise in commodity prices. The systemic private debt crises were largely managed by public mechanisms of risk spreading, notably public debt which ropes future taxpayers into national risk pools. Above all, it was and still is monetary risk sharing that has saved the European economies from a more severe downturn – the monetary “channel” does not even figure in this literature because the methodology is based on national accounts data. Finally, the exit from years of lingering financial crisis is so difficult because it is impossible to tell how the financial system will be affected when the monetary life support of zero interest rates ends; fiscal authorities are too frightened and battered to take on the problems in their banking systems resolutely. Finance is still the problem, not the solution.

But there is also an inconsistency in the approach that cannot be blamed on this risk sharing literature which had undoubtedly scholarly merits. The stipulation that countries have first to converge in their economic structures before fiscal risk-sharing should be contemplated makes no sense. Since common shocks cannot be insured, convergence would actually reduce the potential for risk sharing (Imbs and Mauro, 2007). The convergence postulate is a legacy of the old paradigm that if only every member state exercises fiscal discipline, all macroeconomic stabilization could be left to the independent central bank.

Diversity of economic structures is here to stay. This is not a handicap but can be a source of economic robustness. It requires finding ways of spreading the risks to income and employment from (asynchronous) business cycles and different vulnerabilities. Notably the risks of member states with high growth potential but stability problems can be pooled to mutual benefit with risks of mature member states that are stable but stagnating. Public risk sharing must be strengthened before private risk sharing can be relied on. However, convergence on some imaginary best standard is not even desirable from an economic perspective.

3 Taking political constraints seriously

The “union of unions”-paradigm is a splendid vision of the euro area if one is a great believer in ever closer union. But European electorates seem to be wary of this mantra of European integration and those in the PR department of the EU may want to take notice. European electorates resent ever further steps and roadmaps towards closer integration not because they are ignorant and have not seen the light. It is because they sense that it is a road full of uncertainty, with the potential for serious accidents along the way. An agenda that tells the public that the monetary union is really a union of many unions is like telling somebody who wanted to buy a simple doll that they got a Russian doll with more dolls inside, none of which is particularly fun to play with.

But instead of admitting to uncertainty, we are getting a firm roadmap with timetables. The promotion of a capital markets union is the next big project. This is again following the script of the literature that sees in cross-border capital ownership the most powerful risk sharing channel (Sørensen and Yosha, 1998: 213). If every household in the euro area would get its income from holding a representative portfolio of shares in the output of the euro area, national output fluctuations would not matter to consumption as the income streams would be equalized. This could even deal with permanent shocks to a regional economy. Any default would be spread among the many shareholders, not banks and sovereigns that tend to get into a fatal embrace, dragging each other into the abyss.

Unfortunately, households do not hold and get their income from representative portfolios. And governments could not ignore the default of a major player in stock

markets. Lehman Brothers was an investment bank, AIG a wholesale insurer of the financial industry. If a big pension fund would collapse in a stock market crash, whose responsibility would it be if this were to wipe out the old age security of many pensioners in several member states? If it were the responsibility of the fiscal authority in the country where the pension fund had its headquarters, one might see the same negative feedback loop that we witnessed in the case of Irish and Spanish banks.

Governments are still not ready to underwrite the risks of an integrated financial system in the euro area. The banking union has not eliminated negative feedback loops because the resolution mechanism has no underpinning from a euro bond. The German Treasury seems to have got cold feet on this once the threat of a euro area break-up was over. But it is irresponsible to press ahead with a capital markets union as if governments were willing to incur joint liability for cross-border default of systemically important financial businesses. They are not.

This has to be taken as a hard political constraint. Ignoring it amounts to a political strategy that tries to panic governments into ever closer union, with the mother of all crises as the ultimate threat. At the moment, the end of the union seems to be the more likely outcome of such a strategy.

Taking seriously the political constraints imposed by integration fatigue requires thinking of public risk management short of joint fiscal liability. If governments are not ready to underwrite the risks of financial integration, then it seems logical to limit and possibly even reverse financial integration. Macroprudential instruments are a good start, since they are sensible capital controls that dare not speak their name. They are sensible because they do not create costly and hard to maintain borders with regressive distributive effects but organize collective action of supervisory authorities against the herding behavior of lenders and investors. One should probably contemplate also other forms of segmenting (dis-integrating) financial markets, as the Dodd-Frank Act in the United States and the Vickers rule in the UK have done.

Reversing the order of private and public risk-sharing expressed in the report should be considered as well. Public risk sharing can be improved without a central budget and a common debt instrument, even though the latter would be a desirable stabilizing instrument. Re-insurance mechanisms that draw on the deep pockets of central banks are an alternative. For instance, the re-insurance capacity of the resolution mechanism could be enhanced if it were given a banking license and could thus get access to the ECB as a lender of last resort. It would no longer confine it to a finite amount of firing power, in line with what the financial industry is able to pay or beleaguered governments are able to stump up. In a systemic crisis, pre-committed amounts tend to trigger adverse speculation that funds run out rather than assure everybody that “it will be enough”, to paraphrase Mario Draghi. In contrast

to direct lending of last resort by the ECB, the resolution mechanism could attach strings to its rescue operations for banks, such as a strict cap on bonuses.

Another risk sharing mechanism, operating at the interface of public and private finance, would be an insolvency law for sovereign debtors (Gianviti et al., 2010). It is a long over-due international public good. Financial investors must get back the sense that they have to share the pain and that returns are earned for taking not only the upside but also the downside risk. Obviously, banks and funds would try to pass on the losses to their shareholders and clients. But this would be preferable to the present situation in which the public institutions that rescued them have to do this unpopular business for the bank and fund managers, passing losses onto taxpayers. Before a union of unions can be proposed to these taxpayers, the monetary union will have to show that it can do better than that.

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