The European Tragedy: What Way Out?

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Europe can choose its musical accompaniment. In Berlin, 50 Cent's All Things Fall Apart has just had its premiere. Or go back to Giuseppe Verdi, born two hundred years ago. His second last, and probably greatest, operatic achievement, starts on the coast of Cyprus with a storm of fantastic violence and with the first words of the hero, Otello, on a high B: *Esultate*, rejoice! The war has been won, the storm overcome: but the hero's achievement is destroyed by his jealousy.

Cyprus appears to have been rescued: but the rescue has set off a rift that threatens the whole of Europe because of the way that the traumas of the early twentieth century are being relived.

The Great Depression has been a constant backdrop of debates about the post-2008 financial crisis but also about the Euro crisis. What made the interwar slump so intractable was that it was not just a financial issue, but also a crisis of democracy, of the international political system, and of social stability. It is now clear that contemporary Europe is reenacting that interwar upheaval.

In the interwar period, increased social tension as a consequence of increased unemployment and of widespread bankruptcy made normal democratic politics impossible. In Germany, the epicenter of the breakdown of democracy, nationalist radicals on both the right and the left raged against the postwar peace settlement and the Versailles Treaty. In the last years of the increasingly unstable Weimar Republic, as democracy was fraying, German government started to use the radicalism of their opponents as a way of trying to extract security concessions from the western powers. Domestic political pressure became a source of heightened international tension.

That is true in today's Europe. Democracy has become a central target of complaints by the European elite. Luxembourg Prime Minister Jean-Claude Juncker and former Euro group chair stated that it wasn't that European leaders didn't know what the right policies were; but that they didn't know how to be reelected after they had implemented them. Italian Prime Minister Mario Monti after a humiliating election defeat wistfully explained how the Italian electorate was too impatient to bear reforms whose benefits would only become evident over a longer time frame than that of the election cycle.

The Cyprus crisis has exposed two new dimensions to the clashes over Europe's debt and bank crisis. The discussion of a levy on bank deposits, and whether small customers should be exempted, puts class conflict at center stage. The question of foreign, and especially Russian, depositors – along with the proximity to Syria - makes the incident into an international relations problem.

The initial idea of making depositors with less than 100,000 euros pay a bank levy in the first proposed Cyprus rescue package came not from the European Union or from Germany, but from the Cyprus government. It must have been clear that the expectation that small retail customers should bear a significant part of the sacrifice was likely to generate a wave of outrage and anxiety. Expecting the Cypriot parliament to vote for the proposal was unrealistic.

Perhaps the government felt that it would strengthen its hands to have mass protests with placards denouncing the EU as a stage of a revived Nazi German dominance of Europe. Even very moderate Cypriots were outraged by the bullying of their small island by Germany and by Europe.

The other side in the negotiations also played class politics. At one of the tensest moments, as Cyprus was looking for an alternative rescue package from Russia, the German Bundesbank announced the results of a ECB new study on comparative wealth distribution in Europe. According to this study, German average wealth was below that of the southern European states, largely because fewer Germans own their own houses.[1] The message must have been intended to influence the international discussions: why should poorer Germans make sacrifices to support Mediterranean millionaires.

[1] http://www.bundesbank.de/Redaktion/EN/Pressemitteilungen/BBK/2013/2013_03_21_phf.html

In the aftermath of the financial crisis, income and wealth distribution has moved to the center of political discussion. Even the cardinals of the Catholic Church seem to have caught the new mood quite precisely, when they elected Archbishop Bergoglio as Pope Francis. The clear reference to St. Francis of Assisi recalls the Church's mission to stand up for the poor.

The second dimension is the security issue. After 2010, as the European crisis developed, Cyprus lost many European deposits, but deposits from Russian businesses and individuals increased. Cyprus is also crucial as a staging post for U.S. security interests in the eastern Mediterranean. Finally, the gas fields off the Cyprus coast might be developed as an energy source that would – at least after 2017 – reduce European dependence on Russian supplies. There are in consequence a large number of reasons why Russia might want to use money as a way of buying political control.

In an earlier phase of the European crisis, Russia gave Cyprus a $3 bn. credit. What would be needed in the current episode is not a new credit, which would only serve to make the level of government debt unsustainable, but a purchase of all or some of the problematic Cypriot banks. Why was Russia unwilling? Because in the aftermath of the crisis, intensified by the class conflict rhetoric, it might be able to extend its control more significantly, and at a lower price.

The increase in social polarization, together with the way it can be instrumentalized in political negotiations, along with the intrusion of a new security element, gets in the way of the solution advocated by most economists and most political commentators. 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.

A state, especially in the modern form of the European welfare state, depends on mechanisms for arbitrating and resolving social disputes. The story of Cyprus shows how much European integration risks becoming an impossible dream.

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."[2] The Presidents of the ECB seem to endorse this advice. Accepting the Charlemagne Prize in Aachen, Jean-Clause 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, 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."[3]

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 are facing the dark night of the European soul.

A few years ago, the European Union was extolled as a postmodern creation, not like a traditional state with a firmly defined sovereignty. Sometimes analysts looked at the old, but very long-enduring, Holy Roman Empire, famously analyzed by the jurist Samuel Pufendorf as "like a monster" because it had no clear head or sovereign. In fact, I believe, something of this flexibility needs to be revived.

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[2] Thomas Sargent, "United States Then, Europe Now," Nobel Prize speech 2011: http://www.nobelprize.org/nobel_prizes/economics/laureates/2011/sargent-lecture.html; Paul de Grauwe, "The Eurozone's Design Failures: can they be corrected?," Nov. 28, 2012, LSE lecture: http://www2.lse.ac.uk/publicEvents/pdf/2012_MT/20121128-Prof-Grauwe-PPT.pdf .

[3] Jean-Claude Trichet: Building Europe, building institutions, Speech by Jean-Claude Trichet, President of the ECB on receiving the Karlspreis 2011 in Aachen, 2 June 2011; Remarks by Mario Draghi, President of the ECB, 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*, Aug. 29, 2012, http://www.ecb.int/press/key/date/2012/html/sp120829.en.html

What is needed is a new flexibility: not a replication of an existing state. Here I sketch out two flexi monetary solutions, and one flexi political solution.

1. Currency Innovation

In 1992-3, the EMS crises almost destroyed the path to the Euro, but the crisis was resolved by instituting greater flexibility: through wider (15 percent) margins in the exchange rate bands. The modern equivalent to the band widening of 1993 would be keeping the Euro for all members of the Eurozone but also allowing some of them (in principle all of them) to issue – if they needed it – national currencies. The countries that did that would find that their new currencies immediately trading at what would probably be a heavy discount. California adopted a similar approachat the height of the recent financial crisis, issuing IOUs when faced by the impossibility of access to funding. The success of stabilization efforts could then be read off from the price of the new currency. If the objectives were met, and fiscal stabilization occurred and growth resumed, the discount would disappear. In the same way, after 1993, in a good policy setting, the French franc initially diverged from its old level the band but then converged back within the band. Such a course would not require the redenomination of bank assets or liabilities, and hence would not be subject to the multiple legal challenges that a more radical alternative would encounter. There would also be the possibility that the convergence did not occur. The two parallel currencies could then coexist for a very much longer time period. This is not a novel thought. It was one of the possibilities that was raised in the discussions on monetary union in the early 1990s, that there might be a common currency but not necessarily a single currency.

2. More flexibility in monetary policy

A common criticism of monetary union is that it requires a single monetary policy, that thus becomes "one size fits all" and deprives policy-makers of a policy tool in responding to particular national or regional circumstances. 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."[4] 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 Eurozone is now moving to a modern equivalent, driven by a new concern with macro-prudential 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.

3. *More political flexibility*

In the aftermath of a big financial crisis, banking regulation is inevitably linked to implicit or explicit lender-of-last-resort functions and to resolution for failed banks. So there is also a significant fiscal cost, and that raises the same thorny political questions. In particular, what is the optimal unit for handling the resolution issue? The logic of possible bank workouts points to a desirability of larger banks and more cross-national banks as a risk-sharing mechanism. But the fiscal cost and the fact that only states can bear that cost push in the opposite direction, and have led in the past three

[4] Harold James, *Making the European Monetary Union,* Cambridge Mass.: Harvard University Press, 2012.

years to a dangerous disintegration or renationalization of finance in Europe.

What is now termed a banking union – that is common European regulation with some fiscal capacity for resolution in the case of failed banks – is a very belated but necessary completion of the monetary union. Even this step is still uncertain, and excites a great deal of opposition from Germans who do not want to bailout south European banks. The critics have correctly identified the problem, that some sort of permanent fiscal mechanism is required in order to pay for the bailouts and thus in fact implies a move to a real political union which regularly redistributes resources.

Problems of transfers in a large unit are at the heart of the political process of building federations or federalism.

Integration had its own historical momentum, and if and when it goes into reverse, that process will also have a counter-momentum. The argument against European structures depends on hostility to a transfer union that might lead to some redistribution of resources. Why should our money be taken away and given out to people in a very different area? What sort of claim do those very different peoples have?

The 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. It would provide an important buffer in that booming areas would pay in more, and shrinking areas would draw out more – without these payments going through government bodies and appearing as transfers from North to south – whether in a country such as Italy or in the whole of the European area. Defusing the political problem requires less statehood, rather than necessarily requiring the erection of a European super-state.

Restraint is required for another reason. We know that a commitment to monetary stability is only possible in the context of governments that can credibly commit to a fiscal regime in which there is no long term build up of claims that cannot be funded through taxation - or in modern parlance, avoid fiscal dominance. That was a problem to which federal systems of the past were especially vulnerable.[5] Hyperinflation almost tore apart early 1920s Germany, with separatism in Bavaria, the Rhineland and Saxony. In late 1980s Yugoslavia, as the socialist regime disintegrated, the monetary authorities in Belgrade were closest to Serbian politicians such as Slobodan Milosevic and to Serbian business interests. The Croats and Slovenes wanted to get away. In the Soviet Union, inflation appeared as an instrument of the central Moscow bureaucrats, and more remote areas wanted to break away. A coherent and stable framework is needed to stop the proliferation of fiscal actions that destroy monetary stability.

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The unhappy marriage analogy for Europe's current malaise is helpful. Europeans may have thought they got married for the wrong reason: neighbors who have a quarrelsome or violent past are not always well advised to heal themselves by marrying. Then they convinced themselves that they had a unique relationship that should not be interfered with by the rest of the world. The problem was that they didn't understand what marriage was really about, that they had exaggerated expectations of romantic marital bliss, but also and that a stable marriage is almost impossible when the surrounding society is profoundly unstable.

The Euro story is about the breakdown of governance mechanisms in the face of enormous financial claims. It holds broader lessons, for other countries and also for the United States.

(1) Mega-finance is a danger to fiscal stability, because first it permits the easy financing of deficits, but also the development of large disparities of wealth and income. Its breakdown then requires large government funded rescues and raises the problem of fiscal sustainability.

(2) Fiscal sustainability in the long run requires some sort of politically negotiated agreement. That needs to be

[5] Thomas D. Sargent and Neil Wallace, "Some Unpleasant Monetarist Arithmetic," *Federal Reserve Bank of Minneapolis Quarterly Review*, 531, Fall 1981, pp. 1-17.

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.

(3) Without such 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, that is merely hope that with time the problems would vanish.

The management of cross-national problems and the containment of nationalistic quarrels certainly require technical fixes. But it also needs 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 twenty-first century. It is unrealistic to suppose that new state mechanisms can be invented to deal with this problem – hence the call for flexibility.