The political economy of monetary integration

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“The euro, the only transnational currency issued and managed by a single common institution, was the last utopia of the 20th century [..]. It was a complete economic and monetary revolution: a currency that did not rely on a state or on a commodity. [..] There were reasons to be sceptical, but Europeans decided to push through with the project nonetheless.”
(Jean Pisani-Ferry 2014)

Discuss in groups of two or three what you think of this quote. Do you agree? Does JPF nail the problem, or the achievement, that the euro area is in your view? Take some notes, we’ll come back to it.

Overview

- Why I think that two prominent theories of monetary integration are inadequate
  - The theory of Optimum (!) Currency Areas
  - Varieties of Capitalism/ Growth Models

About 20 minutes, followed by discussion

- An alternative, the political economy of monetary solidarity
  - A political-economic paradox of diversity
  - The evolving system of re-insurance in the euro area

About 20 minutes, followed by discussion and Q&A

Why existing theories of monetary integration are inadequate

Traditional theory of Optimum Currency Areas (Krugman 2013)

Varieties of Capitalism (Hall 2012, 2014; Johnston and Regan 2014)

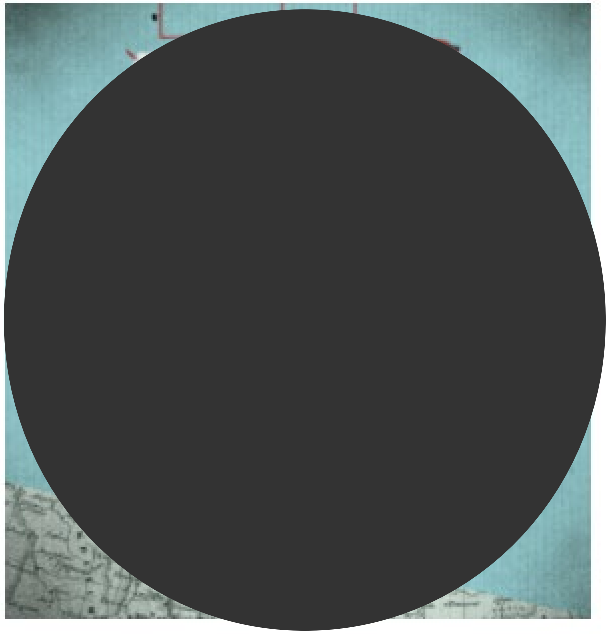
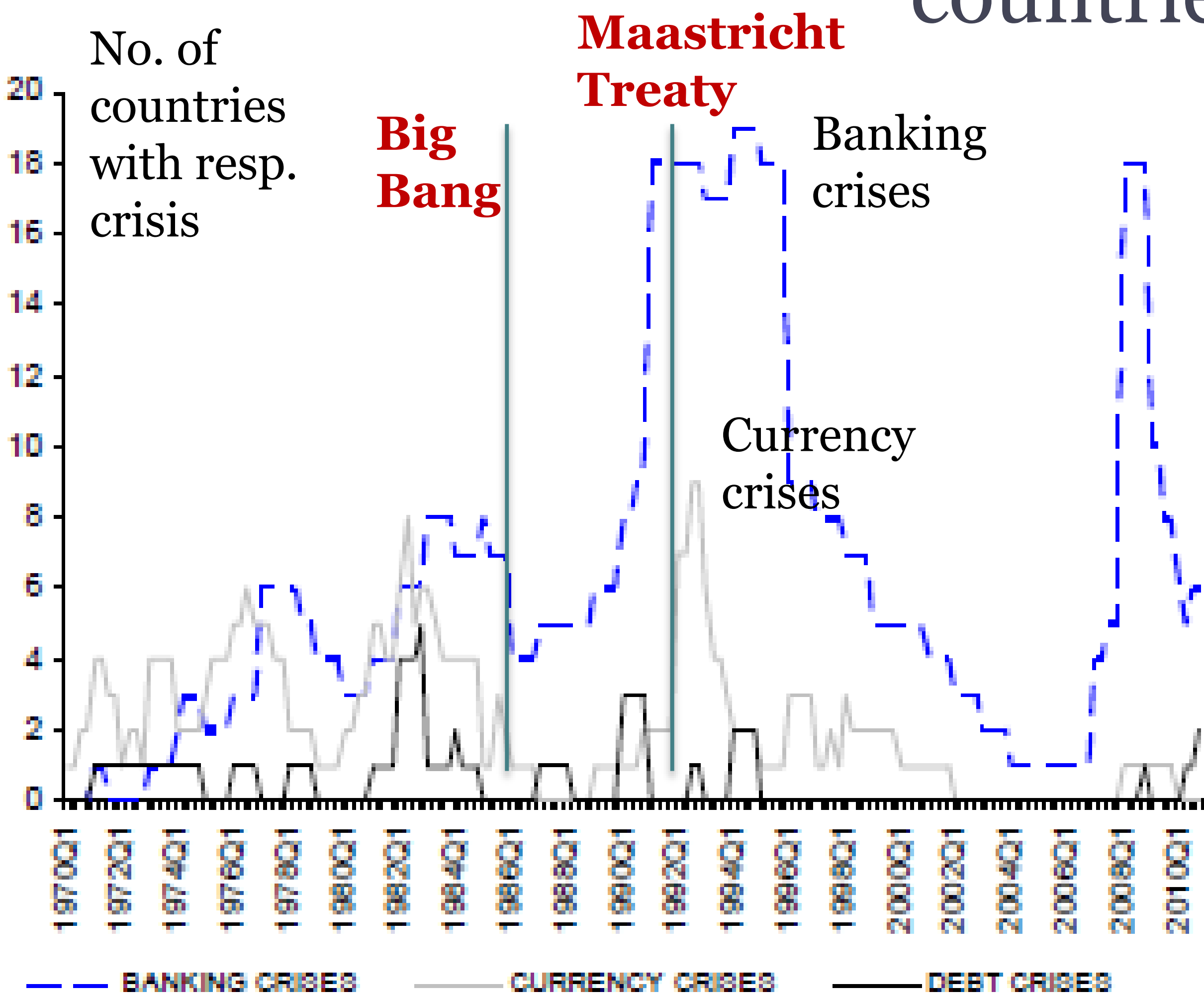


Illustration by David Plunkert, The New Yorker

Traditional OCA theory

- Perspective is the joining member state
  - MU as an act of ‘irrevocably’ fixing exchange rates
- Exchange rates are a reliable adjustment mechanism that needs to be replaced
  - Primarily by labour market mobility and ability for internal devaluation
- Must treat the financial crisis since 2008 as an
  - Exogenous
  - Country-specific shock

Financial market risks of developed countries, 1970-2010

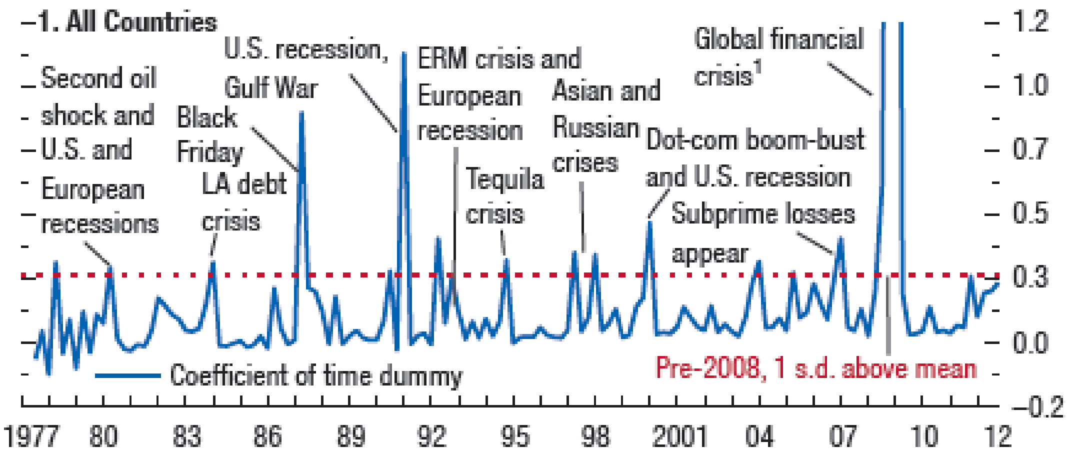


Source:
ECB Working paper No.1485, 2012

Evidence of a common financial "shock"

Figure 3.4. What's behind "Common Shocks"?

Spikes in global comovement correspond to well-documented global events such as oil shocks, financial shocks, and recessions in major advanced economies. Regional output comovements confirm the importance of financial crises in increasing output synchronization.



IMF, WEO (Oct 2013), ch.3

- Co-movement of output in 2008-09 four times larger than in previous crises
- This was a systemic financial crisis, amplified and transmitted through financial integration

Incompatible growth regimes
(eg Johnston and Regan 2014)

Diagnosis:
export-led Northern growth model feeds on current account imbalances of domestic demand-led growth model, results in debt crises

Fig. 5.3: Current account balances of the “South” and the “North”, 1980-2015

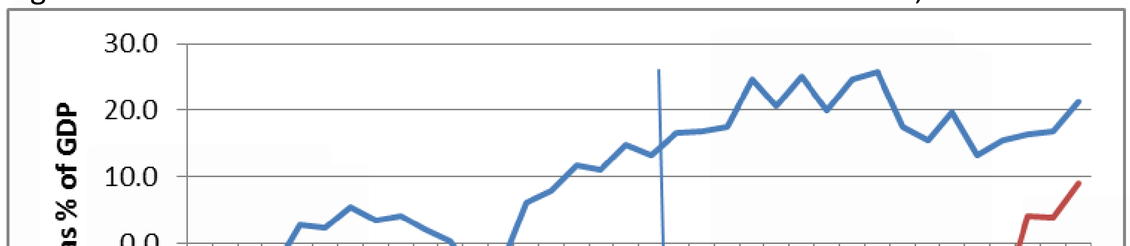
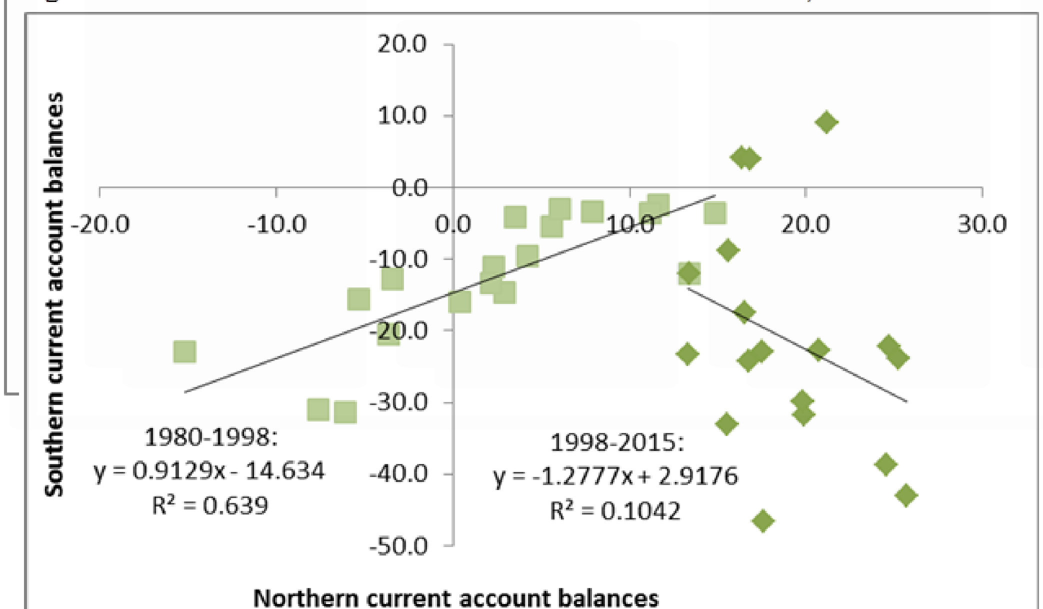


Fig. 5.4: Correlation between Southern and Northern balances, 1980-1998 v 1998-2015



Source: AMECO series UBCA, own calculations (unweighted sums of national balances)

Incompatible growth regimes, cont'd

Table 5.2: External trade balance and debt position, 2006-2008, in % of GDP

	Trade balance*		Net IIP**
	Total	Intra-EA	end of 2008
Austria	-0.2	-5.8	-16.9
Belgium	3.0	5.2	39.8
Finland	2.9	-0.8	-9.7
France	-2.9	-3.2	-12.9
Germany	7.4	2.5	25.0
Netherlands	7.0	19.5	4.2
Greece	-18.1	-8.5	-76.9
Ireland	15.4	11.4	-75.7
Italy	-0.8	-0.5	-24.1
Portugal	-13.6	-10.0	-96.1
Spain	-9.3	-3.9	-79.3

*three year average 2006-2008; **IIP = International Investment Position

Source: ECB (2013: 69)

Only BE and NL fit the VofC hypothesis; BRICs are a more likely cause: expanding markets for Northern Europe, competition for Southern Europe

Political-economic puzzles for the existing literature

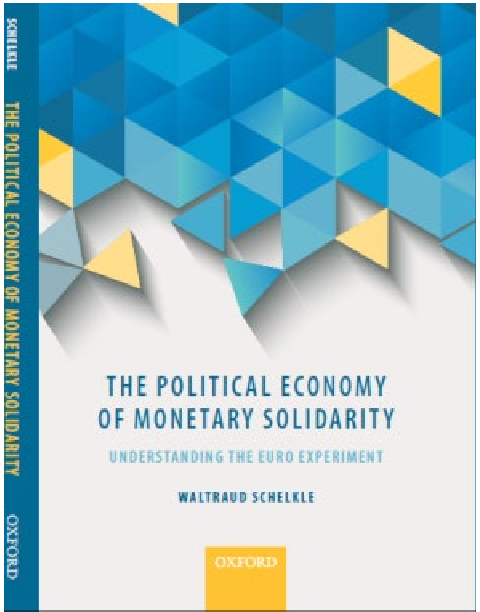
1. Why has a motely set of established nation states given up on national currencies?

   Existing theories of monetary integration (traditional OCA and VoC) see diversity only as a problem

2. How could the EU hope to make it work without a budgetary union?
   - Single Market/ free movement was meant to work its magic
   - Diversity is not only a constraint but also an opportunity

Comments?
Questions?
Critique of my critique?

The research programme of the political economy of monetary solidarity



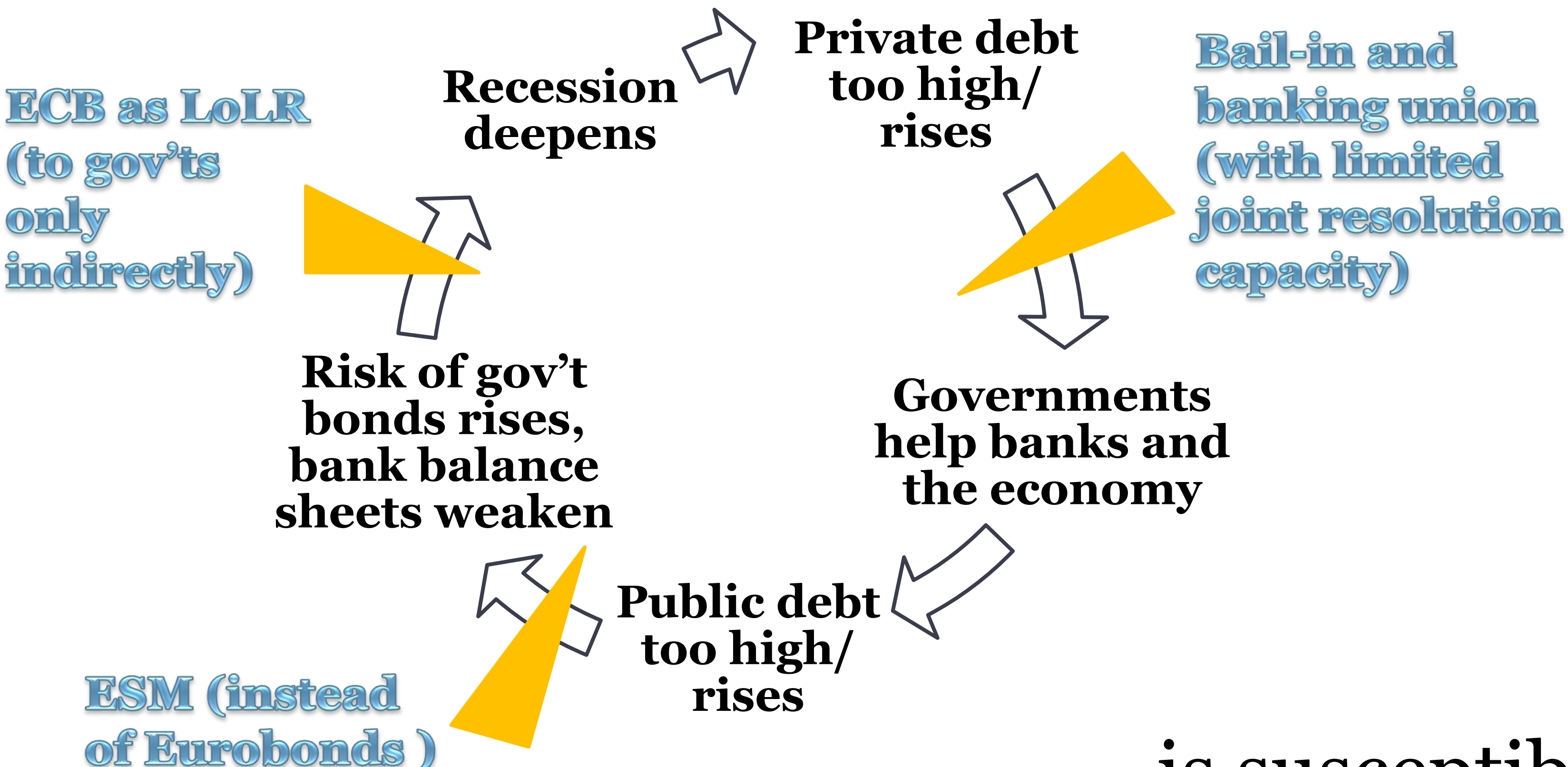
The political economy of monetary solidarity

- A monetary union can be analysed as a risk and insurance pool
- By default (eg cross-border payments system)
- And by design (eg central bank, free movement)
- Diversity of members creates a paradox
  - the more diverse, the higher potential insurance benefits
  - But also the more difficult is political cooperation to realise the insurance potential

The political economy of monetary solidarity, cont'd

- Hence, risk sharing and solidarity are likely to emerge as **a by-product of national incentives** rather than as a direct solution to collective action problems
- It is more plausible to see the EA as created for **limited risk pooling** (indirect evidence: obsession with Moral Hazard) in a **world of unstable financial markets** (ERM crisis strengthened resolve)

The price for limited risk sharing capacities..



...is susceptibility
to negative feedback mechanisms

Examples of monetary solidarity

Monetary solidarity is acknowledged and at least tolerated risk-sharing that is likely to arise for other reasons than open solidarity

Before 2008

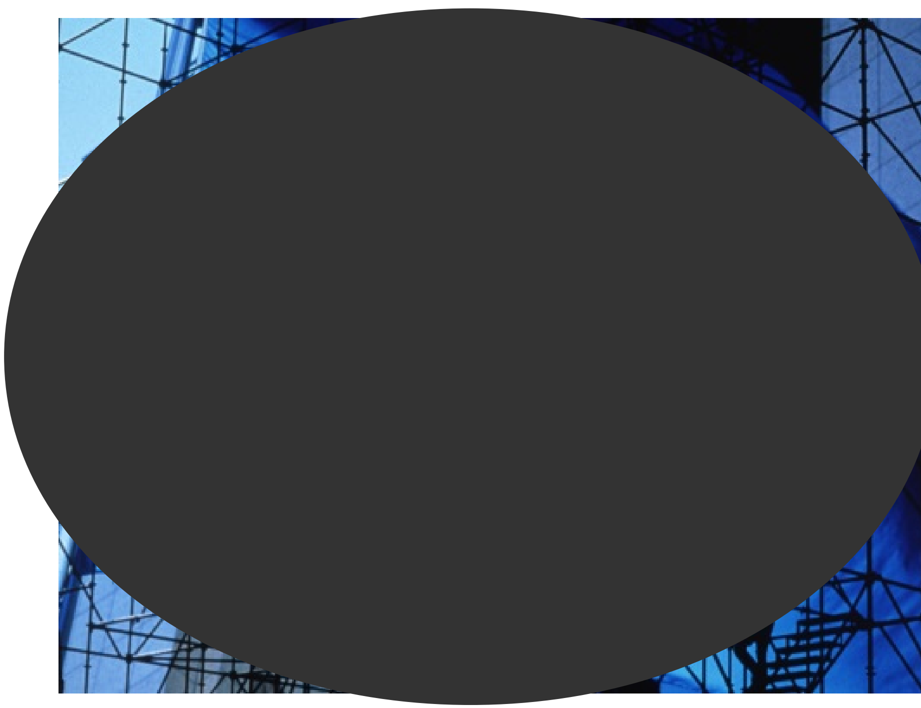
- The ECB's collateral policy (contra Buiter and Siebert)

After 2008

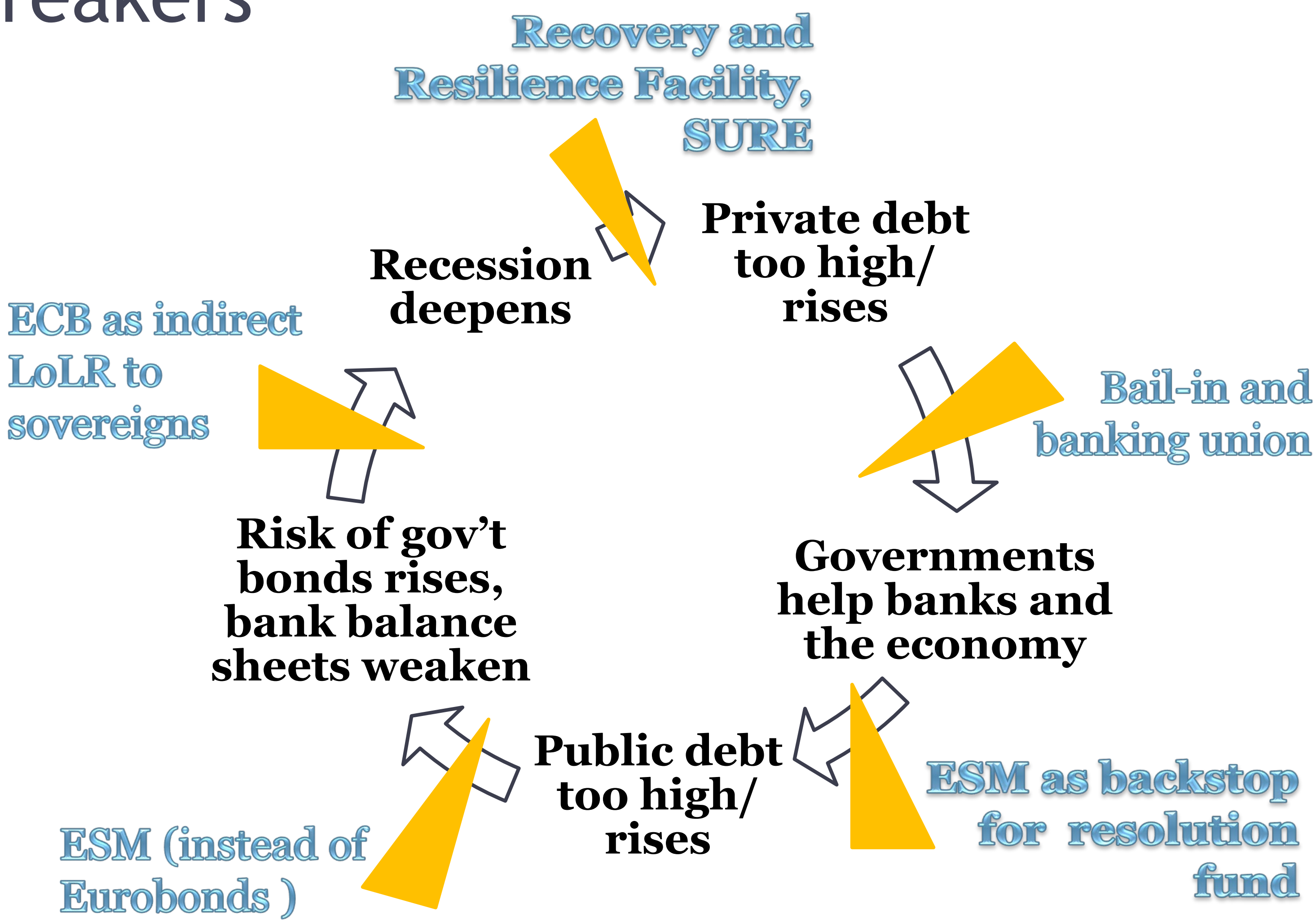
- The cross-border payments system TARGET (contra Sinn et al)
- The bailout fund ESM (contra Schäuble and Varoufakis)

Where to go from here? The construction site of fiscal risk pooling

An emerging system of
re-insurance



Pandemic response added more circuit breakers



Does this add up to a macroeconomic system or is it just a weak substitute for a budgetary union?

- Fiscal federalism: **co-insurance** of federal and state level
- EU fiscal risk-sharing: **re-insurance** of primary ‘insurers’ (member states)by EU schemes
  - Secondary safety net for catastrophic and/or endogenous risks of monetary-financial integration
  - Reinsurance is standalone and can be categorically different
  - Moral Hazard less of a problem as primary insurers bear the brunt of a crisis

An emerging system of re-insurance?

'Insurers' ***Reinsurance providers***	**Financial markets**	**Sovereign public finances**
European Central Bank	Lending and market making of last resort; TARGET as insurance against sudden stop	Open-ended support (OMT announcement), Quantitative easing for sustained stimulus
Single Resolution Fund	Restructuring of too-big-to-fail banks, zombie banks	Doom loop of bank-sovereign balance sheets
European Stability Mechanism	Backstop for an industry-financed resolution fund	Bailout with conditionality, earmarked lending for pandemic
Recovery and Resilience Facility, SURE	n.a.	Substitute for bond market to finance public investments and job retention

Source: Schelkle, forthcoming

To sum up by coming back to JPF

"The euro, the only transnational currency issued and managed by a single common institution, was **the last utopia of the 20th century** [..]. It was a complete economic and monetary revolution: a currency that **did not rely on a state** or on a commodity. [..] There were reasons to be sceptical, but **Europeans decided to push through** with the project nonetheless."

Not utopian but experimental in its political form, with re-insurance as the principle of fiscal risk sharing

Exactly, no strict complementarity of monetary and fiscal authorities – not by mistake but by design

The political-economic paradox I see suggests that political choice does put on some brakes on fiscal integration