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**PAVED WITH GOOD INTENTIONS: GLOBAL FINANCIAL INTEGRATION, THE EUROZONE, AND THE IMAGINARY ROAD TO THE FABLED GOLD STANDARD**

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# ABSTRACT

## Paved with Good Intentions: Global Financial Integration, the Eurozone, and the Imaginary Road to the Fabled Gold Standard*

Regional systems of governance may resolve some of the dilemmas of global financial integration, and the eurozone is among the most advanced examples of attempts to do so. This paper argues that the recent Euroland sovereign debt crisis is a test of this proposition, and the outcome leaves the EU found wanting. The first section of this paper places EMU in the broader context of financial liberalisation and the crisis of 2007-09. The second section demonstrates that there were plenty of warnings in the pre-crisis theoretical and empirical literature in economics and policy studies that financial instability could be closely associated with financial liberalisation, and that robust mechanisms of governance were required to deal with this eventuality. A third section examines the crisis in the Eurozone and the reaction to it in the light of this literature, demonstrating that the lessons available pre-crisis remain poorly learned. The financial market phase of the crisis showed the EU and ECB as capable of leadership and innovation in crisis management. The sovereign debt phase was less successfully managed, with domestic political dynamics stimulating centrifugal tendencies among eurozone members claiming to be committed to an 'ever closer union'. The reforms so far proposed offer little in terms of optimism. The EU appears to be looking for a functional equivalent of the lost, mythical Gold Standard: if only the rules are the right ones, and everyone behaves properly, stability will be achieved automatically. Such an outcome is unlikely, and the eurozone hangs in the balance as a result of serious policy mistakes.

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# Paved with Good Intentions:
# Global Financial Integration, the Eurozone, and the Imaginary Road to the Fabled Gold Standard

Working Draft 16 November 2010
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Thorough-going global market integration might prove economically efficient, yet the outcome confronts democratic demands for redistributive or other interventions in the market necessary to the legitimacy of authority. Financial market instability in particular may challenge the authority of the institutions of governance. Meanwhile, national governments as the locus of political legitimacy in democratic systems have diminished capacity to simultaneously deal with this problem on their own and preserve the efficiency benefits of market integration. Regional integration projects may prove effective in managing some of these pressures of global integration (Hveem 2006: 300-1), and the EU with its single currency is surely the archetype of this sort of arrangement. The recent financial crisis has certainly produced systemic instability and drawn attention to the highly unequal distribution of benefits brought about by interacting national, regional and global patterns of liberalisation, and this has been exacerbated by the subsequent and related sovereign debt crisis in the Eurozone.

The debt crisis therefore provides a test of the proposition that regional forms of governance might play a positive role in the resolution of these dilemmas of global integration. Two conditions might confirm that this is the case. First, successful co-operative resolution of the debt crisis would require that the EU as a regional project had achieved sufficient levels of cross-national legitimacy and shared identity (in the EU referred to as "solidarity") to produce a solution in the first place. In turn, the solution would need to demonstrate to member citizens and national governments alike that a common solution was more effective than a national one, thereby strengthening the collective identity and legitimacy of the EU as a regional project. The outcome so far tells us that the supporters of regional solutions may have been overly optimistic, even in the case of the crowning achievement of the EU. If so, the financial crisis has landed the EU in greater trouble than we may yet realise.

The first section of this paper will briefly establish the context in terms of financial liberalisation and the crisis of 2007-09. The second section will examine the pre-crisis literature that warned of the potential dangers of the emerging liberal order, demonstrating that the crisis was less a result of bad bankers than of bad public policy driven by policy rent-seeking and based on blithe assumptions with no historical evidence to support them. A third section will address the crisis of the Eurozone and the reaction to it in the light of this literature, demonstrating that lessons available *pre*-crisis remain poorly learned. The paper will conclude with further reflections on the requirements of successful and legitimate financial and monetary governance.

## Global Financial Integration

Global financial integration became a defining feature of the late 20th and early 21st centuries, along with a somewhat less consistent push for a more open trading order. This market-oriented trend in economic policy was largely justified in terms of the broad, aggregate economic benefits that it might bring to both the developed and the developing world, differentially distributed though they might be. The general turn towards more liberal market-based strategies followed the apparent exhaustion in the crises of the mid-1970s and early 1980s of the thirty years of post-war economic miracle fostered by often interventionist reconstruction and development policies and the rise of the welfare state as a political imperative in many lands.

Taken up to varying degrees depending on the country, this policy turn made considerable sense for national economies in search of the future through widening the market while forcing necessary adjustments by increasing the competition in some way or other. Post-war reconstruction was long over and the sectors that had fuelled the boom had reached maturity. New sectors and technologies sought widened access to world markets, and the revolution in services industries was part of the trend.

Most importantly, there were the unintended consequences of wealth in the developed world. Many of the policies that had been set in place in the aftermath of war were policies aimed at the economic transformation of poor societies. Europe west of the Berlin Wall was suddenly far from poor, and nor was Japan. The successful and rapid growth of productivity had meant that wages rose and organised labour enjoyed the political benefits of full employment combined with rising consumerism. People lived longer, were healthy and sought pleasures in consumption and returns for their surplus wealth. Population growth in the developed world came to an end, school rosters shrank, and a wealthy new generation less chastened by the Depression and the War took power and began to move about the planet with increasing frequency.

These changes greatly altered the needs of these societies in terms of demand for products, finance, public services, and of government budgetary priorities. Trade agreements had brought down many of the trade barriers to manufactured products, and the rise of off-shore capital markets in London and elsewhere provided the functional equivalent of increased capital mobility. The end of the boom saw high labour costs juxtaposed on industrial crisis in the developed economies. A yearning for industrialisation elsewhere presaged a shift in the more labour-intensive segments of the production chain that also served the cause of price competition. In response, multinational enterprise began to implement more global production and corporate strategies as increased economic openness provided new incentives, often to the cost of those without the resources and know-how to adapt. The European Union was indulging in yet more radical experiments with regional liberalisation across state boundaries.

Perhaps most importantly, states emerged from the 1970s and 1980s downturn with vast mountains of debt. This had to be financed, and once Paul Volcker ruled out inflation as a solution an adventure with financial internationalisation seemed a good bet. OPEC oil surpluses provided markets with a massive increase in capital just as recession had dampened private appetites for investment. The public sector could conveniently fill this gap (Cohen 1982: 471) as state treasuries and increasingly-independent central banks discovered the delights of access to international capital markets. The major international banks were hardly averse to such a strategy. Governments and their economies gained enhanced access to international capital while large financial institutions facing market saturation at home gained access to new public and private markets. Cross-border coalitions formed to press their own and foreign governments to engage in cross-border financial liberalisation (Underhill 1993) and this proved an enduring alliance for the promotion of cross-sectoral and cross-border financial market integration

Financial and other forms of globalisation served material interests by providing (unequally-distributed) benefits or would not have happened, specially given the very real costs (Rodrik 1998). This period of rapid financial integration came to be punctuated by frequent and severe episodes of financial crises (Bordo *et al* 2001). For a while these crises appeared limited to the 'emerging markets', which led to the implementation of reforms in these 'weakest links'. This market-based 'New International Financial Architecture' emerged as the underpinning to asset bubbles and economic imbalances in the global economy (Guttman 2009).[2] In the end the weakest link proved to be the financial system and payments imbalances of the United States (Schwarz 2009). The booming market for securitised mortgage-based assets became unstable and by the summer of 2007 an avalanche

[2] See also a debate on the matter, "Focus: Sustainability of the US External Deficit," articles by Cooper, Roubini and Setser, Mann, and Gray (2005), CESifo Forum, vol 6/1, spring, link http://www.cesifo-

of misunderstood risks metamorphosed into demon uncertainty, paralysing the interbank market. The entire edifice collapsed and deflation and depression threatened to possess the spirit of the age.

Public authorities re-established a modicum of financial stability by mid-2009 and an internationally-co-ordinated fiscal stimulus appeared to have launched a fragile recovery. Worries began to shift away from the health of the financial sector to the rising public debt burdens exacerbated by the financial sector rescue and cost of the recession. By late 2009 this was focused on the weaker economies of the Eurozone, particularly post-election Greece (the outgoing government of which had been highly economical with the truth about its debt burden). Governments squabbled, publicly assigned blame while remaining inactive, worsening an otherwise containable situation which required another dramatic rescue under crisis conditions. The jewel in the crown of European integration, Economic and Monetary Union and the single currency, seemed and may still be under threat.

**Distilling the Lessons of a Crisis Well-enough Deserved (by some)**

We know and have long known that liberal financial markets are potentially unstable. There is historical evidence a-plenty (Kindleberger 1989; Galbraith 1993, 1995), and adequate theoretical explanations of the phenomenon.[3] The case for adequate governance in the form of supervision and regulation is well-understood and entrenched in the fabric of post-Depression post-war economic systems. There are those who argue it was the most warned-of crisis in history,[4] and others who claim that no one saw it coming. The latter have little evidence on their side. A brief examination of some twenty years of research findings and scholarly analysis should allow one to review the record of our prior understanding of the

group.de/pls/guestci/download/CESifo%20Forum%202005/CESifo%20Forum%201/2005/Forum1-05.pdf

[3] See among others Minsky (1975) on Keynes and also (1982) on the financial instability hypothesis; Kindleberger and Laffargue 1982; Galbraith (1993) on the psychology of speculation.

[4] The 2006 warnings of 'Dr. Doom' Nouriel Roubini were famously dismissed; see *New York Times*, 15 August

matter.[5]

Among the most consistently prescient of political economists was Susan Strange. The rise of off-shore and de-regulated financial markets outside national systems of governance had largely been responsible for the breakdown of the international monetary system during the 1970s (Strange 1976: ch. 6). In *Casino Capitalism* (1986) she argued persuasively that the increasing liberalisation of capital markets and their cross-border integration was transforming and risked disrupting the system of states and the global economy. Despite the increasing prevalence of arguments concerning the importance of financial market discipline on government finances and macroeconomic policy, the increasing availability of private finance arguably postponed or allowed states to avoid altogether the required adjustment to international imbalances (see also Cohen 1982: 471-5). The distortionary growth of the financial sector was skewing incentives in western societies, destabilising the international monetary system, and was an inherently unstable enterprise. This *Retreat of the State* (Strange 1996) in favour of markets not only increased the risk of major financial crisis, but by enhancing private power it correspondingly disarmed crucial instruments of public policy which risked de-legitimising government over time. Her last book was appropriately entitled *Mad Money* (1998) and was published at her death and just in time to welcome the DotCom bubble and crash, in retrospect a forerunner of the crisis of 2007-10.

A range of scholars followed Strange's lead (e.g. Cerny 1993; Moran 1991) to focus on this 'phoenix risen' (Cohen 1996) of global finance and the domestic dimensions of policy change (Moran 1984; Pauly 1988; Rosenbluth 1989; Coleman 1996). Many of the works emerging at this time focused on the causes of this major shift in global order, while others debated the balance of economic costs and benefits of financial openness (King and Levine 1993; Demetriades and Hussain 2006) and/or possible systems of regulation and supervision

2008, link http://www.nytimes.com/2008/08/17/magazine/17pessimist-t.html?_r=1.

[5] See analysis of origins of the crisis in Schwarz (2009), 27-38.

(Steil 1994; Barth et al 2006). Often enough cautionary messages in the literature emerged that should have served as ample warning that global financial market integration was potentially problematic. At least four such messages can be distilled from the literature (Underhill, Blom and Mügge 2010):

*Lesson 1: financial instability prevalent*

A first message has already been alluded to: that a liberal or market-based order of cross-border and cross-sectoral financial integration underpinned by a high degree of capital mobility constitutes an inherently unstable system. As mentioned, this was a point emphasised by Strange and based on historical research (Strange 1976, also Kindleberger and Laffargue 1982), but there were prominent economists who also argued this point well before the crisis of the 21st century (see e.g. Minsky 1982; Rodrik 1998; Bhagwati 1998; Stiglitz 2000, 2002). In particular, the consequences of financial liberalisation for developing countries were always in serious dispute. Despite the predictions of 'standard' economic theory, empirical research revealed that net capital flows to developing countries over time mostly flowed 'uphill' from poor to developed economies, with (fortunately) foreign direct investment as a major exception (Prasad, Rajan and Subramanian 2007). If one adds to this 'Lucas paradox' (Lucas 1990) picture the frequency of crises in emerging market economies,[6] then it was highly likely that capital market integration would develop as an erratic system, potentially destabilising for exchange rates and other macroeconomic variables, and often costly for economic development. While there were identifiable longer-run benefits to financial openness, these might require considerable and successful institutional development and governance in developing countries if the benefits were to be realised properly (Kose *et al* 2006).

[6] The concept of "original sin" developed by Eichengreen and Hausmann (eds. 2005)

There is in any event no real-time historical case of successful economic development under conditions of financial openness. On the contrary, successful development strategies in 19th and 20th Europe and from the US to Japan to the Asian tigers to contemporary China rather demonstrate that economic development is accompanied by a range of strategic of state intervention measures: capital account and/or exchange controls, selective protectionism, and measures to attract and shape foreign direct investment flows to national advantage.[7] The clear conclusion was that financial openness would most likely turn out badly if insufficient attention were to be paid to governance and if there were to emerge an over-reliance on the market as the core mechanism of the system.

*Lesson 2: constraints on policy space*

This brings us to the second cautionary tale of the literature: this institutional fabric of financial governance must be consciously developed, and cross-border market integration will require substantial levels of international co-operation if national policy goals are to be achieved. A crucial element of this institutional underpinning concerns the macroeconomic policy framework, particularly in the domain of monetary, exchange rate policy, and public debt. The macroeconomic environment and the autonomous use of national policy instruments will be rendered more difficult through the introduction of a high degree of capital mobility, especially in the domain of monetary and exchange rate policy. The dilemma is what Cohen has called the problem of the 'Unholy Trinity' (Cohen 1993; 1996: 90-4) based on the long-standing work of Mundell and Flemming. Capital mobility can also increase constraints on the fiscal options available to governments: the redistributional and social welfare policy choices crucial to domestic political legitimacy, placing governments between often-incompatible global market pressures and national political imperatives

[7] See Schwartz 2009 on late industrialisation.

(Underhill and Zhang 2003; Rodrik 2007). Managing these tradeoffs is far more difficult for poor and emerging market economies than for the developed world and often challenges their historical economic development models (Underhill 1999), but the pressure is felt by all. Achieving the benefits of better access to international capital frequently involves tradeoffs against other policy options, yet far too often regulatory change was implemented without due consideration for the macroeconomic consequences thereof, and capital market regulation and macroeconomic considerations involved quite different policy communities and processes wherein the gains of the financial sector were not measured against potential losses for others (Underhill 1996).

The reform of the international financial architecture, undertaken in the shadow of the serial emerging market crises from 1994-2002, was designed to deal with these growing tensions. What is interesting is the way in which this problem was addressed and why. The approach at Bretton Woods in 1944 had been to render the international monetary and financial order compatible with creating for national governments the policy space required to make in their own way according to their internal politics the difficult choices involved in adjustment to international imbalances. In other words, the aim was to make the world compatible with the political vagaries and legitimacy requirements of national democracy. The financial architects of the 1990s saw the problem the other way around: the focus was on adapting and strengthening the 'weakest links' in the global chain, the developing and emerging market economies, to the pressures of a market-based and integrated global financial system. There was no provision for macroeconomic stability or monetary order; on the contrary, the monetary system and system of international adjustment was *de facto* simply a derivative of the market-based financial order. Volatile capital flows were seen as constituting useful pressure to develop sensible norms and standards to underpin macroeconomic policy compatible with the global system. Because national financial regulation and monetary governance was increasingly ineffective a market-based system strengthened by sound domestic regulation, better crisis prevention mechanisms, and better national macroeconomic policies and related international monitoring and coordination was billed as the solution.

Therefore a major plank in the reform process was the promulgation of a range of 'global' standards in the domains of macroeconomic policy, financial stability, accounting and corporate governance to which emerging markets and poor countries with weak institutional capacities were to conform and adapt via new international standards and codes (Tirole 2002: 18-22). In this way the 'new' international financial architecture focused on facilitating the free flow of capital across borders, preserving the same market-based characteristics that emerged in the 1980s and 1990s while aiming to render national economic policy and space more compatible with the demands and pressures of financial integration. If the rules were right and properly applied, the market would function in a stable manner.

A range of initiatives was taken in the field of crisis prevention, with a focus on improving transparency in financial markets and macroeconomic governance (IMF Reports on the Observance of Standards and Codes or ROSCs). New consultative forums emerged as a response to the exclusion of emerging markets (G20) and the need for better overview and supervisory coordination of globally integrated markets (Financial Stability Forum or FSF – recently renamed and strengthened as the Financial Stability Board or FSB). Yet none of these bodies had or have real power to set rules for global financial governance; the key still lies with the major G7/G10 economies despite the new role for the G20 and the major emerging market countries therein. The one serious institutional innovation in the field of crisis resolution, the Sovereign Debt Restructuring Mechanism (SDRM) failed to materialise and was replaced by the incremental and voluntary Collective Action Clauses (CACs) and the non-binding private sector 'principles' promulgated by the Institute for International Finance

(IIF 2006b). These and other private sector initiatives were as much an attempt to pre-empt public intervention as they were attempts to fill gaps in governance. The subsequent 'period of calm', 2002–7, bred a sense of complacency that the new global financial architecture was working and was successfully preventing the outbreak of new major crises. Nonetheless, less positive signs were visible to those who wished to see: capital flows to emerging markets and poorer developing countries remained volatile and unpredictable over time (World Bank 2006a), and deadly toxin was accumulating in western banking systems.

*Lesson 3: skewed policy input*

Perhaps more important is how demands for these new forms of international financial governance initially emerged and were adopted as policy. Financial firms and their associations have historically close and relatively exclusive relationships with elite state policy-makers and with the key international organisations together responsible for the design of the reforms. There was already a private sector-state agency coalition in favour of liberalisation the policy preferences of which was observable in the norms and rules of the new architecture. G7 governments generally backed the preferences of their corporate financial sectors (Baker 2005) in an increasingly transnational policy community. Cooperative institutions of global financial governance, such as the Basel Committee and the International Organisation of Securities Commissions (IOSCO), were characterised not only by exclusive policy communities, but also by virtual separation from accountable political processes (Underhill 1995, 1997), a problem further exacerbated by frequent recourse to self-regulation. As a result, the transnational financial system is increasingly regulated by agencies constituting regimes that are more responsive to private interests than to providers of collective goods (Cerny 1996: 96–9; Porter 1999).[8]

[8] Oatley and Nabors (1998) document how the original Basel Accord was created to respond to the rent-seeking demands of private financial firms in leading industrial

Evidence indicates that crucial multilateral IFIs, such as the IMF, were part of this constellation of interests (Wade 1998; Stiglitz 2002). Private institutional investors have attempted to shape the investment environment in emerging market economies by pressing these countries to adopt policy frameworks favourable to their interests (Maxfield 1998; Porter 1999), even though such policies might exacerbate problems of economic development and socio-political stability. The emerging system of financial governance across national and global levels was thus flawed in important ways in terms of input-side, policy-process legitimacy. The guardians governing the monetary and financial order had become relatively autonomous from the traditional mechanisms of (democratic) accountability and control as well as from the influence of broader social constituencies. The point here is not that there should be no private sector involvement in financial governance, but such involvement is problematic if it aligns notions of the public interest with those who not only profit most from financial markets, but also represent the greatest risks to the financial system as a whole.

*Lesson 4: policy rent-seeking and capture*

This brings us to the fourth cautionary tale that was reflected both in the literature and on the ground. The problem of narrow, exclusionary policy communities that generated the international financial architecture is anchored at the domestic level of the countries that host the principal financial centres. Skewed policy input results in a skewed balance of public versus private authority and interests in the fashioning of both supervisory/regulatory policy and the financial order itself. As a result, the output side of policy-making becomes flawed in terms of legitimacy *and* effectiveness: liberalisation and market-based financial architecture did not improve the stability of the system, and ultimately raised the costs for ordinary citizens. Financial liberalisation and the subsequent establishment of a market-based approach to financial governance constituted a process of policy-rent seeking which yielded important competitive advantages for the major international investment banks and financial conglomerates who pursued the policy in the first place. State agencies involved in financial governance also had a crucial interest in financial liberalisation and frequently made common cause with the financial sector.

This private dominance at the domestic level of decision-making is based on the close relationship between private financial institutions and supervisory and regulatory agencies, with frequent delegation of oversight to self-regulatory processes (Baker 2005). Most often statutorily independent from politicians and other state institutions, regulatory agencies are highly responsive to the preferences of private financiers, their main domestic political constituency. In fulfilling their regulatory and supervisory functions, they draw much of their legitimacy, and work in close communion with, private financial firms. Regulators also collaborate with national firms to adopt policies that promote their competitiveness in the transnational market place. Close public-private ties are further reinforced by common professional norms, the specialised and technical nature of expertise in the financial sector, and the shared need to maintain public confidence in the financial system itself.

The Basel II supervisory accord was perhaps the best example of the problem. Oatley and Nabors (1998) document how the original Basel I Accord was created to respond to the rent-seeking demands of private financial firms in leading industrial nations. The process through which B-II was formulated was a second example of policy rent-seeking by financial interests seeking liberalisation and lower regulatory charges.[9] Basel II capital requirements were formulated in a relatively exclusionary and closed policy community consisting of regulators and supervisors from the G10 leading industrial nations and their private sector interlocutors. In these networks, private market interests found respondents in finance ministries and central banks and have thus been able to shape policy at the global level. The final rules and

[9] For a more substantial account of this point, see Claessens *et al* 2008, especially pp. 318-27.

standards sanctified by B-II tend to award competitive advantages to powerful market players with little regard for either their smaller (systemically less significant) competitors or developing and emerging market economies, and the impact of B-II is far wider than the banking institutions and markets of G10 committee members. The bottom line is that private actors, in particular large internationally active financial institutions, had more influence on pre-crisis financial architecture reform than developing country members of the Bretton Woods Institutions.

To conclude this section, it had become clear at the very least through the regularity and persistence of crises that a liberal financial order posed important risks to developing and developed countries alike in terms of market instability and risk management. No one denied the need for better national-level governance and greater levels of co-operation at the international level. The result however was a crisis-prone system of ‘governance light’ that delivered material advantages to those who had proposed it and unduly constrained the policy space available to the very governments in whose name it was promulgated. Private preferences dominated the making of public policy in the new financial architecture and at the domestic level.

This section has demonstrated that the literature had warned policy makers representing the public interest of these problems. Policy-makers and private interests chose to listen to arguments in favour of financial integration and market-based governance, putting other people’s money and future at serious risk. There was no serious evidence that untrammelled capital mobility was either universally or unmitigatedly beneficial; and even if beneficial, it was clear that these benefits were not straightforwardly to be achieved. Regulatory and supervisory policy change was required, but policy capture ensured that this went awry. Even major industry players warned policy-makers of the problem, for example hedge fund luminary George Soros (2005) and President of State Street Bank Avinash Persaud (2000[10]). We knew all we needed to know in order to prevent the outcome we achieved.

Ultimately the costs of the system were born by poor country and developed country citizens alike through the public rescue of the banks and the recession that followed. The lesson is that well-placed private interests win out against common sense and scholarly understanding and also win out against the dispersed and unorganised interests of the general public unless specific measures to prevent such an eventuality are positively developed. This outcome again should not surprise us and we were so warned by Adam Smith some 240 years ago: “People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the publick....” The inherent interest in financial stability of those who ultimately bear the risks and pay for policy failure should be reflected in the content of policy. As Louis W. Pauly asked some time ago (1997), *Who Elected the Bankers?*

**Euroland in Search of the Lost Gold Standard**

The lessons that were well-known but unlearned prior to the credit crunch should have increased in importance as the recession closed in upon developed economies. This section looks at the onset and initial EU member-country and European Central Bank (ECB) reaction to the broader financial crisis, and then focuses on the reaction to the sovereign debt crisis in the eurozone of spring 2010. It will be argued that EU financial integration and the eurozone were very much part of the adventure of global financial integration, with similar assumptions that ‘governance light’ was a workable option and that monetary and financial stability could be automatically achieved, given the correct rules and proper application by governments and financial institutions alike. I called this ‘the political economy of the

[10] Persaud’s essay criticising the market-based approach to financial supervision even won the prestigious Jacques de Larosière prize issued by the Institute for International Finance in the year 2000 and was promoted widely on that basis.

stability culture' (Underhill 2002).

This combination of intense integration into the liberal financial order plus weak institutional fabric rendered the EU and single currency in particular vulnerable to either monetary or financial crises. The sub-prime crisis, credit crunch and banking collapse, and sovereign debt problem focused on Greece were the first major test, and they were a major one indeed. The available lessons were of course no better learned by the EU than anyone else, and so the crisis caught the authorities by surprise. The section will nonetheless demonstrate that the financial crisis and banking collapse phase was extraordinarily well-managed under the circumstances, with the ECB at the helm, whereas the sovereign debt phase was a lamentable policy failure which still risks unravelling the accomplishments of the single currency. The EU as a collectivity proved ready and willing to bail out banks with trillions of euros, but bailing out the citizens of vulnerable developing member state economies, citizens who had helped bailout the banks and were already paying the price as such, was not worthy of prompt or proper action.[11]

Even after the onset of the sovereign debt phase of the crisis, the lessons concerning the need for better and *different* financial architecture (in this case better EU machinery for crisis management and prevention) were poorly absorbed. Nor were lessons learned concerning the need to expand member state policy space, especially in relation to particular needs of the weaker (developing) members of the Union. There has been little attention to the need to think about, and to respond decisively in relation to, the domestic political imperatives of political systems experiencing the turmoil of crisis wherein a fragile political legitimacy may be breached. The EU emerged from the crisis divided between rich and poor, institutionally in disarray, and demonstrating a poor understanding of successful crisis management. The solution developed will likely lead to further division and difficulties in the future. In short,

[11] Thank you to Marc Uzan for first articulating this point to me.

the direction of policy at the moment still yearns for an automatic solution akin to the myth of the 19th Century Gold Standard: if only the correct rules and standards of behaviour are adopted and followed, all will be well in the not-so-stable 'stability culture'. This situation belies a profound misunderstanding of monetary governance deep within the EU and its member governments.

*EMU: global finance, the 'stability culture' and institutional lacunae*

It is useful at this point to review four observations made at the inception of Economic and Monetary Union (EMU) (Underhill 2002). First, there was and remains a central paradox concerning the place of the eurozone as an economic unit in the structures of global monetary and financial system: the EU is relatively self-sufficient in terms of international trade, but is deeply integrated into the structures of global financial markets and investment flows. Capital flows not trade pressures will mediate between EMU and the rest of the world. This means that while EMU member states are subject to all the market adjustment pressures of capital mobility, the exchange rate matters a lot less and there is also insulation from at least short-term current account constraints (Jones 2003).[12] Secondly, while there is a clear legal institutional mandate in terms of managing the Eurozone's monetary policies, it is unclear how other policy domains such international monetary relations or the nature of global financial architecture are to be managed. There is also a dearth of collective EU machinery for managing internal or externally-induced crises. Both of these characteristics, it is argued, tend towards the neglect of the exchange rate as a tool of macroeconomic policy and a reliance on rules and macroeconomic standards which are easily and perhaps necessarily breached under pressure. The theory was that of the German Bundesbank: if policy remained resolute and free of political interference, a 'stability culture' could be achieved quasi-

[12] *Within* the Eurozone of course there is no longer any exchange rate fluctuation at all.

automatically. This was an unfortunate misinterpretation of German economic success,[13] but the case appeared well-grounded in experience and was anyway politically unassailable if the German government were to agree to the Union in the first place.

Thirdly, financial integration and EMU confronts members on the one hand with considerable pressure for convergence in terms of macroeconomic management and corporate governance practices, but on the other there are the intense bottom-line pressures of political legitimacy in terms of social policies, national (and other) identities, and the role of national democracy in an increasingly integrated economic unit. This is often perceived as the “sovereignty issue,” though the debate is probably better characterised as one concerning identity and policy autonomy, which are not the same as sovereignty. Fourthly, following from the third point, the Eurozone can be seen as a radical extension of the Single Market. EMU enhances the cross-border market forces already at work and was explicitly intended to do so. Yet, this integration process is juxtaposed on what remain distinct political systems with their own internal dynamics. The economic development and adjustment process associated with the single currency would furthermore prove highly asymmetrical with the greatest adjustment pressure on the weaker economies (Padoan 1994; Feldstein 1997, 2000).[14] The Eurozone was consequently likely to encounter its share of disagreements among its members as the asymmetrical distributional consequences of integration became clear. As we now know, it did, and crisis made this worse.

As already implied, EMU was very much unfinished business that suffered from institutional lacunae which would make the collective management of these problems a serious challenge. Dealing its interrelated policy dilemmas would require EU-level

[13] This stability culture version of German monetary history in the post-war period left out many factors such as successful industrial renewal and development wherein government policy played a central role, externally-supported political stability and democratic development, post-war deutschemark undervaluation, EU integration as a growing market for German export success, and the refusal to recognise the German current account surplus as a problem for anyone but Germany’s trading partners.

[14] Although these have also of course experienced the fastest growth. Developing economies which do well often experience severe short and medium term external imbalances, difficulties with public debt, and perhaps inflation. This

institutional development and further compromise in terms of national policy autonomy, and failure would render the future of the single currency a difficult one. The unknown factor in the eventual success of the stability culture would likely be external to the Eurozone itself: the periodic eruption of monetary and financial crisis at the global level. Would the Eurozone be the island of monetary and financial stability its architects had hoped? Given the transmission mechanism for contagion and spillover provided by the process of global financial integration, of which EMU was an intentional part, there was insufficient attention to this problem as we now know. The institutions and co-ordinating mechanisms for prudential supervision and oversight of the financial system and eventual crisis management were woefully underdeveloped at the level of the Eurozone and even after post-crisis reform still remain essentially the stuff of national jurisdiction.

The Maastricht treaty itself reinforced what the logic of global financial integration already implied: a reliance on market forces to provide discipline and stability. The only collective mechanism for dealing with crises was the Stability and Growth Pact that accompanied the treaty. This was essentially an agreement on sovereign debt burdens, less inflexible than many thought, but the overall framework implied that governments, not financial markets, were the problem: if the rules were properly applied, stability would prevail. The Treaty thus favoured price stability and the fight against inflation over growth, employment, and social policies. Monetary policy and day-to-day exchange rate management would be in the hands of a highly independent central bank, not at the discretion of elected governments or an integrated Council-based mechanism.

Of course there were also substantial benefits. Members of the Euro would gain weight in global financial and monetary affairs. Those who had been subject to German monetary policy would now have a voice at the ECB table. Internal exchange rate crises would be a

phenomenon is well known in the literature and should surprise no one (see Eichengreen and Hausmann 2005).

thing of the past, and the most competitive economies (Germany, Netherlands) would no longer suffer the devaluations of others. Member states would have better access to cheaper capital, a serious benefit for the poorer and weaker economies. Given that by far most EU member trade was with other EU partners, eurozone participants would be sheltered also from global exchange rate volatility. Members would be relatively free of current account constraints as well (Jones 2003), though (no devaluations!) *less* free of the need to adjust to competitive pressures in the long run. Last but not least, and in retrospect perhaps the most important, national central bank reserves and resources that might be required for adjustment or in a financial rescue would be pooled: large and stable economies could, and *would* (it was assumed), support the weaker links. The stability culture was a safe harbour from the winds of financial, exchange rate, and monetary instability and this was central to the compromise. What political and institutional machinery was to manage the process when push came to shove was unclear, but over time there was as much talk of solidarity as of the need for discipline.

How did the eurozone and EU perform in the crisis, particularly relative to the lessons of the literature rehearsed in the first section of this paper?

*Crisis: the financial phase*

The ECB largely compensated for the lack of collective machinery by exceeding its mandate so as to resolve what might have been severe collective action problems across the EU banking and financial system. While member states of course played a role at the national level, the European System of Central Banks proved a miracle under fire, pooling resources and co-operating with the US Federal Reserve among others. The ECB rapidly developed a repo market for distressed assets, eased the terms of refinancing for banks in difficulty, eased monetary policy without running out of ammunition from the start by approaching zero interest rates too soon, and early in the process introducing quantitative easing techniques. Trillions were put up to restore confidence in the stricken banks and national governments chimed in with nationalizations under fire where necessary.[15] The ECB took the lead in ensuring that national systems of deposits were protected and there was an initially shaky but eventually systematic move towards 100% coverage for the duration of the crisis. Panic avoided, despite some initial bank runs, the interbank market was slowly resuscitated, and the ECB co-ordinated the effort internationally with the federal Reserve system of the US, the Bank of Japan, and other major players. Much largesse was shown to the new members and neighbouring economies, though one might have wished for more yet. Budgetary rules were loosened for the crisis, and fiscal stimulus was encouraged and co-ordinated, though of course implemented at the national level. Finally, the EU Commission and the Bank also took their place in the new G20 context and there was an open admission that the institutional lacunae in terms of EU financial regulation and supervision required filling in without delay: national autonomy would give way to collective comfort and insurance.[16]

There was of course plenty of drama, but the markets and the banks stayed open and recovered substantially from March 2009. Overall, the financial crisis management phase could have been expected to go much worse. In contrast to the 1930s, public authorities largely did the right thing and kept lines of credit open to each other. Beggar-thy-neighbour policies were notable for their absence despite the extreme pressure on national governments. ECB and national outlays may yet be recuperated as the Bank's balance sheet is restored to its normal state.

What then of the sovereign debt phase of the crisis, which emerged well into the recession and a year or so after the peak of the financial crisis? The result was a lamentable policy failure largely directed and motivated by the German government, supported by the

[15] See BIS 2009, ch 6, a comprehensive survey of policy responses to the crisis including government and central bank outlays.

proportionately largest net contributor to EU finances, The Netherlands.

*Crisis: the sovereign debt phase*

A first point to be established is that the sovereign debt crisis was no surprise, or at least should not have been. There are two phenomena which made it obvious that national debt burdens would become a concern to the financial markets which were financing these deficits: a) there had been a stupendous transfer of private debt and toxic assets to national central banks and government balance sheet; b) fiscal stimulus measures and automatic stabilisers built into welfare systems added to the government debt burden. These facts were no mystery,[17] and the G20 summits and IMF meetings resounded with talk of 'exit strategies' and the risks of inflation associated with deficits and monetary easing. A second point, it was hardly unexpected that the weaker economies in the Eurozone would be the worst hit: the effects of EMU and financial integration were known to be asymmetrical. The experience in the Euro and non-Euro new members of Central and Eastern Europe was there for all to see. Of course national choices mattered and Greece did 'cheat', and proportionately by a considerable amount, but this behaviour was well-established (see Jones 2010: 26-7) was also largely forecast by IMF country reports in the public domain (IMF 2009: 20-1). Anyone who should have known could have known.

The next problem was an apparent failure to separate out the debt *crisis* and crisis management phase from the rules of the game under normal circumstances. The German government consistently drew attention to the Growth and Stability Pact and the imperative that it implied. Yet already the G20, EU, and other bodies had accepted that for some time exceptions to normal fiscal prudence would have to be allowed (again, see BIS 2009: ch VI). International co-operation would be required to ease the burden for the hardest hit, usually

[16] Though the promises of reform at time of writing were far from fulfilled.
[17] See BIS 2009, 2010; see also regular IMF *Staff Report for the [year x] Article IV Consultation*, e.g. 2009.

the poorest. Aid should not be cut, welfare provision would continue. There would be solidarity.

But suddenly within the eurozone this was all to be denied by one country showing the most abject lack of understanding as to why the financial rescue had been mounted at all: to safeguard citizens whose future was threatened by monetary Armageddon, and whose resources of course also provided the ultimate guarantee for the banks in the first place. Trillions had been thrown at the banks in the face of moral hazard problems and the greedy snatching of salary bonuses, but citizens of the poorest of the ‘old’ EU members were not worth as much care even when the price was a paltry amount in relative terms. Bond spreads relative to German Bunds in November-December 2009, as the crisis began to break, were still a modest 200-250 points (BIS 2010a: 3; *Financial Times* Lex column 15-12-2009) and the most pessimistic talk was of a potential rescue in the €20 billion range. The problem soon began to spill over to Portugal and other eurozone countries, and by April-May Greek bond yields were at one point over 1000 basis points above German levels with debtloads commensurately higher. In the end the German government did begin to worry, but that was once it was hastily and quietly informed by their own bankers their own bankers (not to mention alarm from the US president) that Greek bonds about which the default debate was taking place were largely held by, yes, German, French and other banks (BIS 2010: 27).[18] The prospect of simultaneously dealing with a sovereign default and collapsing banks as well was sombre, and this time German and eurozone public finances in Germany were also denuded because of the crisis. Whatever the political climate in Germany, which at the time included tense provincial elections that stimulated Merkel’s party to appear tough on Greek ‘cheaters’, a prompt and decent policy reaction could have avoided the problem altogether and a crisis-avoidance solution would surely have bolstered her political fortunes too.

[18] 70% of Greek debt was held by non-residents in 2010 (BIS 2010: 68), so someone out there thought they were a decent investment.

This was all the more ironic in view of the past record of Germany on the observance of the maximum 3% of GDP budget deficit provisions of the Stability Pact. Germany and France taught everyone in the EU that the Pact was to be ignored and that cheating was acceptable in times of fiscal difficulty: after the bursting of the DotCom bubble and subsequent recession the German deficit 2002-5 was respectively -3.7%, -4%, -3.8% and -3.3% of GDP; France was above the limit 2002-4, and Italy from 2003-6. These large countries even caused the terms of the Stability and Growth Pact to be softened in 2005 to help themselves out.[19] The rules are for the small and weak, and discretion remains in the hands of the powerful member states. The Pact was after all a largely German idea, which only increases the irony.

Next, Greece *did* massage the figures and the deficits grew alarmingly fast (much due to widening bond spreads), but in absolute terms the Greek economy is small, poor, and has little weight in the eurozone or global scheme of things (see discussion *Financial Times*, Lex, 15-12-2009). The initial market reaction to the crisis was relatively calm as a result. As Jones (2010: 27-9) points out, Greek debt auctions continued to be oversubscribed until the end of April 2010. But time was of the essence, as was a clear policy line from the EU and eurozone members. To the bewilderment of all the German Chancellor declared that there would be no rescue until the capacity of Greece to finance its debt was exhausted. By that time, as we soon saw, it would be too late and the problem would be spiralling out of control. There was high-handed talk of temporary expulsion of eurozone members (taking away their Council vote remains another favourite of the German chancellor) who failed to deliver on policy promises. Even in March 2010, when panic was clearly spreading and the question was no longer whether a bailout but what sort and how large, Merkel astounded all by insisting that the crisis should not be discussed at the EU summit because there was no crisis

[19] Deutsche Bundesbank, *Monthly Report*, April 2005 link (consulted 15-11-2010): http://www.bundesbank.de/download/volkswirtschaft/mba/2005/200504mba_en_changes.pdf

and Greece had not requested help.[20] Greece learned to its horror that internal political constraints from riots to strikes were unimportant to Germany and others, though German political constraints had been imposed on all when Germany violated the pact a few years earlier.

The German approach clearly made the problem rapidly and terrifyingly worse. If the problem was largely dismissed by commentators in December 2009, or bailouts were discussed at around the €20 billion mark, by 11 April 2010 a €45 billion joint EU-IMF package was on the table. Too late: the 27 April ratings downgrade of Greek and Portugese bonds to BB+ sent Greek spreads to 1200 points and debt also skywards. A Greek bond auction failed. The next (2 May 2010) package that eventually stopped the rot was €110 billion, some €32.5 billion extra per week or €4.6 billion a day! (BIS 2010a: 3-4) plus a combined EU-IMF standby bailout fund of €750 billion (BIS 2010: 26). The failure to adopt an appropriate solution also meant playing huge risks with contagion for other member states: Ireland, Great Britain, Portugal, Spain, the new members. As of writing there are open discussions of Irish and again Greek bailout and default potential in the financial press (e.g. *Financial Times* 14-11-2010). Policy space for the Greek government and through spillover effects much of the eurozone will be constrained for years to come. The markets trump the people, especially if it is not initially understood that under conditions of EU financial and monetary integration it is only a matter of time before they are also *your* people.

Three final points may be made to round off this section. Firstly, one cannot but most unwisely on the one hand condemn the markets for 'causing' the financial crisis, as the German government has been wont to do (ignoring official policy failure) while at the same time exposing eurozone partners to cold market forces in dealing with the very debt born of rescuing the financial markets in the first place. In the end, is there public authority and

[20] Richard Wray, *The Guardian* online, 21 March 2010, http://www.guardian.co.uk/business/2010/mar/21/eu-greece-angela-merkel (consulted 15-11-2010).

policy in the EU financial and monetary system, or only the rules of private competition and declaratory national self-interest? Why would small and vulnerable economies want to lose their monetary and exchange rate policy autonomy and join the euro, as new members are obliged to do, if the protection of pooled reserves is demonstrably to be denied in the most crucial of moments?

Secondly, and even in the face of serious institutional lacunae, if one has a single currency then in a crisis one must behave as though the eurozone is a single economic entity. During the *financial* phase of the crisis the EU led by the Bank behaved in just such a ‘federal’ fashion, violating its own rules to take on all sorts of dubious collateral from banks. A repeat performance on sovereign debt was not to be and instead loans with stringent conditionality attached were hastily arranged. Ironically, the eurozone demonstrated very publicly to all that the IMF, not the EU, was the source of a real rescue. European ‘solidarity’ proved non-existent at first, and it has since most likely worsened the problem for all. Returning to the points raised in the introduction to this paper, EMU did not prove particularly effedtive for its member states in dealing wioth the sovereign debt phase of the crisis. Neither national nor EU institutions have seen their legitimacy enhanced as a result,a nd it is unclear whether the eurozone will yet survive. The most worrying development is that the German (and other) creditor government reactions have now infected national electoral politics with the centrifugal forces of populist beggar-thy-neighbour sentiment, making future rescues even more problematic.

Finally, Germany and other eurozone current account surplus economies refuse to look at their position as at least in part a problem for the creditors. The terms of the rescue show that debtors to bear the burden of adjustment essentially alone, even in a monetary union. Yet who buys creditor exports, if not the deficit countries? In a crisis one should stimulate them maintain a reasonable level of consumption so that trade recovers for all, and that means internal transfers one version of which might be a (timely) rescue. And who benefits most from monetary union in a crisis if not the surplus economies (because the others cannot free ride through devaluation)? In the end, there was a clear belief that pouring sterilising and cleaning fluids on the guilty country will resolve the problem. If all eurozone members behave like Germany then the stability culture will be achieved. But even in the most virtuous of all possible worlds it is impossible for all economies to have a current account surplus simultaneously, or has Chancellor Merkel not yet learned of this fundamental axiom of international economics? The issue will be back to haunt us when the loans come due.

Meanwhile, what should have been done? The first point was to remain calm at the outset (November 2009), to deal with the matter quietly behind closed doors, and to demonstrate to the markets that there was no danger of default. This would have prevented the whole unhappy train of events and Greece and others would have had smaller (if still large) debts to deal with. The starting point could have been a simple press conference in early December 2009 of the ECB President Trichet, the Commission President and relevant Commissioner for monetary affairs, and the Greek premier: 'welcome ladies and gentlemen of the press, thank you for coming. There will be no sovereign defaults in the eurozone. European institutions and partners will ensure that deficit finance and financial sector liquidity remain available under all circumstances. That is all we have to say and there will be no questions. Thank you.'

Next, official loans are a poor solution in a monetary union where the central bank can indulge in quantitative easing as it is called, or printing money, as in a domestic economy. Loans only add to the debt burden and allow markets to focus on the risk of default once again when loans are due. Further lending does little to restore the confidence in the bond market, the scene of the carnage. The ECB should have adopted immediately the same strategy it adopted in relation to rescuing the banks: unlimited repo operations in the asset markets concerned (this is now taking place). That places a floor under the price of bonds and brings the yields down, easing the increase in debt load. This is also a highly profitable operation if one understands the one and only rule of successful investment: buy low, sell high. The ECB can finance itself for nothing indefinitely (danger of eventual inflation duly noted). Distressed sovereign bonds can be purchased all time low prices, while income from yawning yield spreads are generous. As the market stabilises and the situation eventually approaches resolution, spreads will come down and bond prices will rise, just in time to unravel ECB positions. For the monetary sadists out there, the price for Greece would have remained very high, but no German or Dutch taxpayer would have been asked to put up money, thus depoliticising what became an ugly, populist row across several EU countries with serious centrifugal results for the eurozone. Of course this strategy carries with it risks and an exit plan would be required, but the risks were rather less than they were in the case of the insolvent banks (Greece is after all sovereign and EU resources can be pooled). And indeed such a strategy would have been against the ECB's own rules, but no more so than was the acceptance of essentially toxic collateral from private banks in the context of the ECB's Covered Bond Purchase Programme. Purchasing sovereign bonds before they are distressed is of course not about saving risk-taking financiers, but about stabilising the future of those whose resources already have been called upon and have done their duty. Somehow one should really prefer people to banks, at least if democracy and citizenship are to have any meaning.

## Conclusion

This paper has shown that there was more than sufficient knowledge of the problems inherent in a liberal and integrated financial order to alert private and public authorities to the predictable dangers of financial instability. There was no historical evidence to support the approach adopted to liberalisation and cross-border financial integration, nor for the theories which underpinned market-based 'governance light'. This knowledge was not brought to bear and taxpayers and future generations are to suffer as a result. Nonetheless, important policy lessons from the 1930s appeared to have been well-learned during the financial market phase of the crisis. The financial system was successfully rescued albeit at a considerable cost, and a serious depression and deflationary episode have hopefully been avoided as well.

Unfortunately, during the EU sovereign debt phase of the crisis, more primitive instincts prevailed. Domestic political dynamics stimulating centrifugal tendencies among eurozone members were stoked up not just by a frequently jingoist press but by the very member governments who claim to be committed to an 'ever closer union'. What might have been a noble exercise in *ad hoc* EU governance innovation, demonstrating the validity of the claim discussed in the introduction to this paper concerning the efficacy of regional arrangements, instead ran seriously aground. A poor strategy was eventually adopted that saddles Greece among others with yet more debt and at the time of writing had far from removed market doubts concerning the possibility of default for a range of weaker eurozone economies. The proposed reforms to the Stability Pact aim to constrain national policy space yet more and to punish errant debtors, with likely consequences for political legitimacy of both the single currency and of debtor governments.

Of course Greece should long ago have reformed its system of tax collection, its accounting procedures, the audit and relative size of its civil service, but France and Germany cheated just as blatantly from 2002-2005, albeit in better economic times. Perhaps there is something wrong with the assumption that the origins of the crisis lay in the failure of government fiscal policy, rather than in the way in which an integrated and liberal financial and monetary order works. In 2009, only 6 of the 27 EU members held to the Stability Pact budgetary norm, and Greece did not end 2009 as the worst offender. At the very least, current account weakness, budgetary problems, and a fragile financial system are all well-known characteristics of small, open emerging market economies like Greece or the next potential domino in the eurozone, and the financial crisis simply accentuated these problems by rather a lot. Under duress, stricter rules are no more likely to work in the future than in the past two years. The burden of adjustment to global market pressures must be rendered more compatible with the requirements of national political legitimacy, and a sensible and predictable debt crisis management mechanism making sensible use of eurozone resources and the ECB needs to be put in place.

The EU appears for a long time to have been looking for some functional equivalent of the lost, mythical Gold Standard: if only the rules are the right ones, and everyone behaves properly, stability will be achieved automatically. The literature analysed and historical experience tells us that this is unlikely to be achievable. There is as yet no sign of an adequate debate or proposals concerning the further development of EU institutions to prevent and/or manage crises in the future. The risk of sovereign default had already returned at the time of writing, and purely national solutions may yet prove the only option and the European dream would then die. The eurozone hangs in the balance as a result of serious policy mistakes led by the largest economy in the Union, Germany. The worst is that banks turned out to be more important than fellow citizens of the Union, especially citizens in poorer economies. The poor and the ‘other’ too frequently appear expendable in our world. There are sombre days yet ahead of us where regional governance in the EU is concerned.

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