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Why can't Europe save itself? A note on a structural failure

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Europe's Economic and Monetary Union (EMU) has been struck by one financial crisis after another. Yes despite many bold new initiatives, instability and uncertainty persist. Why can't Europe save itself? The answer, this chapter argues, lies in a structural failure. EMU lacks a credible mechanism to cope with the threat of imbalances within the group – a framework to manage the European region's *internal* payments problems. The challenge was foreseen from the beginning. How could a regional monetary union manage the risk of fiscal imbalances among its members? Europe might have turned to the USA for inspiration. For analytical purposes, the USA too can be considered as a regional monetary union comparable to EMU, facing the same fundamental challenge. America's solution was to create a permanent 'transfer union', featuring more or less automatic flows of funds through the federal budget at the centre. But European policy-makers chose otherwise, for reasons that go to the very heart of their ongoing integration project. EMU is a league of sovereign states, each determined to retain for itself as many rights and privileges as possible. In such a structure, a permanent transfer union never had a chance; and since no adequate substitute has yet been found, Europe is forced to pay a high price in terms of instability and lost growth.

Keywords: euro; EMU; transfer union; Alexander Hamilton; stability and growth pact; fiscal compact

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Introduction

Recent experience has not been kind to the euro. Starting with Greece in early 2010, Europe's Economic and Monetary Union (EMU) has been struck by one financial crisis after another, roiling bond and banking markets and stalling economic growth. Repeatedly, bold new initiatives have been proclaimed, each intended to rescue the eurozone from its troubles. Recently, some signs of recovery have appeared. Yet instability and uncertainty persist, and fears persist that crisis could again raise its ugly head at any time. After years of frustration, it does not seem unfair to ask: Why can't Europe save itself?

The answer lies in a structural failure. EMU lacks a credible mechanism to cope with the threat of imbalances within the group – a framework to manage the European region's *internal* payments problems. Many reasons have been offered for the eurozone's difficulties: fiscal profligacy, banking excesses, asymmetrical shocks or the global crisis triggered by the collapse of America's housing market back in 2007, among other causes. But at the bottom of them all,

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as many now acknowledge, lies a fundamental mismatch between EMU's rules for monetary policy and fiscal policy. While national currencies are merged under a single monetary authority, the European Central Bank (ECB), public budgets remain almost entirely in the hands of individual governments. The challenge has been to find some way to reconcile institutional arrangements for the two realms of policy.

The aim of this brief note is to document EMU's structural failure in greater detail. I begin with an analogy: the similarity between Europe's challenge and the comparable threat faced by the USA ever since the creation of its own monetary union. Faced with the same underlying mismatch, America eventually found its own unique solution – a permanent 'transfer union', a form of mutual risk sharing featuring more or less automatic flows of funds through the federal budget at the centre. Europe had much to learn from the USA experience, had policy-makers been more receptive.

Admittedly, the analogy between contemporary Europe and the historical USA is by no means perfect. Obviously, the two sides of the Atlantic differ in many critical details. Not least, the USA is a genuine federal union, whereas Europe remains, at best, the equivalent of a confederation – a league of still sovereign states. Nor is the American model of regional financial crisis-management ideal in every respect; it too has its limitations. But a comparison of the two cases does suggest one critical advantage. By making transfers automatic, America's model succeeds in *depoliticizing* the mutualization of risk, thus enabling the system to work smoothly with relatively little controversy. It may not be optimal, but it does work a lot better than anything that Europe has been able to put together until now. However imperfect the analogy, therefore, it is clear that the USA experience offered useful lessons for Europe. Much the same point is also made by Sonja Puntscher Riekmann and Doris Wydra in their contribution to this collection of essays. Riekmann and Wydra provide insightful historical detail on how America's transfer union, now firmly entrenched in practice, was constructed incrementally over the course of many decades.

Here, to avoid duplicating the Riekmann and Wydra narrative, I outline just the essential elements of the US model. I then go on to chronicle and critique Europe's repeated attempts to build a comparable scheme of its own. Initiatives began with the Maastricht Treaty, EMU's founding document, and have continued to the present day. Europe's efforts to save itself have been extensive and most recently, under the pressure of repeated crises, unexpectedly swift. Results, however, have been meagre and, barring a radical change in European political culture, are likely to remain so, dooming Europe to the dismal possibility of yet more financial instability and lost growth. Comparison with the American model helps to explain why.

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The challenge

The challenge facing Europe was foreseen from the beginning. How could a regional monetary union manage the risk of fiscal imbalances among its members? As early as 1989, an influential report of the European Commission – the celebrated Delors Report (Committee for the Study of Economic and Monetary Union, 1989) – argued that a European common currency would need fiscal shock absorbers to cope with the possibility of asymmetric disturbances to member states. And over the course of the 1990s, as planning proceeded for the birth of the euro in 1999, there were many voices calling for some kind of mutual insurance mechanism – a form of institutionalized risk sharing – to provide help to states in distress. What might that mechanism have looked like?

Europe might have turned to the USA for inspiration. America has been living with the same risk of internal imbalances ever since the Union was founded, with its separate states and single dollar. For analytical purposes, the USA can be considered as the equivalent of a regional

monetary union comparable to EMU, facing the same fundamental challenge. America's solution, building on the early reforms of Alexander Hamilton, George Washington's Secretary of the Treasury, was to create a transfer union based on the principle of automatic risk sharing. In practice, however, European policy-makers chose otherwise.

The US system is hardly a perfect model. Like Rome, it took much more than a day to build – nearly a century and a half, in fact. Moreover, financing of imbalances within the USA is far from comprehensive, in part because the process of adjustment is eased considerably by a degree of wage flexibility and labour mobility between the states that remains far higher than in today's European Union (EU). But there is no reason why Europe could not have learned from America's experience, and there was certainly no reason why Europeans should have to wait a century and a half to find their own solution. In practice, however, policy-makers chose otherwise for reasons that go to the very heart of their ongoing integration project. EMU, like the broader EU of which it is a part, remains a league of sovereign states, each determined to retain for itself as many rights and privileges as possible. In such a structure, a permanent transfer union never had a chance and no adequate substitute has yet been found.

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The American approach

The American approach, arrived at experimentally over many decades, combines three critical features: (1) transfers between the federal government and the 50 states; (2) limitations on the deficits of individual states and (3) an absence of federal bailouts of states in difficulty (Bordo, Markiewicz, & Jonung, 2011; Henning & Kessler, 2012). Together, this trio of features operates to minimize stresses that might otherwise emerge from payments imbalances within the Union. They are like the three legs of a stool, all necessary to keep things stable.

Of course, the risk of crisis is by no means eliminated, as anyone from California – which just a few short years ago appeared to be teetering on the edge of bankruptcy – can easily attest. But the chance of a systemic crisis within the US monetary union is certainly lowered to a considerable degree from what it might otherwise be in such a heterogeneous collection of units. Through the operation of so-called 'automatic stabilizers', the system works admirably to ease tensions when troubles do erupt. States in deficit automatically benefit from increased transfers from the centre – in the form of unemployment benefits, welfare assistance and similar expenditures – as well as from reduced tax payments to Washington. Effectively, the money comes from states in surplus, whose net transfers to the centre correspondingly increase. Studies suggest that federal fiscal stabilizers act to offset asymmetric shocks in the USA by anywhere from 10% to 40% (Her Majesty's Treasury, 2003; Kletzer & von Hagen, 2001; Mélitz & Zumer, 2002; O'Rourke & Taylor, 2013).

The origins of the American approach go back to the so-called debt assumption plan of Alexander Hamilton, appointed by George Washington in 1789 as the country's first Treasury Secretary under the newly ratified Constitution. Under the earlier Articles of Confederation, some of the original 13 colonies had engaged in extensive borrowing, resulting in unbearably high level of debt. Under Hamilton's plan, salvation lay in a once-and-for-all debt mutualization. All state liabilities were consolidated and assumed by the federal government, which in turn was granted new powers to raise taxes as well as the sole right to issue currency. Outstanding obligations were converted into long-term bonds and mechanisms were created to both service and amortize the collective debt. The core idea of the 'Hamiltonian moment' was to stabilize the public finances and firmly establish the fiscal authority of the centre.

The next step came in the 1840s, following a new period of large-scale borrowing by the states. When a crisis struck with the financial panic of 1837 and subsequent recession in 1839–1843, numerous states again sought bailouts from the federal government, recalling the

precedent of the Hamiltonian moment. There had also been a second takeover of state debts after the War of 1812. But this time Congress refused to comply, forcing some eight states (plus Florida, then still a territory) into default. At issue was the problem of 'moral hazard' – the risk that states might repeatedly engage in excessive borrowing precisely because of an implied commitment of support from the centre. Washington, it seemed, was determined to send a costly but clear signal that states could no longer rely on the federal government to dig them out of their own holes. A new no-bailout norm was to be established.

In effect, Congress was invoking what an old jest calls the First Law of Holes: When you find yourself in one, stop digging. States, in turn, apparently got the message. In subsequent years, most states eventually adopted what today would be called 'debt brakes' – balance-budget amendments to their constitutions or equivalent provisions in state law requiring balanced budgets. The principle of limitations on state deficits also became an accepted norm.

The final step came during the Great Depression of the 1930s, when Franklin Roosevelt's New Deal programmes greatly expanded Washington's role in the national economy. Though many states again found themselves in trouble (and one state, Arkansas, did in fact default in 1933), no new federal bailouts were provided. The no-bailout norm held. But much help did begin to come instead in the form of conditional or unconditional transfers for such purposes as unemployment compensation or welfare relief. From that point on, automatic stabilizers became an integral part of the federal system, a form of risk sharing that is so familiar today that it is rarely even noticed – hidden in plain sight, as it were. The third leg of the stool was now set in place.

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The European approach

With its three-legged stool, the USA transfer union operates with reasonable effectiveness to cope with imbalances among the states. The system is hardly perfect. From time to time states do still get into trouble, sometimes quite deeply. But not a single one of the 50 states of the Union, in modern times, has ever actually been forced into bankruptcy. Because transfers occur more or less automatically, overt controversy is eliminated. Effectively the process is *depoliticized*, barely noticed and rarely questioned. Compare that with the recent turmoil in EMU members like Greece or Cyprus, both of which have actually defaulted on parts of their debt. In their cases, political conflict could not be avoided either domestically or in relations with creditors.

Regrettably, Europe has not chosen to learn from America's experience. EMU's architects were not unaware of the US precedent, but they were unprepared to replicate it. The opportunity was missed. Only two legs of the stool were ever attempted – a no-bailout norm and limitations on budget deficits – and neither has proved to be particularly supportive. The third leg – automatic fiscal transfers – has never even been seriously contemplated.

Maastricht

Throughout the planning for EMU, it was clear that member governments were determined to keep fiscal policy in their own hands. But it was also understood that some kind of discipline would have to be enforced to limit the risk of excessive borrowing. That was the clear message of the Delors report. Hence two carefully crafted safeguards were written into the Maastricht Treaty (formally known as the Treaty on European Union), which was signed in 1992 and came into effect in 1993. One provision banned bailouts of states in difficulty. The other set limits on permissible deficits and debt (the 'excessive deficit procedure' (EDP)).

The ban on bailouts was quite explicit. In the Treaty's words (Article 104b), 'The Community should not be liable for or assume the commitments of central governments, regional, local or

other public authorities, other bodies governed by public law, or public undertakings of any Member State.' But the force of the ban was vitiated by a giant loophole spelled out elsewhere in the Treaty (Article 103a), which allows that 'Where a Member State is in difficulties or is seriously threatened with severe difficulties … the Council may … grant, under certain conditions, Community financial assistance to the Member State concerned.' In effect, the ban holds only until it is tested, and then it may be pre-empted. Essentially, it is a dead letter and has not prevented rescues of several governments since EMU's troubles erupted in 2010, including Portugal, Ireland, Greece and Spain – the derisively labelled PIGS – plus, most recently, Cyprus.

In similar fashion, the EDP was spelled out in considerable detail in the Treaty (Article 104c) and an accompanying protocol. Budget deficits were not to exceed 3% of gross domestic product (GDP); government debt was not to exceed 60% of GDP; and should either of these limits be violated, penalties might be imposed, including 'fines of an appropriate size'. Further detail was added in the so-called Stability and Growth Pact (SGP) agreed in 1997, clarifying provisions both for surveillance of individual government performance (the 'preventive arm') and for imposition of sanctions (the 'dissuasive arm').

Here too, however, the force of the safeguard turned out to be considerably less than intended, to widespread disappointment. In actual practice, the EDP and SGP proved to have little real 'bite'. The first major test came in the early 2000s, when both Germany and France found themselves with deficits in excess of the 3% limit. Enforcing penalties on EMU's two largest members simply proved infeasible. Instead, in the name of greater flexibility, Berlin and Paris pushed through a reform of the rules in 2005 that allowed them to receive a waiver of their violations, setting a precedent for others to follow. That does not mean that the arrangement thus became absolutely toothless. Empirical evidence suggests that, at least in its early years, the SGP did in fact manage to exercise some measure of discipline, with an especially strong impact on EMU's smaller members (Annett, 2006). But it is significant that to date not a single government has ever been formally penalized for missing prescribed budget or debt limits.

Crisis

And then came the global financial crisis, which was bound to put EMU's design to the test. It quickly became clear that Europe's wobbly two-legged stool was no place to sit.

At first, Europeans were inclined to breathe a sigh of relief. Monetary union, they felt, had actually reduced their vulnerability to the kind of financial tsunami that was engulfing nations elsewhere. In the past, a crisis like this one might have triggered waves of speculation against the EU's weaker currencies, creating a maelstrom of monetary instability. But now, with a single joint money having replaced a gaggle of national currencies, members no longer had to fear the risk of exchange-rate disturbances inside their bloc. As *The Economist* (2009a) commented at the time: 'Being part of a big club has made a currency run far less likely.' For a continent long plagued by monetary instability, that seemed no small accomplishment. Europeans could be forgiven for thinking that, for them at least, the worst had been averted.

It soon became apparent, however, that they were wrong. Speculative tensions had not been eliminated. They were merely *diverted* – from the currency market to the market for government bonds. Prior to the global tsunami, investors had barely distinguished among the securities of different governments in the eurozone; spreads over the key 10-year German 'bund' remained remarkably narrow, rarely going even as high as one-half of 1% (50 basis points). But by 2009 the climate had shifted. Instead of gambling on exchange rates, investors began to bet on sovereign debt, with the greatest attention focused on weaker members at the periphery of EMU. That meant in particular the notorious PIGS, with their massive liabilities and gaping

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budget deficits. For all four PIGS, credit ratings soon were being downgraded and spreads started to widen dramatically – at times, to as much as 500 basis points or more. After ‘a brief moment in the sun’, as *The Economist* put it (2009b), EMU found itself increasingly threatened by looming storm clouds of potential default. By 2010, it was plain that Europe faced an acute internal payments problem.

Response

How should Europe have responded? For some, it was time at last to take the American precedent seriously. ‘Oh, for an Alexander Hamilton to save Europe!’, lamented the eminent economist Ronald McKinnon (2011). EMU, he declared, needed its own Hamiltonian moment. And many in Europe agreed, including the European Commission (2012) which issued a policy paper – known as the blueprint report – calling for a full fiscal union within as little as five years. Central, said the Commission, would be ‘an autonomous euro area budget providing for a fiscal capacity for the euro area to support Member States in the absorption of shocks’ – in other words, the missing third leg of the stool. But once more the opportunity was missed. Yet again, Europe’s response was two-legged, leaving the stool as unsteady as ever. The third leg is still missing.

To begin with, the Maastricht Treaty’s bailout ban – already effectively a dead letter – has now been formally abandoned. Following an initial rescue package for Greece in March 2010 (a second rescue had to be organized two years later, and a third may still be in the offing), policy-makers moved in May 2010 to create a more regularized safety net for troubled debtors. Alongside an already existing Commission lending window of some €60 billion, available to all EU countries, a new European Financial Stability Facility (EFSF) was set up as a temporary backstop for EMU. The EFSF was established for a period of three years with total resources advertised at €440 billion. Together with a parallel pledge from the International Monetary Fund (IMF) of an additional €250 billion if needed, this meant a total of €750 billion (close to one trillion dollars) might now be available to sustain investor confidence. The hope was to calm the financial waters with what would be seen as an overwhelming show of force – a strategy of ‘shock and awe’, as it were, to forestall any further spread of default concerns across Europe.

The impact, however, was short-lived. Observers were quick to note critical weaknesses – most importantly, the fact that no money was actually being provided up front. The EFSF was not a fund. Rather, EMU governments merely committed to backing a borrowing mechanism, a so-called ‘special purpose vehicle’, that would be authorized to raise money by issuing debt should a member country find itself in trouble. Moreover, not all of the €440 billion would actually be available for lending, since some of the cash raised would have to be held in reserve to protect the EFSF’s triple-A credit rating, and all eurozone governments would have to agree to the loan. In practice, not more than €250 billion might have been truly usable in the event of an emergency. The general sense was that the Europeans were still far from a real solution to their problems. In the words of *The Economist* (2010), ‘the rescue plan has a patched-together feel … . The package, impressive though its scale and speed may be, only buys time for troubled governments’.

Within months, therefore, Europe’s leaders were forced back to the drawing board, to try again to calm the waters. In November 2010, simultaneous with a rescue mounted for Ireland (the second of the PIGS to get help), agreement was reached to create a permanent new lending arrangement for EMU. That was the European stability mechanism (ESM), which began life in 2012 and formally succeeded the EFSF at the end of the temporary facility’s three-year life in 2013. Unlike the EFSF, the ESM is a genuine inter-governmental organization with paid-in capital of €80 billion and an effective lending capacity of €500 billion. Loans from

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the ESM are meant to be available on an ongoing basis to deal with any future asymmetric shocks within the bloc. From now on the eurozone would have a formal safety net for governments, though numerous details of the new fund's structure and responsibilities were left to be worked out – and, indeed, are still being negotiated years later. In many respects, the ESM remains a work in progress. Yet the essential message was clear. Member states were no longer on their own. The ban on bailouts was now officially renounced.

But what, then, about the moral hazard problem? What might now stop member governments from digging new holes for themselves? It was clear that once the ESM backstop was put in place, more effective safeguards would also be needed to curb the risk of renewed fiscal profligacy. So even while weakening the no-bailout leg of the stool, policy-makers sought to strengthen the second leg, aiming to further limit budget deficits and debt. Under pressure from Germany, the eurozone's paymaster, a twofold strategy was devised. To deal with immediate threats, tough policy conditions would be imposed on even the most deeply troubled debtors. Austerity was the price to be paid for a bailout, even if it meant prolonged stagnation or worse. To deal with the longer term a tighter version of the SGP would be implemented, giving real teeth to EMU's debt brakes. Discipline would have to be hard-wired into the management of EMU. There could be no more Greek tragedies.

Thus, after vigorous lobbying by Berlin, the European Fiscal Compact was born – an updated version of the SGP. Agreed in March 2012 by 25 of the 27 countries that were then EU members (all but Britain and the Czech Republic; Croatia joined the EU later), the Compact called for formal balanced-budget rules to be written into national law or constitutions within one year. At the heart of the Compact is a new 'golden rule' limiting primary budget deficits (i.e. deficits before interest payments) to no more than 0.5% of GDP over the full economic cycle. In addition, both the preventive arm and the dissuasive arm of the SGP were given new muscle. Budget projections are now to be submitted to the Commission every year for its approval; fiscal outcomes are to be carefully monitored on a regular basis; and unless voted down by a weighted majority, costly sanctions are mandated for governments that breach the SGP's deficit limit of 3% of GDP. Access to the ESM safety net would by no means be easy.

A structural failure

Will all these be enough to save Europe? Key officials express little doubt. 'A widespread lack of trust in public finances weighs heavily on growth,' said Bundesbank president Jens Weidmann in a typical statement (as quoted in *New York Times*, 2012). In these circumstances, he optimistically maintained, a firm golden rule should 'inspire confidence and actually help the economy to grow'. But was such optimism justified? One is reminded of the jocular definition of second marriage: the triumph of hope over experience.

A wobbly stool

In reality, the stool is as wobbly as ever, still resting on just two legs: the ESM plus the Fiscal Compact. Neither support is especially reliable and the critical third leg – some sort of mutual insurance mechanism to complete the transfer union – is still missing.

At least two questions hover over the ESM. One issue is whether the planned lending capacity of the fund, at €500 billion, will actually be enough should serious shocks simultaneously hit one or two of EMU's larger members, such as Spain or Italy. With financial-market contagion an ever-present threat, spreading pressures from country to country, the credibility of the safety net could quickly wither. And a second issue is whether governments would be prepared to accept the tough policy conditions that are supposed to be tied to any financial assistance. There is nothing

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automatic to the ESM's operations. The model is IMF conditional lending, not the US transfer union. To qualify for help, a member state must first agree to the terms of a strict adjustment programme, featuring above all fiscal 'consolidation' (a polite synonym for austerity). Governments are well aware of the high price some of the PIGS have been forced to pay, in terms of lost growth and high unemployment. They can also see how difficult it has been for countries like Greece or Portugal, once bailed out, to get out from under the tutelage of their creditors. Few will want to be put through the same kind of wringer. For some, default may begin to seem a more attractive option.

Likewise, a major question hovers over the Fiscal Compact: Can it be enforced? We know what happened to the SGP. When push came to shove, members shrank from the drastic step of enforcing formal sanctions. The dissuasive arm proved feeble. So why should any greater sense of resolve be expected now? For all of the Compact's insistence on formal debt brakes, the same risk of hesitation remains. Already, in its first year of operation, the terms of the Compact were greatly eased. In 2013 as many as six countries – including such major players as France, the Netherlands and Spain – were all given extra time to bring their budget deficits down below the magic 3% limit. No offending state was penalized, and further delays have more recently been approved. Observers could be forgiven, therefore, for thinking that the new Compact is turning out to have no more bite than the old SGP. Simon Tilford, chief economist at the Centre for European Reform in London, probably put it best when he described the Compact as 'little more than a stability pact with lipstick' (as quoted in *New York Times*, 2011).

Clearly, EMU would be better off with American-style automatic transfers to balance the other two legs of Europe's stool. Even the normally circumspect IMF concurs that 'some system of temporary transfers … to increase fiscal risk sharing' would seem 'essential' (Allard et al., 2013, p. 4). A formal shock absorber would not be a magic bullet, solving all ills. Perfection is too much to hope for. But without something of the kind to help cope with imbalances within the group, the eurozone will remain condemned to persistently sub-optimal economic performance. Failure is built into EMU's institutional structure.

The reason

The reason for failure is clear. Despite all the troubles of recent years, the fundamental mismatch between EMU's rules for monetary policy and fiscal policy is still firmly in place. Member governments, ultimately, remain in charge of their own budgets; and that in turn is due to a European political culture that remains stubbornly resistant to the final surrender of the last shreds of national sovereignty. As one acute observer summarizes (Unger, 2013):

> The basic problem is that the EU is not a true union but more a collection of states that have not in any real sense ceded decision-making power to a central authority. The result is chaos fed by conflicting national objectives.

In practice, EMU's structural failure could be remedied in any number of ways. The closest to optimal would be a full fiscal union as recommended by the European Commission (2012) in its blueprint report, modelled on (though not necessarily identical with) the historical American approach. To borrow from the language of international trade theory, that would be EMU's 'first-best' option. A recent study suggests that introduction of a European transfer union replacing just one-third of national tax regimes would serve to offset up to 15% of regional asymmetric shocks (Bargain et al., 2013). But, sadly, a system of automatic stabilizers working through a large budget at the centre seems beyond reach. The Commission's proposal was firmly rejected at a summit of EU leaders in December 2012.

More realistic might be some form of limited risk sharing that would not be strictly conditional, as suggested recently by the IMF (Allard et al., 2013). One possibility would be a

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partial mutualization of sovereign debt through the issue of joint bonds – 'Eurobonds', in the jargon. Another might be a system of collective bank-deposit guarantees, to help share the burden of sudden banking crises, or a common scheme for unemployment insurance. And yet another might be common dedicated 'rainy day' fund authorized to make transfers to members experiencing negative shocks. Options such as these may be 'second-best', but they would surely be better than nothing.

As a practical matter, however, not even any second-best choice seems feasible in today's Europe. In late 2013 Pierre Moscovici, then France's Finance Minister, proposed a form of mutualization through creation of a shared unemployment insurance system. But his idea was immediately shot down by German chancellor Angela Merkel in remarks during Germany's parliamentary election campaign. 'I oppose mutualizing things … as proposed by other parties,' she declared. 'When at the end the stronger countries also get weak, everybody will be weak and this mustn't happen to Europe' (as quoted in the *Wall Street Journal*, 2013). As the IMF (Allard et al., 2013, p. 6) commented dryly, 'political backing … remains elusive'.

Therein, down deep, lies the most critical difference between the European and American approaches. The pieces of America's transfer union began to fall into place only once the original Articles of Confederation were replaced with the hallowed USA Constitution, providing the space for what we now remember as the Hamiltonian moment. Thirteen fractious former colonies were merged into one federal state, with ultimate authority over fiscal policy now shifted to the centre. Europe, by contrast, remains at the Articles of Confederation stage – still far from anything that might be described as a genuine political federation. Policy-makers as yet are unprepared to countenance seriously any kind of automatic transfers within their group. As a result, EMU's structural failure persists. Europe is still trying to perch on a stool with only two legs – an uncomfortable prospect at best.

The price

Europeans are entitled to their political culture, of course. If they prefer to remain at the Articles of Confederation stage, that is their choice. But they should also be aware of the material price they are forced to pay for their resistance to some form of genuine risk sharing. The cost of a wobbly stool, in terms of real economic performance, is lamentably high.

The dilemma can be simply put. Begin with the irrefutable fact that occasional payments problems are a virtual certainty in a group of states as heterogeneous as the membership of EMU. Any country can unexpectedly find itself in trouble. We may recall Germany at the time of the euro's birth, then labelled by some the 'sick man' of Europe. Or think of one-time high flyers like Ireland or Spain, brought down by banking crises not of their own making. In the absence of a permanent and automatic transfer union, every instance of serious imbalance must be negotiated anew; and since as a practical matter terms are invariably set by creditors, pressures to adjust tend to be fatally skewed, falling mainly on debtors. As John Maynard Keynes wrote about the classical gold standard: 'The process of adjustment is *compulsory* for the debtor and *voluntary* for the creditor' (as quoted by Moggridge, 1980, p. 28; emphasis in the original). While healthier countries can afford to be relatively passive, distressed states have little choice but to respond more proactively. But what can they do? Trade or capital controls are ruled out by their membership of the EU. Likewise, an independent monetary policy or exchange-rate devaluation is ruled out by their membership of EMU. Effectively, all that is left to them is what is politely called 'internal devaluation' – another synonym for austerity. An anti-growth bias is created.

Not everyone would agree with this interpretation, which is essentially Keynesian in nature. There is also a respectable alternative line of argument represented by Bundesbank president Jens Weidmann and others, variously labelled 'Austrian school' or 'ordo-liberalism'. According to this

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line of argument, austerity is precisely what is needed to promote growth, by restoring trust in public finances. But after half a decade of exceedingly disappointing performance, it is hard to accord much credence to that sanguine point of view. Fiscal consolidation has generated not growth in Europe but repeated recessions, mass unemployment, and most recently the creeping onset of deflation. An anti-growth bias seems undeniable.

Indeed, matters might even be worse were it not for the actions of the ECB, which after some hesitation has moved vigorously to counter the risk of deflation. At the outset of the global crisis, the ECB hewed closely to its traditional anti-inflation mandate, even briefly raising interest rates in mid-2011. But a turning point came a year later, when the troubles of the PIGS seemed to threaten a break-up of the eurozone. The paucity of action on the fiscal front finally prompted Mario Draghi, president of the ECB, to intervene in a now celebrated speech to the London financial community in July 2012. The ECB, he pledged, would do 'whatever it takes to preserve the euro', adding 'believe me, it will be enough'. Specifically the ECB would now begin, under certain conditions, to buy up some of the debt of troubled sovereigns under a new programme given the label of 'outright monetary transactions'. Although in fact no such purchases have yet been made, the impact of Draghi's words was positive, easing some of the sense of panic that had taken hold in Europe's financial markets. And since then a broad range of measures have been undertaken to reduce interest rates and expand bank lending. At best, however, the ECB has been able to hold the fort, forestalling further deterioration. Its initiatives have done nothing to address the euro's underlying structural defect. EMU's anti-growth bias remains largely untouched.

Of course, the bias is nowhere to be found in the charter of the ESM or the fine print of the Fiscal Compact. De facto, however, it is plainly there for all to see. In effect, EMU has succeeded in resurrecting at the regional level the nineteenth-century rules of the game, when exchange rates were rigidly fixed, capital controls were *verboten*, and the preferred method of adjustment was domestic contraction – an updated version of the gold standard without gold. 'You shall not crucify mankind upon a cross of gold,' declared William Jennings Bryan in 1896. Today Europe's economic fortunes are being crucified upon a 'cross of euros' (O'Rourke & Taylor, 2013).

Conclusion

The bottom line, therefore, is clear. Europe's arrangements for coping with regional financial crisis, even after recent reforms, are inadequate; and barring a fundamental change in European political culture, are likely to remain so. The opportunity to take a lesson from the American experience has been brushed aside. EMU's structural failure remains unremedied, and the cost of that failure is high.

This does not mean that EMU must necessarily be abandoned, as the French intellectual Francois Heisbourg (2013) has argued in a recent book, *La Fin du Rêve Européen* (The end of the European dream). In his view, the euro cannot survive without a major shift towards a more federal structure, which he deems unlikely. Hence the common currency, he says, is doomed. But that is too extreme. Europe is capable of saving its monetary union from outright collapse. As I have argued elsewhere (Cohen, 2012), lack of success does not mean outright failure. What it means, rather, is more of the same sub-optimal performance that has plagued Europe since the crisis began, including sluggish growth, persistent unemployment and financial instability. The eurozone will endure, but it will not prosper.

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