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THE KNOWN UNKNOWNS AND UNKNOWN UNKNOWNS OF EMU

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research strategy was to 'operationalise' Mundell's theory of Optimal Currency Areas (OCA) and develop *ex-ante* criteria for assessing the potential consequences of monetary unification. 'Operationalise' was a term first used by Tam Bayoumi and Barry Eichengreen (1999), but it applies to a much wider strand of research than their own[1].

The main conclusion from this research programme was that compared to the benchmark case of the US, European Monetary Union (EMU) would be characterised by stronger asymmetry across countries (especially the peripheral countries) and would only be able to rely on significantly weaker adjustment mechanisms (especially because of the low degree of labour mobility and the absence of any risk-sharing arrangement).

1. References to the literature are kept at minimum in this paper. It is not intended to be a comprehensive survey.

An interesting issue for discussion is whether these developments were the inevitable consequences of monetary unification or the result of the particular set of exogenous conditions that prevailed during 1997-2008: the fast pre-unification convergence of southern bond rates towards those of the North, the German drive to structural reform after it was realised that it had entered the euro at an unfavourable exchange rate, high risk appetite during the 2000s or shocks coming from the growing participation of central and eastern Europe in European production networks – thereby strengthening northern European and especially German manufacturing. Both a macroeconomic and a structural reading of the euro crisis are indeed possible, and there has been no attempt to discriminate between them. Whichever is the most relevant, however, what is clear is that policy responses to these asymmetries were weak at best, and were in fact mostly non-existent.

A second, prominent topic in the pre-EMU literature had to do with the consequences for public finances of monetary unification. It was pointed out early on that monetary union involved a risk that incentives to fiscal laxity would be strengthened (see for example Beetsma and Bovenberg, 2001); that games of chicken in the Sargent-Wallace (1981) vein could be played between monetary and fiscal policy; and that the internalisation or not by governments of fiscal discipline constraints was a major issue for the stability of monetary union, because sovereign crises could have severely disruptive effects. Re-reading the 1998 article of Barry Eichengreen and Charles Wyplosz, one can only be struck by its prescient character. The *ex-ante* literature also discussed if markets would price sovereign risk accurately, especially

'It is striking to observe the degree to which optimistic convergence bets were wrong. From 1999 to 2007, intra-euro area differences accentuated, real exchange-rate misalignments aggravated, current-account imbalances widened and net foreign asset positions built up.'

would morph into a financial crisis was correctly anticipated.

Finally, there was a specific discussion on the ability of the ECB to act as a lender of last resort to the banking system, especially in view of its price-stability focus and the absence of an explicit financial stability mandate (Prati and Schinasi, 1999). Here, worries expressed in the literature proved to be excessive, as the ECB in 2007 did not hesitate long before providing wholesale liquidity to the banking system. The central bank's genetic code was strong enough to compensate for the absence of explicit treaty provisions.

Against this background, why were warnings, especially about the risk of economic divergence, largely ignored by policymakers? One reason was that EMU was an economic endeavour based on a political decision, but even under these circumstances, policy could have been geared towards getting member countries and the euro area as a whole into shape for the new policy regime. This did not happen. When drawing on the literature, European policymakers too often practised selective reading, with worries dismissed and the optimistic interpretation prevailing. There was, for example, much too much confidence that EMU could develop into an optimal currency area. perhaps inevitably, selection criteria were set in nominal rather than real terms, thus making entry feasible also for countries with weaker fundamentals. Post-entry however, and less inevitably, there was no mechanism (and, more importantly, little willingness) to ensure real convergence. Also inevitably, meeting the public debt ratio criterion was not considered mandatory but, less inevitably, the commitment to bring it down once in the euro was weakly enforced, to say the least. In general, member countries often considered they had done enough by meeting the explicit entry criteria. Considering that the euro was spurring favourable macroeconomic conditions, they deemed it superfluous to embark on the politically unappealing processes of structural reform and fiscal consolidation.

The complacent reading of the literature also provided a cover for the avoidance of difficult choices. The assumption that the private economy was inherently stable, even under this particular type of macroeconomic policy guidance, opportunely meant that it was easier to avoid politically difficult discussions on the reforms needed to make EMU resilient, and on the appropriateness of oversight of national structural and financial policies. The convenient fiction was that, provided governments abided by fiscal discipline, economic and financial stability would be ensured and there was therefore no need to go beyond the already hard-to-implement Stability and Growth Pact.

Therefore, if concerns were not transposed into concrete action, economist should not be blamed – though they could have been more vocal. Rather blame should be apportioned to policymakers who too often opted for complacency when designing the building blocks of what turned out to be a perilously weak monetary union. In fact, and unsurprisingly perhaps, warnings were only taken seriously by those governments that had political or doctrinal reservations about European monetary unification, such as the United Kingdom and Sweden. In the UK, the Treasury prepared a formal report to assess if the 'five economic tests' set by the government for joining the euro were fulfilled (HM Treasury, 2003). Although selective and on the whole biased, the report was at least a coherent attempt to provide an economic basis for

two years. The combination of a deterministic, rather than risk-based approach to the deficit, and the neglect of contingent liabilities, made the Maastricht system very ineffective.

The second reason has to do with what the Maastricht tecod

2. The BEPG would have made possible for the EU to address to member states recommendations to adjust economic policy.

to give the ECB the role of a lender of last resort to sovereigns. This would not have amounted to giving it the task of making insolvent countries solvent, but rather to allowing it to prevent self-fulfilling debt crises by keeping the bond rate above the risk-free rate but below the prevailing market rate.
Assuming this could be done for a limited period, a possible instrument would be secondary market purchases. A variant would be to enable the ECB to provide a credit line to a public entity (the EFSF in the Gros-Mayer 2011 proposal, the EFSF) in order to leverage its capital and give it enough firepower. This entity would then intervene in the market. Either way, the ECB would provide liquidity that would help prevent states from being cut off from financing, and it would help put a ceiling on what they have to pay to borrow, thereby stemming potentially self-fulfilling debt crises. In a way, ECB support would serve as a deterrent.

There are however significant problems with this approach. First, the ECB does not have an explicit mandate to act as a lender of last resort for sovereigns – it is instead prohibited from entering into monetary financing – and changing the mandate would require an unlikely unanimous agreement of the 27 EU members. Second, unlike the Fed when it buys US treasury bonds or the Bank of England when it buys gilts, the ECB is not the central bank of a single state and any such move would inevitably involve distributional dimensions. Should it incur losses on its bond portfolio, the ECB would have to request from its shareholders the injection of additional capital, thereby becoming a vehicle for fiscal transfers – something central banks are not made for. This largely explains why the ECB was uncomfortable with the Securities Market Programme, the bond purchase scheme it launched in May 2010 (for Greece and Portugal), reactivated in August 2011 (for Spain and Italy), and finally let expire.

The ECB's September 2012 decision to initiate a scheme called Outright Monetary Transactions (OMT), which will make it able to purchase short-dated government paper of countries benefitting from a support programme negotiated with the European Stability Mechanism, can be regarded as yet another step in this direction. However the ECB has made it clear this time that its primary intention is only to address the effects of financial fragmentation, that its focus is on credit conditions faced by private agents, and that it is not going to purchase longer-dated government bonds. It is doubtful it will go further and accept a role in the containment of state insolvency.

A second possibility could be to move closer to a fiscal union by mutualising the guarantee on the public debt issued by euro-area counties, via some form of 'Eurobond'. The aim would be creation of a euro-area safe asset, because sovereigns would be jointly and severally liable for debt. It is unlikely that all of the debt would be mutualised. Rather, it could be split into two parts, with the mutualised part presumably senior to the non-mutualised part (Delpla and Weizsäcker, 2010). As a quid pro quo, states would lose the freedom to issue debt at will. The policy system would move from a framework of *ex-post* sanctions in case of infringement of common rules, to a framework of strong *ex-ante* control, with member states agreeing to submit their budgets for approval. Should a draft budget fail to respect common principles, the euro-area partners could veto it before its entry into force.

Eurobonds would in principle have three types of benefits (Claessens and Vallée, 2012):

- First they would create a common safe asset for the euro area.
- Second, they would protect sovereign states from acute funding crises as these would always retain access to issuance, at least for amounts corresponding to redemptions (though in a dual scheme the Modigliani-Miller theorem would apply, leaving the average cost of borrowing constant[3]). The interaction of these two benefits would make banks more secure and better protect states from self-fulfilling solvency crises.
- Third, by subscribing to Eurobonds and accepting the necessarily-associated scrutiny of national public finances, euro-area members would signal that they are willing to accept the full consequences of participation in the monetary union.

There are however significant hurdles before Eurobonds could become a reality. First, Eurobonds and *ex-ante* approval would represent

3. The Modigliani-Miller theorem in this case means that the aggregate cost of borrowing is independent of the structure of funding.

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