International Economics 138 (2014) 49–62

Contents lists available at ScienceDirect

International Economics

journal homepage: www.elsevier.com/locate/inteco

From mutual insurance to fiscal federalism: Rebuilding the Economic and Monetary Union after the demise of the Maastricht architecture ☆

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A R T I C L E I N F O

Available online 28 December 2013

JEL classification:
E63
F33
H77

Keywords:
Monetary Union
Euro area
Fiscal federalism

A B S T R A C T

The policy response to the current European crisis has largely focused on its financial symptoms rather than on its deep economic and political causes. The aim of this paper is to contribute to the debate about the current architecture of the European Economic and Monetary Union. The crisis has cracked the intellectual consensus and the political compromise that underpins the architecture of the monetary union enshrined in the Maastricht Treaty. The intergovernmental insurance mechanism that has emerged in response to the crisis could offer a path to buttress the existing architecture, but it is economically limited and politically unsustainable. Indeed, the mutualisation of economic risks that has started tacitly through various mechanisms (European Stability Mechanism, interventions by the European Central Bank) cannot succeed without a more profound rebuilding of the monetary union that involves a move towards pooling of resources and a form of fiscal federalism.

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2110-7017/$ - see front matter © 2014 Published by Elsevier B.V. on behalf of CEPII (*Centre d'Etudes Prospectives et d'Informations Internationales*), a center for research and expertise on the world economy
http://dx.doi.org/10.1016/j.inteco.2013.11.003

1. Introduction: the original sin

The financial crisis that erupted in 2007 became a distinctly European crisis in October 2009[1] when the newly elected Greek government turned the music off[2] and cast light on the abysmal state of its public finances. Since then, the European policy response has largely focused on dealing with the financial symptoms rather than the economic and political root causes of the euro-area crisis. It has focused on fiscal consolidation efforts across the currency union, largely on the basis of on an incorrect diagnosis of the supposedly fiscal nature of the crisis. Only in the spring of 2012 did European policymakers start to recognise and accept publicly that the architecture of the monetary union itself was at least partially at the origin of the crisis and its continued worsening. This has sparked a vivid intellectual debate about the shortfalls in the current architecture and has highlighted a number of flaws in the original design of the monetary union.

The first and the most salient one is the benign neglect of the financial system. The fact that a stable and increasingly integrated financial system would drive the economic integration and the performance of the euro area was well understood. But the reverse—that is, the fact that financial instability and fragmentation could in turn become an existential threat to the currency union—was never seriously envisaged.[3] As a result, the monetary union promoted an extraordinary degree of financial integration while allowing financial institutions to remain regulated, supervised and eventually resolved along purely national lines. This undoubtedly exacerbated inadequate incentives and vicious dynamics of political capture[4] that undermined the quality and rigour of supervision, weakened credit standards and fostered a form of financial repression[5] that encouraged banks to dangerously build up portfolios of national government debt and eventually made the resolution and restructuring of troubled banks both longer and more costly to European taxpayers.[6]

As much as this omission is striking today, it was certainly more the result of a cognitive lapse or an intellectual blind spot. What could have been benign blunder was compounded by a generalised and global dysfunction of financial markets fuelled by excessive leverage, inadequate self-regulation and pernicious incentives. The prolonged meeting of a globally disenfranchised financial system and an inadequate architecture eventually produced the Euro crisis we know.

But there were more troubling omissions in other areas where there was ample scholarship and where there had been far more political discussion.[7] Walters (1990) had for instance explained early on the dangers of a single monetary policy applied to a profoundly heterogeneous zone. He argued forcefully that divergent levels of real interest rates would lead to pro-cyclical credit developments and destabilising asset bubbles. Even as divergent levels of inflation were observed in the early years of EMU, the conventional wisdom concluded optimistically that these were transitory developments linked to convergence that did

[1] Bruegel has made available a detailed timeline of the crisis available on its website: http://www.bruegel.org/eurocrisistimeline/.

[2] Reference to a sentence by Chuck Prince, the then CEO of Citigroup, a few weeks before the financial crash: “When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.” (Financial Times, July 9, 2007).

[3] With the exception of Barry Eichengreen who saw the risks of the decentralisation of regulatory and supervisory functions in a context of high financial integration or Peter Garber who was one of the few to understand how internal financial imbalances and capital flows remained an important potential source of risks that would be concentrated in the payment system of the ECB. See Garber (1998) and Eichengreen (1993).

[4] There is limited academic literature on these dynamics in Europe and they are surely not homogeneous considering the profoundly different structures of national banking systems. However, the arguments made notably about the US on the matter would certainly apply at least in part. See for example Johnson and Kwak (2010).

[5] Financial repression is somewhat of a catchphrase for a series of practices that lead governments to secure preferable funding from the financial sector by either controlling, or influencing banks or by manipulating the level of real interest rate. For a broad discussion, see Reinhardt (2012). For a more focused look at the situation of European banks' portfolios, see Angeloni and Wolff (2012).

[6] Indeed, Between October 2008 and October 2010, the European Commission has approved €3.6 trillion (equivalent to 31% of EU's GDP) of State aid measures to financial institutions, of which €1.2 trillion has been effectively used (of which €409 billion was used for capital injections and asset relief programs). See Impact Assessment on the Recovery and Resolution Directive, European Commission http://ec.europa.eu/internal_market/bank/docs/crisis-management/2012_eu_framework/impact_ass_en.pdf.

[7] See Pisani-Ferry (2012).

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