Some Thoughts on Monetary and Political Union

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Introduction

- The question of the future of the monetary union in Europe is first and foremost the question of whether a monetary union can be sustained without a full-fledged political union
- Facts are that eurozone is unbalanced in that monetary policies are fully centralized
- While most other instruments of economic policy have remained national
- Is this sustainable?

Introduction

- Two schools of thought
  - monetary union cannot survive in the long run without a strong political union
  - the present degree of political unification reached in the EU is sufficient to guarantee the long run survival of the monetary union.
- The debate is made difficult by a lack of clarity about the meaning of political union.
  - There are many dimensions and many gradations of political union

The many dimensions of a political union

- There is an **institutional** dimension. EU has developed whole set of institutions to which the member states have delegated part of their national sovereignty
  - Executive branch (Commission and the Council). Legislative branch (Council and the European Parliament),

    Judicial branch (Court of Justice)
  - EU has all the institutions of a modern democracy, capable of taking decisions with direct impact at the national level.
  - In this sense there is already a significant degree of political union within the EU.

- There is a **functional** dimension.
- The transfer of sovereignty has been very unequal
  - Transfers are important in some area (agriculture, foreign trade, competition)
  - Few or no tranfers in the areas of government spending and taxation social policies
    wage policies

- The question that arises is what areas are important for a monetary union.
- Do we need a transfer of sovereignty in all these areas so that the European institutions become the embodiment of a true “superstate”, or can this transfer be selective?
- If the latter is true, what principles should be followed to allocate responsibilities between the union and the member-states?
- In order to answer these questions we turn to the theory of optimal currency areas.

The theory of optimal currency areas and political union

- There is no supranational coercive power that can force the member states to stay in the monetary union
- Therefore, for the Eurozone to survive, the member states must continue to perceive their membership to be in their national interest.
- If that is no longer the case, the temptation to secede will exist and at some point this temptation may lead to secession.

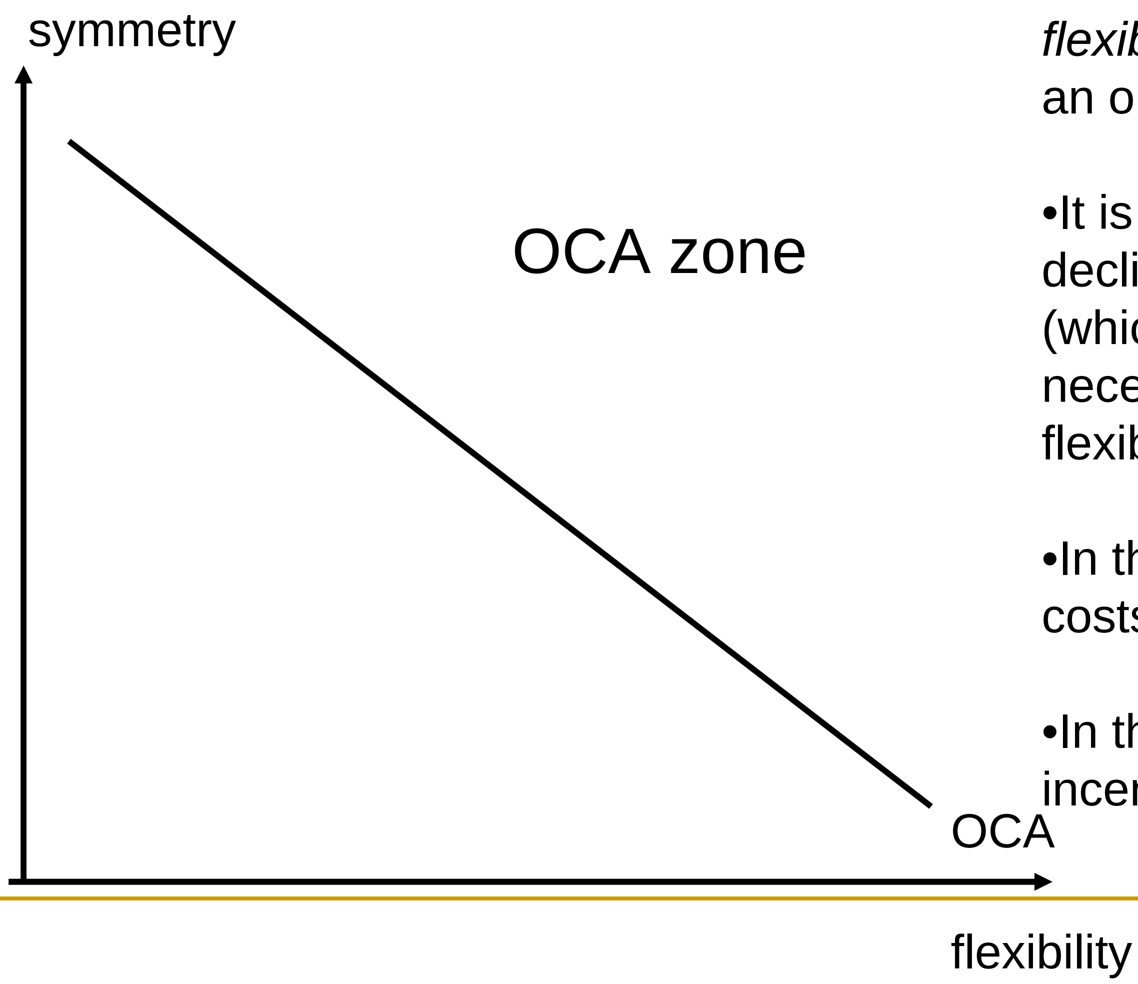
- What kind of governance of the union can ensure that countries willingly stay in the union?
- Put differently, what is the nature of the political union that can maintain the cohesiveness of the monetary union?
- the OCA-theory allows us to shed light on this question

Political union in the OCA-theory

- OCA-theory has been used almost exclusively to analyze whether countries should join a monetary union.
- It can also be used to study the conditions in which existing members of a monetary union will want to leave the union.
- OCA-theory says that if the benefits of the monetary union exceed the costs, member countries have no incentive to leave the union. They form an optimal currency area.

- The conditions that guarantee that monetary union is optimal and thus sustainable are well-known
- They can be summarized by two concepts:
  - Symmetry
  - Flexibility
- The theory is represented graphically as follows:

Symmetry and Flexibility



•OCA-line shows minimal combinations of *symmetry* and *flexibility* that are needed to form an optimal currency area

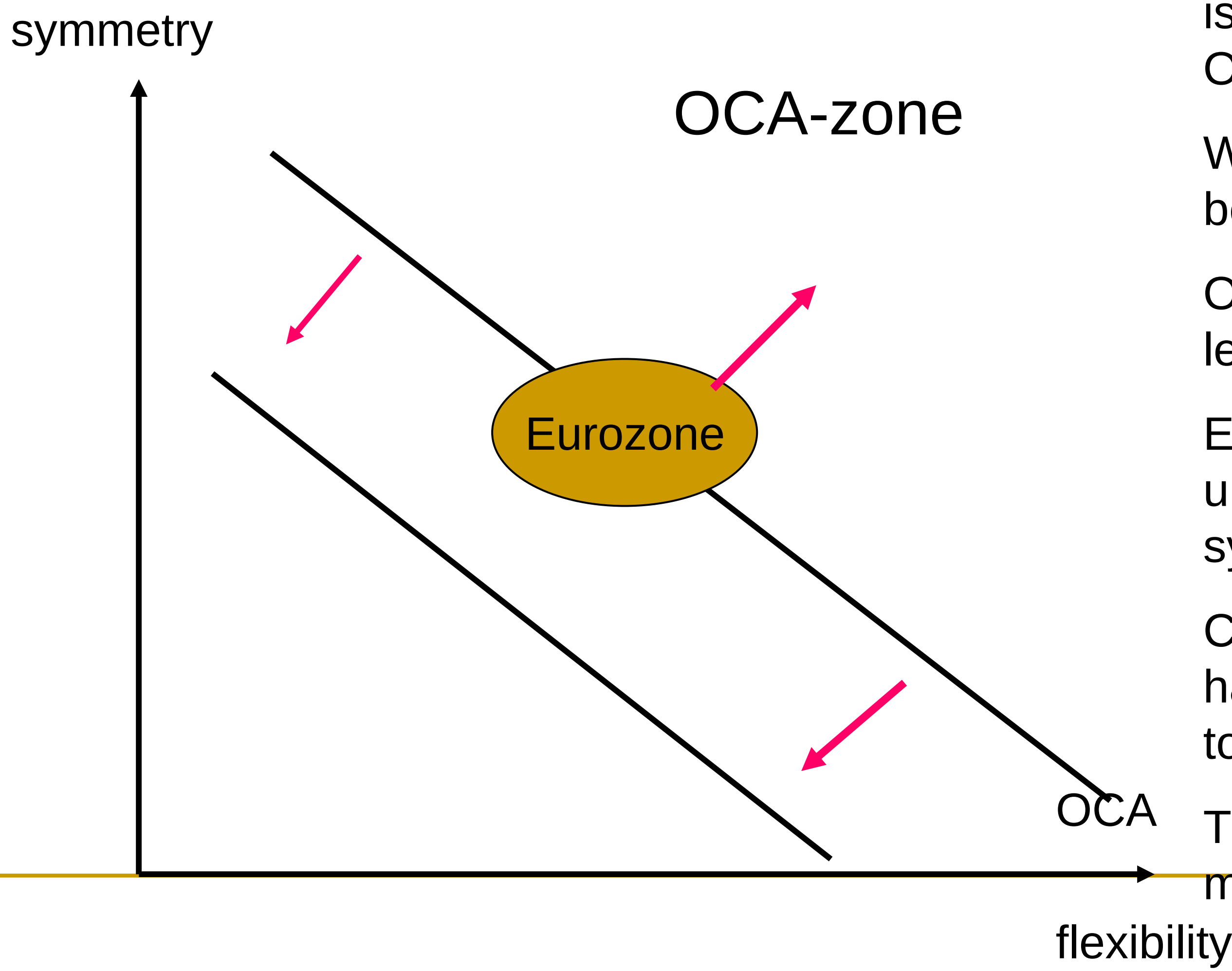
•It is negatively sloped because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility.

•In the OCA-zone benefits exceed costs

•In this zone there are no incentives to leave the union

- How does political union affect this cost benefit analysis?
- Two channels of influence
  - political union makes it possible to organize systems of fiscal solidarity that provide some insurance against asymmetric shocks.
  - political union reduces the risk of asymmetric shocks that have a political origin (e.g. shocks in government spending and taxation; social policies, wage policies)

Political union affects OCA-analysis



Assume that Eurozone is on borderline of OCA-zone

When political union becomes more intense

OCA-line shifts to the left (more redistribution)

Eurozone shifts upwards (more symmetry)

Countries in eurozone have weaker temptation to leave the union

The eurozone becomes more sustainable

- OCA-theory concludes that in order to enhance the sustainability of a monetary union it is important to have a central budget that can be used as a redistributive device between the member states
- it also matters to have some form of coordination of those areas of national economic policies that can generate asymmetric macroeconomic shocks

- I think these ideas remain important, although they are not popular anymore
- Eurozone will be hit by large shocks at some point in the future
- The absence of any kind of solidarity is a danger for its survival
- If a country gets into a mess and the others tell them to solve the mess themselves
- This country may take it literally

Some updating of the theory

- There is a third dimension to fiscal policy, its stabilization function
- This has become out of fashion in the Eurozone,
- Mainly as a result of the Stability Pact doctrine
- Yet stabilization by budgetary means has reappeared with a vengeance in the present banking crisis

- The question that arises in the context of monetary union is the following:
- Does the absence of unionwide fiscal authority hamper the resolution of financial crisis?
- If it does we can say that the lack of a centralized budget in monetary union is unsustainable
  - i.e either we create budgetary union
  - Or monetary union disappears

Some preliminaries

- When governments are asked to bail-out banks and to take large commitments that will influence future solvency.
- this crisis puts to the fore the hierarchy that exists between the central bank and the government vested with taxing power.

- In a time of crisis when banks fail, it is becoming clear how this hierarchy is
- This is that the government calls the shots
- At two different levels
  - Governments guarantee the solvency of the significant banks, and only governments can do this
  - Government also guarantee the solvency of the central bank

- The fact that the government guarantees the solvency of the central bank is necessary for the latter to be able to provide liquidity in unlimited amounts
- because these liquidity provisions carry the risks of losses which ultimately are borne by the treasury
- Thus paradoxically the lender of last resort function of the central bank is only possible because of the implicit backing by the government

- It is in this sense that there is a hierarchy in the relation between government and central bank: the former has precedence of the latter.
- This puts a natural limit to the degree of independence of a central bank
- It also allows the Treasury to force the central bank to produce inflation as a way to get out of debt

Implications for monetary union

- Preceding analysis identifies the shortcomings of the eurozone
- The absence of political union implies that there is no central government backing the ECB
  - This implies that the potential losses the ECB can make as a result of general liquidity provisions are not backed by a central government
  - This raises the issue of how these losses will be distributed among the 15 national governments (their capital in the ECB?)

- There is also no central governments backing the solvency of commercial banks
  - There are only national governments backing their national commercial banks
  - What about multi-country banks?
  - Fortis case: this was a bank with two nationalities
  - Belgium and the Netherlands disagreed about how to share the bail-out cost
  - They solved the problem by dismantling the bi-national bank

- Another implication is that there is no government strong enough to force the ECB to produce inflation as a way out of the debt crisis
- Even if a number of countries band together it would be difficult to force the ECB into an inflationary path

- This raises a number of issues
  - Will the decentralized nature of treasuries turn out to be a handicap in shoring up the banking system?
  - What if banking systems fail in some countries?
  - Is this a shock that could jeopardize the eurozone?
  - Will the impossibility of solving the debt crisis through inflation increase the probability of explicit default of a member country?
  - Can Eurozone sustain such a default?

- The present plans that are initiated in the eurozone are all based on national bail-outs
- It seems to work up to now
- Is this going to be sufficient?
- I have no ready answer today
- But I think the eurozone is more at risk than the UK

More thinking will be necessary

Thanks you for your attention