The Creation of the Euro: Design Flaws or Universal Predicament?

Harold James

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"Disaster:" Paul Krugman and Martin Wolf think the Euro is simply described by one word. But assessments this year are a little more optimistic, with a return to growth in most of the Eurozone. The most obvious reason lies in the exchange rate, as the rapid fall in the Euro gives a stimulus in particular to the export-dependent areas of the currency bloc. (The IMF in the April 2015 WEO revised its expectations of European growth up to 1.5 percent for 2015, substantially less than the US level of 3.1 percent, but still much better than Japan's 1.0 percent.) The developments of this year suggest that the problems of the common currency are not the result of some bizarre European peculiarity, but rather a consequence of the difficulty in finding answers to the larger question of international adjustment (where no one has really been very good at finding the answers). That difficulty is the major theme of this lecture. Indeed the events of this year suggest powerfully that we should think about the international policy dilemmas, since much of what recovery there has been has come as a consequence of currency depreciation; and in "currency wars" obviously not every country can devalue against the others.

In designing the Euro, European policy-makers in the 1980s and 1990s ignored, disregarded or denied two substantial bodies of economic theory. As a consequence, when problems began to appear, there were plenty of voices who shouted, "I told you so!" Were the architects of the Euro blind? Or were they engaged in finding solutions to a different sort of problem?

The first theory that the Euro ignored was a tradition of thinking that goes back to Aristotle and the ancient world, but really found its highest theoretical elaboration in the nineteenth century, in works such as G. F. Knapp's *State Theory of Money*. Money could only be issued by the state because of government's ability to define the unit of account in which taxes should be paid. In the *Nicomachean Ethics* (Book V), Aristotle explained that money owes its name to its property of not existing by nature but as a product of convention or law. Greek coins usually carried depictions of gods and goddesses, but the Romans changed the practice and put their (presumed divine) emperors on their coins. Christ famously answers a question about obedience to civil authorities by examining a Roman coin and telling the Pharisees, "Render unto Caesar the things which are Caesar's." (Matthew 22:21)

Contemporary economists say much the same thing. Paul de Grauwe (2012) has recently stated the case quite simply: "The Euro is a currency without a country. To make it sustainable a European country has to be created." Thomas Sargent (2011) used the bully pulpit of the Nobel Prize Acceptance speech to tell Europe to follow the U.S. example in the aftermath of the War of Independence and assume the debts of the individual states. Assumption for Hamilton was "the powerful cement of our union." The Presidents of the ECB seem to endorse this advice. Accepting the Charlemagne Prize in Aachen, Jean-Claude Trichet (2011) said: "In a long term historical perspective, Europe – which has invented the concept and the word of democracy – is called to complete the design of what it already calls a "Union". His successor, Mario Draghi (2012), has been even more dramatic, demanding "the collective commitment of all governments to reform the governance of the euro area. This means completing economic and monetary union along four key pillars: (i) a financial union with a single supervisor at its heart, to re-unify the banking system; (ii) a fiscal union with enforceable rules to restore fiscal capacity; (iii) an economic union that fosters sustained growth and employment; and (iv) a political union, where the exercise of shared sovereignty is rooted in political legitimacy." This advice seems appallingly radical to many, since almost every politician denies that there is any real possibility of creating a European state, and almost every citizen recoils at the prospect.

But actually, there is no need to be obsessed by the currency/country problem. To start with, there are long periods of history when people deal easily with multiple currencies, because of the multiplicity of small states: early modern merchants would need to deal with Florentine florins, Genoese and Venetian ducats and escudos, all set at different rates. Most importantly, modern money is not created by the state in the sense that it was when the Pharisees held out the coin. It is created by banks, as financial institutions – many of them very large, and operating in multiple jurisdictions

– establish claims, in currencies that they may choose (according to market conditions in different areas). I shall return to the implications of that fact at the end of the lecture.

The second theory that the Euro ignored was the discussion of optimum currency area (OCA), developed in the 1960s by Mundell (1961) and McKinnon (1963). The core feature of this approach was the concern with how an area in which the exchange rate no longer played a role could adjust in the face of an asymmetric shock. An OCA was viewed as a geographic area in which the benefits of a single currency in terms of reduced transaction costs outweighed the costs of giving up the use of domestic monetary policy to offset the effects of asymmetric shocks. Mundell contemplated labor mobility and wage flexibility as possible solutions, before rejecting them on empirical grounds. The early approaches to OCA in consequence assumed a Keynesian world with nominal wage rigidity and labor immobility. In addition to the degree of labor mobility, the theory stressed openness: the more open an economy as measured by the share of traded goods, the greater the benefits of a reduction in transaction costs. In the wage rigidity and labor immobility environment, a monetary union between disparate regions would only work to the extent that it was complemented by a fiscal union (fiscal federalism), which would compensate those areas already affected by the shocks which an independent monetary policy could have offset. Such a fiscal arrangement generally depends on a high degree of political integration. The argument thus takes us back to the central role of the state and in particular the need for fiscal coordination.

But Mundell added an additional element that might make the adjustment work: capital might flow to the area subjected to the shock, and facilitate the adjustment. This element in the original Mundell approach was developed above all by Peter Kenen, who developed the argument that capital flows could substitute for fiscal transfers (1969). Mundell in consequence developed what was called a "monetarist" approach to European integration (as opposed to the German "economists" who thought union could occur only after convergence): just establishing a money would do the work needed to establish an effective adjustment process.

OCA criteria were extended for the discussion about EMU in the 1980s and 1990s (Eichengreen 1996). Empirical evidence on the degree of labor mobility within Europe, the incidence of asymmetric shocks, as well as the limited practical possibility of fiscal federalism, concluded that the European Union was not an OCA, and that it compared unfavorably with the experiences of federations such as the US or Canada. Despite this negative evidence, the EMU project was successfully driven forward by the political agenda for European integration, and the big European statements about monetary integration remained appropriately silent about OCA. Part of the original inspiration of Mundell's vision of OCA, after all, had been to point out that not even his native Canada was really a perfect fit.

Was it just Politics?

The discussions that see money in political terms are nevertheless deeply significant. We interpret the story almost exclusively in terms of politics. The primary flaw of the Euro is the consequence of the intellectual domination of the state theory of money. In consequence, political myths abound about the origins of the Euro.

The two most influential - but completely wrong – stories that currently circulate about how and why the Euro was created both inflame political passions but give no guidance at all on how to find solutions. Both interpretations focus obsessively on the politics of the German role in driving monetary union, so that it again appears as solving the German question is central to the future of Europe. Both are mirror images of each other: in one Germany appears as uniquely virtuous, in the other as terribly vicious. Looking at the real history of the Euro can clear up misconceptions, but also highlight the real problems that remain to be tackled.

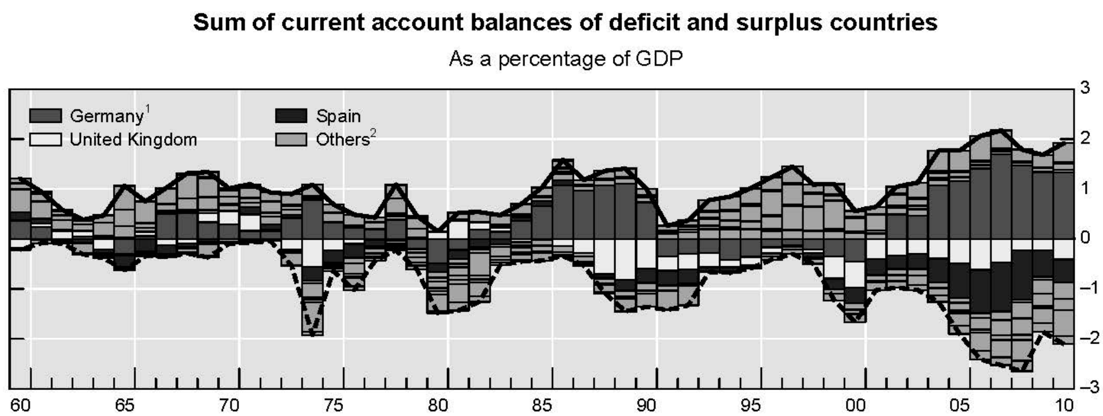
In the first view – the virtuous German story - the currency union was a high-minded European political project that ignored economic realities. It was needed to stop the recurrence of war between France and Germany. Both proponents of the Euro project such as the veteran German Foreign Minister Hans-Dietrich Genscher but also by opponents such as the economist Martin Feldstein (2012) have touted this theory. But it is implausible. Americans are perfectly aware that they haven't had a war with Canada or Mexico recently (although in the long past there were indeed such conflicts), and that they don't need a currency union to improve relations with neighbors. On the other hand, Americans are aware that civil wars can occur in malfunctioning currency unions (in the mid-nineteenth century, at exactly the time Napoleon III was dreaming of world monetary union): and Ireland too also has its own terrible twentieth century experience of the damage done by civil war.

Then there is the vicious view of the origins of the Euro, a conspiracy theory about a deep-seated German masterplan. Some of its earliest proponents were British (like the former U.K. Chancellor of the Exchequer Denis Healey (1990)), but now it is circulating widely in southern Europe. Since Germany had lower rates of wage inflation than France and much lower rates than the Mediterranean countries, a locked currency would guarantee increased export surpluses, at the price of misery elsewhere. A German grasp for European economic primacy would succeed at the end of the twentieth century and in the new millennium where a similar German military plan had failed one century earlier.

This view seems as absurd as the first myth about peace and money. If this is what the Germans were aiming at, wouldn't other countries be able to get some whiff of the nefarious plot? And more importantly, if this were really a strategy it is a pretty short-sighted one (not really that much better than the disastrous Schlieffen Plan of 1914 to defeat both France and Russia at the same time). Plunging one's neighbors into national bankruptcy is not a good way of building any kind of stable prosperity.

For the critics, Germany's currency manipulation was a mercantilist strategy of securing permanent trade and current account surpluses, that would give Germany a commanding control of resources. In each phase of the negotiation about European monetary integration, Germany's partners in consequence tried to devise an institutional mechanism to control German surpluses.

That is a debate that goes back a long way. Raymond Barre, then Vice-President of the European Commission, for instance argued in 1968 that Germany should take "energetic measures for speedier growth and the stimulation of imports," as well as "special action to inhibit the flow of speculative capital into Germany." (Ungerer 1997) In the Bretton Woods era of fixed exchange rates and controlled capital markets, even relatively small deficits could not be financed, and produced immediate pressure on the exchange markets. The deficit countries then had to apply fiscal brakes in a stop-go cycle. Germany's partners, notably France, were faced by the prospect of austerity and deflation in order to correct deficits. This alternative was unattractive to the French political elite, because it constrained growth and guaranteed electoral unpopularity. Their preferred policy alternative was thus German expansion, but this course was unpopular with a German public worried about the legacy of inflation and was opposed by the powerful and independent central bank, the Deutsche Bundesbank.



[1] From 1991 the balance of payments statistics also include the external transactions of the former German Democratic Republic. [2] Including Belgium. Denmark, France, Greece, Ireland, Italy, Luxembourg, Netherlands and Portugal.

Sources: OECD *Economic Outlook*; European commission, Annual Macro Economic database.

Fig. 1: Current Accounts in Europe 1960-2010

Solving the question of the German current accounts in the European setting at first appeared to require some sophisticated and ingenious political mechanism, that would force French politicians to do more austerity than they would have liked, and Germans less price orthodoxy than they thought they needed. A political mechanism however requires continual negotiation and public deliberation, that would have been painful given the policy preferences in the two countries (and in those countries that lined up with each one of the Big Two). The increased attraction of monetary union was that it required no such drawn out political process. The operation of an entirely automatic device would constrain political debate, initiative, and policy choice.

Monetary union was thus conceptualized as a way of simplifying politics. This had been a feature of European arguments from the beginning. Robert Triffin in 1957 had showed how a problem could be reduced to its most basic level: "The significance of monetary unification, like that of exchange stability in a free market, is that both exclude any resort to any other corrective techniques except those of internal fiscal and credit policies."

The problem of current accounts grew bigger, the surpluses and deficits ever larger. The monetary union occurred after a drive to capital market liberalization, and was intended to be the logical completion of that liberalization. Current account imbalances were apparently sustainable for much longer periods – though not forever. The effects of movements in capital in allowing current account imbalances to build up to a much greater extent, and ensuring that corrections, when they occurred, would be much more dramatic, was already noticeable in the late 1980s and early 1990s, before the move to monetary union. Indeed, those large build-ups in the imbalances were what convinced Europe's policy-makers that a monetary union was the only way of avoiding the risk of periodic crises with currency realignments whose trade policy consequences threatened the survival of an integrated internal European market. The success of the early years of monetary union lies in the effective privatization of current account imbalances, so that the problem disappeared from the radar screen of policy debates. It would only reappear when the freezing up of the banking system after 2008 required the substitution of public sector claims for private claims: with that the old problem of the politicization of current account imbalances and capital flows immediately reappeared.

Europe's monetary order was in fact the outcome of global debates about currency disorder. European monetary integration appeared urgent in the late 1960s, as the Bretton Woods regime disintegrated, and in the late 1970s, when U.S. monetary policy was subject to big political pressures and the dollar collapsed.

The most decisive push for a European solution to a global problem occurred in different circumstances. When the dollar was soaring in the mid-1980s, when American manufacturing was threatened and when there appeared to be the possibility of a protectionist backlash, the finance ministers of the major industrial countries pushed for exchange rate agreement. At the G-7 finance ministers Louvre meeting in 1987 they agreed to lock their exchange rates into a system of target zones.

In practice, nothing came of that global plan, but then Edouard Balladur, the French finance minister who had largely been responsible for the Louvre proposal, came up with a tighter European scheme. When German foreign minister Hans Dietrich Genscher appeared sympathetic, Europe's central bankers were asked by the president of the European Commission, Jacques Delors, to prepare a timetable and a plan for currency union: that was the origin of the Committee that produced the detailed blueprint for monetary union.

At a global and a European level, then, policy-makers were trying to find a way around the problems and policy choices that exist in a world of free capital movements, where monetary policy is politically sensitive and exchange rate commitments are a key to trade and global integration. The problems are often treated as if they are narrowly technical: but actually, any investigation takes us beyond technical monetary and economic issues into a deeply political terrain. We may think of the critical challenge in the form of the trilemma originally posed by Mundell.

Trilemmas

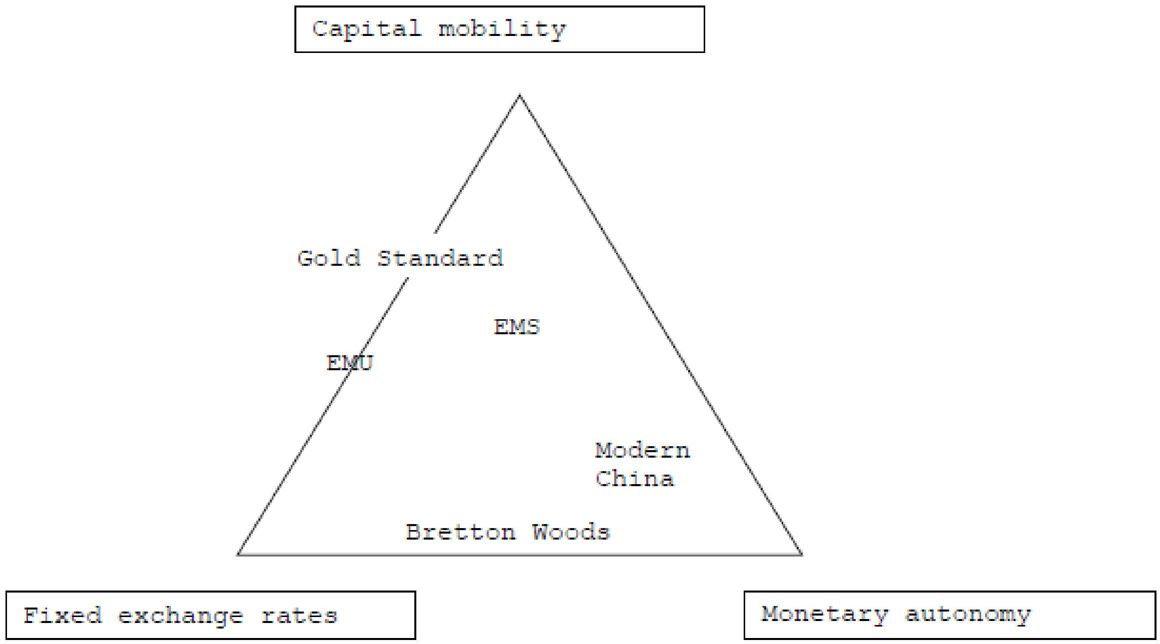
Policy trade-offs in impossible trinities or trilemmas are intrinsic to responses to globalization. The analysis of a policy trilemma was developed first as a diagnosis of exchange rate problems (the incompatibility of free capital flows with monetary policy autonomy and a fixed exchange rate regime); but the approach can be usefully extended into discussions of domestic political institutions and even into international relations.

In practice, as scholars investigating the exchange rate trilemma demonstrated, it is empirically hard to determine a pure policy stance in the trilemma: there are varying degrees of commitment to a fixed exchange rate regime, varying degrees of openness to international capital, and varying extents of monetary autonomy (Obstfeld Shambaugh Taylor 2005). In practice, policy stances fall in the space between the corner positions. That was incidentally true of theological discussions of the trinity too: philosophers reasoned that the mysterious interaction depended on equal closeness (or distance) to the three entities: thus truth is in the center of the trinity (as Raphael depicted it in a stunning visual form). The discussion of the modern trilemma thus serves as a Weberian ideal type rather than an exposition of the world as it actually is (for a fuller exposition see Bordo and James 2015). The same reservation applies to the other sorts of trilemma identified below.

1. The macro-economic trilemma

The first trilemma is undoubtedly the most familiar of the four examined here. Padoa-Schioppa (1982) reformulated Mundell's (1963) proposition as the "inconsistent quartet" of policy objectives by bringing in commercial policy, another central part of the globalization package: free trade, capital mobility, fixed or managed exchange rates, and monetary policy independence. In both the Mundell and the Padoa-Schioppa formulation, the impossible choice provided a rationalization for building a harder or more secure institutional framework for the securing of cross-border integration. Both were major architects of the process of European monetary union. They justified this step of further integration on the grounds that the exchange rate was a useless instrument, the monetary equivalent of a human appendix or tonsils, that consequently could be usefully and painlessly abolished. Some countries, however, continued to regard the exchange rate as a useful tool for obtaining trade advantages.

The policy constraint following from free capital movements has recently been posed in a more severe form by Rey (2013), who shows that in a globalized world of free capital movements, monetary policy is limited even with flexible or floating exchange rates. A choice to have a floating exchange rate thus does not give a free pass to monetary policy.



The logic of the original Mundell trilemma thus points either in the direction of closer cooperation, including perhaps political arrangements that constrain domestic choices; or toward capital controls as a way of rescuing national policy autonomy.

2. The financial stability trilemma

The formulation of the classical macro-economic trilemma says little about the sequencing of policy measures. The original Mundell formulation implies that policy formulation began in an idealized nineteenth century world, in which capital mobility and a fixed metallic exchange rate are taken as given, and central banks mechanically responded to gold inflows or outflows by loosening or tightening monetary policy. The third element, of a flexible monetary policy, is necessarily ruled out if the "rules of the game" are followed. Indeed, almost no nineteenth century analyst depicted monetary policy as a discretionary instrument.

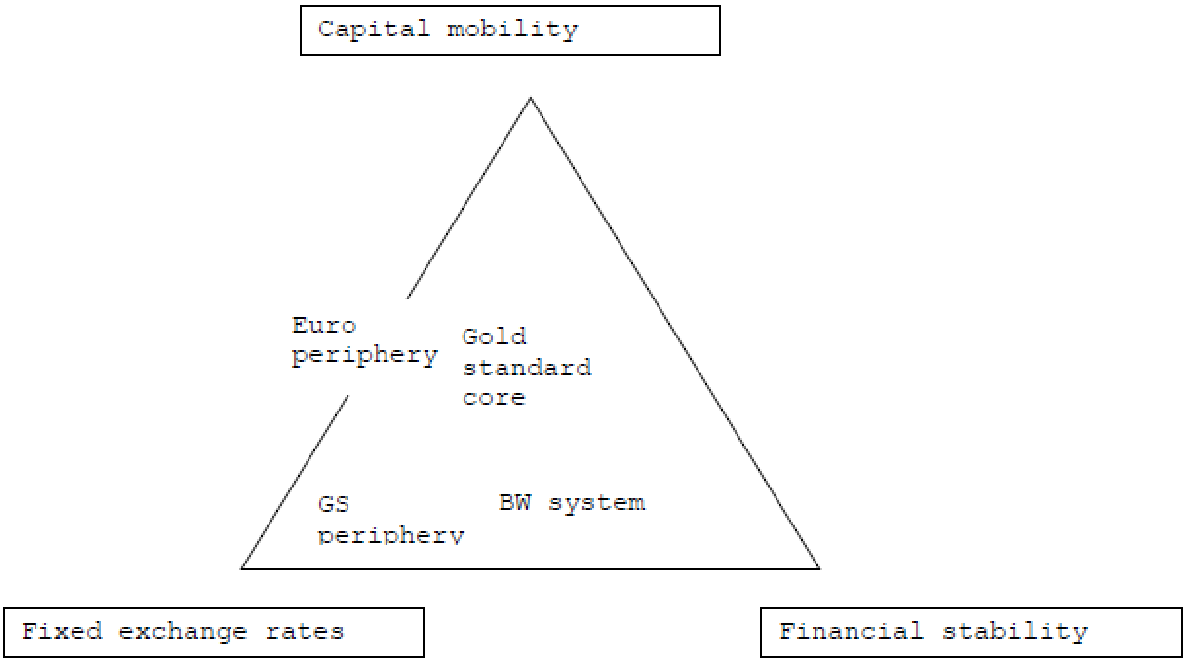
Why did the gold standard appear attractive? Countries went onto the gold standard, as later they engaged in fixed exchange rate arrangements, mostly in the hope that that would enhance credibility, provide a "good housekeeping seal of approval" (Bordo Rockoff 1996), and consequently bring substantial capital inflows. Making the exchange rate stable became a tool that might be used to compensate for an inadequate availability of domestic capital. The beneficial effect of an inflow of foreign capital would only be realized if the domestic financial system started to intermediate the new flows; hence domestic financial expansion or the beginning of an expansive financial cycle was a consequence of the choice of regime.

This domestic financial expansion often (but not always) occurred on a rather inadequate institutional basis. In the underdeveloped financial system, there was little experience in managing credit allocation and in running banks. Countries wanted to go onto the gold standard in the nineteenth century, or to move to capital account openness in the late twentieth century, in order to build up their financial institutions. A result of the financial inflows was thus often a rising vulnerability as the domestic institutions were rather fragile. But as long as the inflows continue, there is often a false confidence that additional capital is indeed producing a more stable and mature financial system.

There was a learning process about finance that set in after the capital inflows, and it clearly took time for countries to adapt their institutions to the capital inflows and risks of crises. But in many cases, countries failed to adapt efficiently and the capital flows simply reinforced existing rent-seeking and corrupt institutions (Calomiris and Haber 2014). In these cases, capital inflows increased rather than decreased the vulnerability.

The interplay of international capital movements and weak banking system in emerging markets has provided a constant source of major international financial crises. Well known examples include the United States in the 1830s, Argentina in the late nineteenth century, Central Europe in the 1920s, some emerging Asian countries in the 1990s, and Southern Europe in the 2000s. In many, but not all cases, the surge of capital also produced fiscal crises in the aftermath of an over-issue of state debt, driven by bailouts of insolvent banks or by guarantees (explicit or implicit). There was often then an attempt to compensate for financial stability by providing government guarantees, which in the end involved unfulfillable promises and made the financial instability greater.

Opening the capital account in a fixed exchange rate regime is hard to reconcile with financial stability. This logic provides the second trilemma.



3. The political economy trilemma

After a period of financial opening, the consequent development of financial imbalances may strain the political system. States (whether they are autocracies or democracies) initially like the benefits that flow from open capital markets. Democracies, in which governments are responsive to short term demands of voters, are also likely to want to set monetary policy independently. They need to work out a trade-off between present monetary autonomy and the ability to attract inflows. In addition, both policies encounter time consistency problems. First, the monetary stimulus will only bring immediate benefits if it is unanticipated; if there is an expectation that the behavior is repeated, agents will build the future into their responses to the stimulus. The stimulus relies on the *non-continuation* of the policy. Second, by contrast, the capital inflows may also bring short term effects, but if they are abruptly curtailed, investment projects will be uncompleted and repayment will be problematical. The benefits rely on the expectation that the flows *will* continue. But states, especially democratic states, find it hard to commit to policies that will really lock in the institutional basis on which the long term inflows can occur: there is much rather an incentive to derive simply short run advantages (such as those following from monetary stimulus), and leave longer term problems to successor governments.

When and while the inflows continue, and the financial imbalances build up, the system appears politically attractive and stable. Indeed, political parties will often make compromises to support governments that can promise the institutional reforms needed to allow the inflow of capital to continue. Since the inflows are the result of general external financial conditions, they should not be interpreted as a response to particularly suitable or well-designed economic policies. But that is the way that they are in practice interpreted by electorates which view economic success as a key determinant in their choice (Kayser 2009). In practice, large inflows may weaken effective economic policy-making, because it relaxes the constraints under which governments operate, and because the generally rising tide means that signals are suppressed that might indicate problematic features of the economy (Fernández—Villaverde Garicano Santos 2013). This view has even become part of the official mindset of Europe, for instance when the important Four Presidents' Report of December 2012 notes that "Macroeconomic imbalances tend to build up slowly and are often masked by favourable economic growth and liquidity conditions." Capital flows thus may suppress basic signals about government effectiveness that are essential to the functioning of democracy, as voters are not correctly informed about the level of competence of their governments. Warning against the potentially deleterious effects is left to unpopular outsiders, who make Cassandra-like prophecies. The insiders who benefit from the inflows ridicule the Cassandras.

However, when the financial strains appear, and with them the costs of the engagement with openness, political parties no longer wish to be associated with the consequences. In the new circumstances, voters will blame the established parties and flock to anti-system or populist parties. The populists may be left or right; in fact, most anti-system parties try to fuse left and right wing critiques of the "system". The left wing critique is that the burden of crisis adjustment falls unequally on the poor. The right wing critique emphasizes that the adjustment benefits foreign creditors and derogates national sovereignty. The democratic principle is simply recast as a defense of national sovereignty.

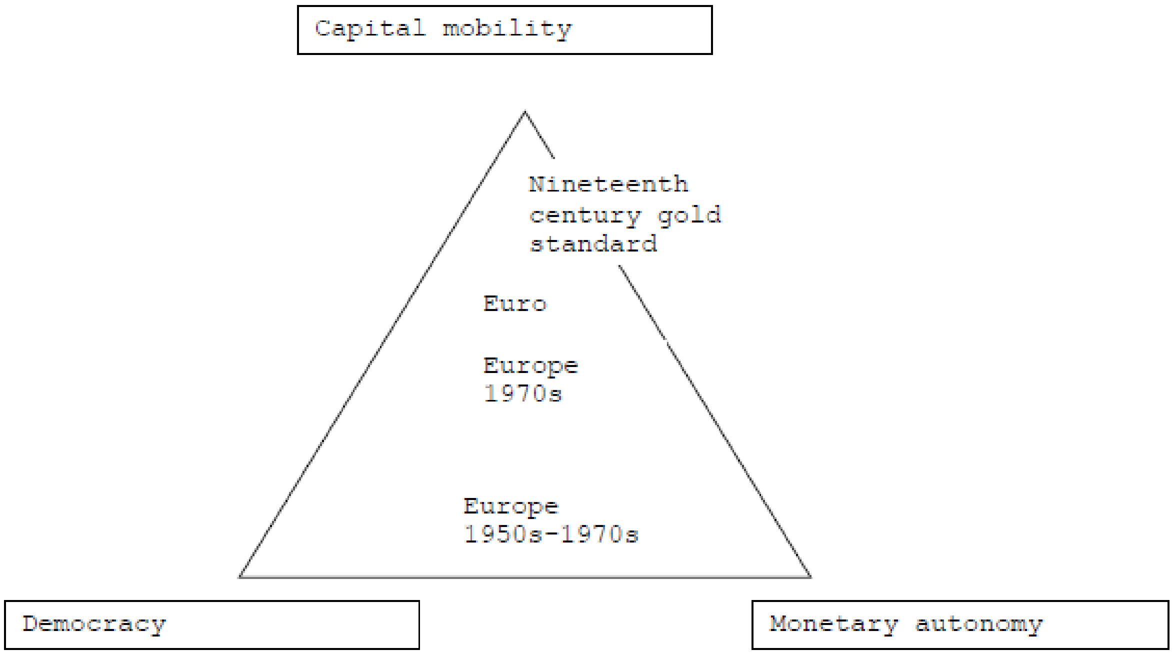
The possibility of populist revolts against international openness was less at the time of the classic gold standard. Then outside investors argued that the extension of constitutional rights would protect investors' rights (Ferguson 1999). The class then represented in parliaments owned assets: subjecting policy to parliament reduced the possibility of creditor expropriation. But as the franchise was extended, parliaments came to represent groups that benefited from state transfer payments, in other words alternative claims to the requirement to service debt. The experience of the first major cycle of the political process in which democracy turned against creditors, in the Great Depression, led Polanyi (1944) to make the famous argument that the gold standard and analogous regimes were impossible in a democratic age.

The memory of the politics of the turning against creditors during the Great Depression faded with the credit supercycle that emerged slowly in the second half of the twentieth century. The argument then began to resurface again primarily in arguments about the compatibility of globalization with democracy in emerging markets (Eichengreen 1996). Rodrik (2000 and 2007) formulated the point in this way as a general argument about the incompatibility of hyperglobalization, democracy and national self-determination: "democracy, national sovereignty and global economic integration are mutually incompatible." He presented the European Union as the best template of a new form of global governance with supranational rulemaking (Rodrik 2011). After the Great Financial Crisis, the same problems and policy dilemmas appeared in rich industrial countries, and globalization appeared vulnerable again.

Democratic politics can be thought of as evolving two sorts of operation: the formulation of laws based on general principles of conduct, and redistribution of resources. The capacity to redistribute is limited if there is a large cross-border mobility of factors of production: capital is most obviously mobile, and escapes if rates of capital taxation are too high; but the same process may also hold true in the case of taxation of high incomes, and income earners will try to operate in a different national and tax setting. Even the capacity to formulate general laws may be limited, in that incompatible principles in different countries may produce anomalies or loopholes, and possibilities for forum-shopping.

Politicians' only way of explaining their position in hard times, when they demand sacrifices of their voters, is often to say that their hands are tied. While that may be a plausible argument for very small countries, the larger the country, the less compatible this stance is with the idea of national sovereignty. Consequently, the demand for an enhanced national sovereignty appears as a frequent response to setbacks, and even small countries may rebel. As Greece's flamboyant radical finance minister Yanis Veroufakis put it in 2015: "The notion that previous Greek governments signed on the dotted line on programmes that haven't worked, and that we should be obliged to just follow that line unswervingly, is a challenge to democracy." (*Financial Times*, February 2, 2015).

The third trilemma may be formulated as the incompatibility of capital flows, independent monetary policy, and democracy. It poses a severe problem for people who believe that a major area of policy in a modern state should be capable of being decided by a democratic process.



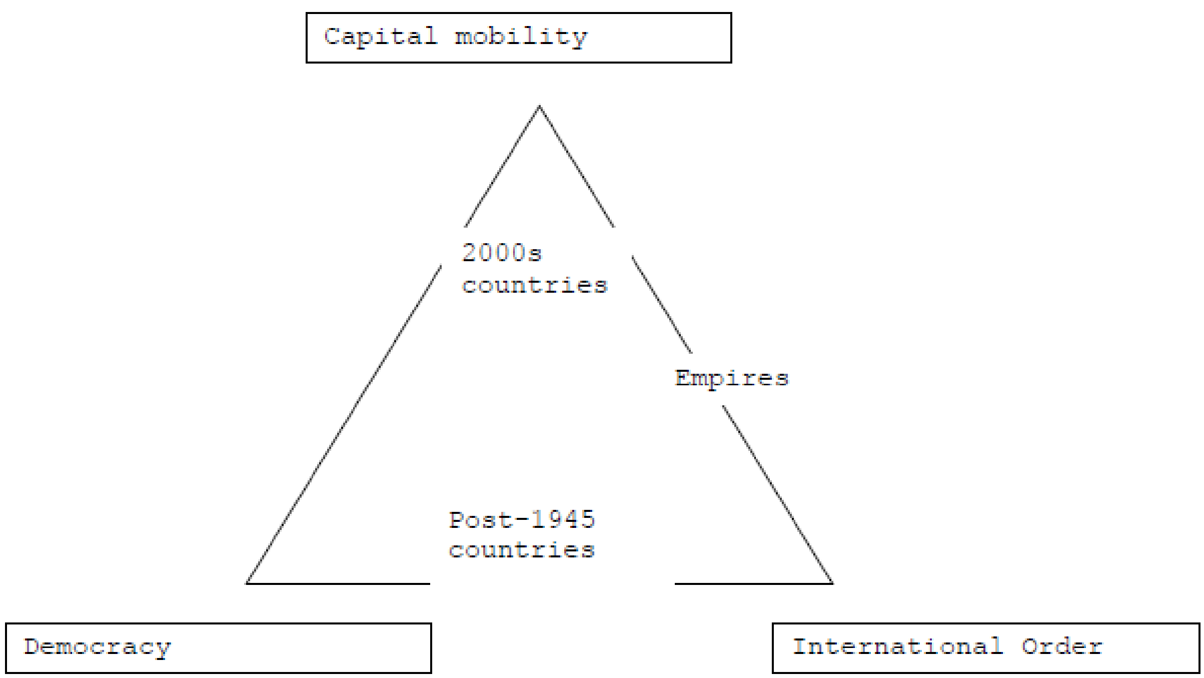
4. The international relations trilemma

Democracies like international order, when it helps them to attract beneficial capital inflows. But both the capital mobility (as we have seen) and the limits imposed by international order narrow the scope for democratic politics.

The tying hands argument in regard to ensuring that democratic decisions were compatible with a longer term framework of stability was frequently presented in the form of treaties or security arrangements. Often the reassurance that creditors needed in order to convince them to lend was political rather than simply a monetary commitment mechanism (such as participation in the gold standard, an exchange rate mechanism, or the monetary union). Alliance links offered to investors the security that creditor governments would put pressure on banks to continue lending, and hence reduced the likelihood of sudden stops. The search for credibility might lead to a security commitment, and countries would seek ties with powerful creditor countries because of the financial benefits. This kind of argument about the security bulwark that locks in capital movements applies to both democratic and non-democratic regimes.

In addition, in democratic societies the redistributory impulse generated by the political process may – especially when the limits of domestic redistribution become apparent – translate into a wish to redistribute the resources of *other* countries. The burden of an unpleasant adjustment could conceivably be shifted onto other people – who are outside the national boundary and thus outside the political process. It is this impulse (Let the others pay!) that is restrained by treaties and security commitments. An alliance system, or closer political union (as in modern Europe) helps to restrain destabilizing democratic impulses, in which one country's democratic choices are confronting the voting preferences of other democracies. In a world in which capital links do not bring mutual gains, democratic politics in each country look as if they are targeted against other countries. Veroufakis again provides a striking instance of this analysis when he referred to lessons from ancient Greece and its warring states: "Sometimes the larger, powerful democracies undermined themselves by crushing the smaller ones." (*Financial Times*, February 7, 2015)

The fourth trilemma can thus be formulated: that capital flows, democracy, and a stable international political order cannot be reconciled with each other.



The multiple trilemmas may not pose the apparently impossible policy straitjackets which they seem to represent. In practice, there are always intermediary solutions: in the original macro-economic version, there is never pure capital mobility, or pure monetary policy autonomy. Some restrictions on capital mobility – even the home preference of investors, or increased macroprudential controls on banking – gives some room for policy maneuver. Policy-makers are always making practical trade-offs.

Such an approach also indicates how practical responses to the other three trilemmas are likely to evolve. Capital mobility is central to all the trilemmas, and so it might be tempting to recast the story in terms of a conclusion that capital mobility is simply not worth it (Stiglitz 1998, Bhagwati 2004). In practice, the historical experience shows that such a turning away from capital mobility is not that easy, and that it carries an economic and political cost. Capital mobility is constitutive of modern globalization. It is the apple in the Garden of Eden: irresistibly attractive but causing constant problems and misery. Once tasted, it is hard to spit the apple out again.

Multilateral institutions can be thought of as a commitment mechanism that improves the quality of democracy by limiting the power of special interest organizations that most frequently make the appeal to an apparent free lunch, and by protecting individual rights (Keohane Macedo Moravcsik 2009). The international relations trilemma is thus potentially solvable in the same way: through the evolution of a longer term framework of stability. International commitments – the foundation of a stable international order – are often ways of locking in particular domestic settlements and ensuring a longer term framework of stability. The Bretton Woods international regime is thus often rightly regarded as a mechanism by which the United States internationalized the New Deal settlement (Ikenberry 2001).

Thinking about a broader concept of democracy in an international setting reduces the political logic of a zero-sum-game mentality in which one country's gains can only be achieved through losses imposed on with others. A larger security umbrella can therefore provide a framework for a system of rules about capital movement and a framework for stability that would limit or circumscribe the destructive capacity of capital mobility fueled credit booms.

But such grand compacts – of which the best historical example is the 1944-1945 settlement that included Bretton Woods – are hard to achieve without a substantial measure of fear. The equivalent today of the time pressure that existed at the end of the Second World War is an urgent but also uncontrollably global crisis. The sad lesson of Bretton Woods is that things need to be extremely dangerous before a political dynamic of reform develops. It may be that today's world, for all its anxieties, is simply not obviously dangerous enough and that policy-makers are too secure about the permanence of the globalization phenomenon.

Negligent Planning?

The Europeans planning their solution to the coordination problem were undoubtedly over-confident (they also could not really have predicted how large the financial system moving vast amounts of money around would become). It has now become fashionable to say that the moved of the early 1990s were undertaken in a mood of carelessness (*Sorglosigkeit*), in Otmar Issing's phrase (2012), or that Chancellor Kohl was neglectful (*leichtsinnig*) – according to Hans Peter Schwarz's monumental biography (2012). Kohl promised a political union: on November 6, 1991, he told an ecstatically applauding German parliament that "one cannot repeat it often enough: political union is the indispensible counterpart of the economic and monetary union." But when the governments negotiated a few weeks later in Maastricht, there were very concrete plans for the monetary union, and for the political union – none at all. Does that really mean that everyone was just unbelievably careless, and that, in the same way as the British empire was allegedly acquired in a fit of absent-mindedness, the European dream was wafted on a post-unification euphoria?

In fact, the planning for monetary union was unbelievably sober and meticulous. In the debates of the central bankers' group that Delors chaired in 1988-89, before the fall of the Berlin Wall, two really critical issues were highlighted: and they were the ones that really mattered.

The first concerned the fiscal discipline needed for currency union. An explicit discussion took place as to whether the capital market by itself was enough to discipline borrowers, and a consensus emerged that market discipline would not be adequate and that a system of rules was needed. The influential Belgian economist from the BIS, Alexandre Lamfalussy, a member of the Delors Committee, brought up cases from the U.S. and Canada as well as from Europe where cities and regions were insufficiently disciplined. Jacques Delors himself at this time appropriately raised the prospect of a two speed Europe, in which one or two countries might need a "different kind of marriage contract." (James 2012) There is a tendency for fiscal policy to be pro-cyclical, particularly when the cycles are driven by property booms, in that enhanced fiscal revenue from real estate exuberance prompts politicians to think that the increase in their resources is permanent. But the pro-cyclical fiscal element may be magnified in a currency union.

The need for fiscal discipline arising from spillover effects of large borrowing requirements is a European issue, but it is clearly not one confined to Europe alone. In emerging markets, this problem was identified after the 1997-8 Asia crisis, and the problem of major fiscal strains became primarily one of the industrial world – and especially of the United States. An appropriate response would involve some democratically legitimated mechanism for limiting the debt build-up, as in the Swiss debt brake (*Schuldenbremse*) which was supported by 85 percent of voters in a referendum. The EU moved toward such a position in 2010 with the adoption of the so-called Six Pack designed to enhance the Growth and Stability Pact.

The second flaw in the European plans identified by the central bankers as they prepared monetary union was much more serious. In the original version of a plan for a central bank that would run a monetary union, the central bank would have overall supervisory and regulatory powers. That demand met strong resistance, above all from the German Bundesbank, which worried that a role in maintaining financial stability might undermine the future central bank's ability to focus on price stability as the primary goal of monetary policy. There was also bureaucratic resistance from existing regulators. The ECB was thus never given overall supervisory and regulatory powers, although a remnant of the initial discussions survived in Article 25.2 of the ECB statute (permitting the ECB to perform specific financial supervision tasks if asked to do so by the European Council); until the outbreak of the financial crisis in 2007-2008 no one thought that was a problem.

By 2010, however, it was clear that there was a very big problem. There had previously been a stream of private sector money from north to south in Europe. The flows of capital had important effects on wage rates, differential inflation levels, and hence on the position of competitiveness. In the monetary union, there was no policy tool to limit inflation through a national monetary policy, and hence in the borrowing countries (now often referred to as the periphery), interest rates were lower than they should have been had a Taylor rule been practiced. Indeed Ireland and Spain, where the biggest property booms occurred, had negative real rates for substantial periods of the 2000s. After the financial crisis, the sustainability of the flows was threatened by banking crises in the periphery, and the long-developing competiveness positions now looked like an argument that the debt levels (private or public) were unsustainable. Growth prospects that looked brilliant before the crisis no longer existed; so there was a debt servicing problem. That in turn seemed to endanger the banks, including particularly big north European banks that had already taken losses on U.S. sub-prime investments. Funding dried up as U.S. money market funds no longer wished to buy paper issued by European bank borrowers. One of the most obvious lessons of the first phase of the financial crisis was that the failure of big banks would have disastrous consequences. That mantra of the policy technocrats produced its own pushback among many voters and politicians: shouldn't the banks bear some of the burden. At Deauville in October 2010, Chancellor Merkel and President Sarkozy agreed that there should be PSI, Private Sector Involvement.

Far from reassuring markets, the move to make private lenders bear some of the cost of past mistakes made for greater nervousness – much more so, indeed, as Jean-Claude Trichet of the ECB had insistently warned. For a decade, markets had interpreted the no-bailout clause of the Maastricht Treaty as making default impossible. It now seemed to be encouraged by the official sector. After Deauville an unhappy mechanism was created which increased the potential for large bank losses and heightened market nervousness. The official sector put in more money, in effect a substitution for the absent private sector flows of the pre-crisis era; and as that occurred and as the public credit was given seniority, the problems of the private sector debt increased rather than diminished.

Who ultimately is to absorb losses from very large banking sector problems? Do states, which rely on borrowing because they cannot increase taxes, have the capacity to do that when the financial sector is failing? It looked as if only monetization of debt by the central bank could solve the problem in the short run, but in the long run that would be a solution involving a write off of debt by means of an inflationary process.

In July 2012, the crisis took a new phase, and the ECB calmed the markets with the announcement of OMT – not so much the actual practice of bond purchases, but the willingness of the central bank to step in to eliminate risk premia stemming from fear of a currency union break-up. In the words of Mario Draghi: "To the extent that the size of these sovereign premia hamper the functioning of the monetary policy transmission channel, they come within our mandate. Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. Believe me, it will be enough." But that commitment only made sense because official proposals for Banking Union had already emerged from the European Council and Euro area summit meeting on June 28-29, 2012. (The Commission then set out more details in September 2012, including a Single Supervisory Mechanism (the SSM).)

The burden of policy innovation now has shifted to governments and to the political process. The test for this new phase arises out of a combination of radical popular unrest and electoral or political uncertainty. There is a need for a new flexibility, but that is hard because of apparently hard quasi-philosophical disagreements. The process of European integration is full of the same kinds of misunderstandings and misinterpretations that often characterize relationships between men and women. According to an American popular psychologist who wanted to provide a "practical guide for improving communication and getting what you want in your relationships," men and women are from different planets (Gray 1982). The book was wildly successful, with seven million copies sold. His title was adapted to international politics by Robert Kagan, who argued that Americans were from Mars and Europeans from Venus. "It is time," he said, "to stop pretending that Europeans and Americans share a common view of the world, or even that they occupy the same world." (Kagan 2003) Europe now has discovered that it has its own version of mutual incomprehension. At the September 2014 G-20 Finance Ministers meeting at Cairns, Australia, US Treasury Secretary Jacob Lew talked about "philosophical differences with our friends in Europe" before urging Europeans to do more to boost their anemic growth rate.

The basic elements of the contrasting philosophies can be delineated quite simply. The northern European vision (let us call it the Baltic version) is about rules, rigor, and consistency, while the southern (Mediterranean) emphasis is on the need for flexibility, adaptability, and innovation. It is Kant versus Machiavelli. Economists have long been familiar with this kind of debate, and refer to is as rules versus discretion.

Some more specific policy preferences follow from the general orientation: the rule-based approach worries a great deal about the destruction of value and insolvency, and about avoiding bailouts that will set a bad example and encourage bad behavior among other actors (economists call this the moral hazard problem). The discretionary approach sees many economic issues as temporary liquidity problems, that can be solved easily with an injection of new lending, liquidity. Here the provision of liquidity is costless: there is no bailout, no incurred loss, and in fact the knock-on effects make everyone better off. There are in this vision, multiple possible states of the world, multiple equilibria, and the benign action of government and monetary authorities can shift the whole polity from a bad situation into a good one. To this, the long-faced adherents of the moral hazard view point out the costs that will pile up in the future from the example that has been provided. The rule-based view is concerned with price stability; the discretionary approach is in love with an idea of managing the economy.

Can there be a way of reconciling these perspectives, of introducing some flexibility to the principle of rules? In the *Nicomachean Ethics* (5x), Aristotle set out the logic of looking for a malleable rule: he thought as an analogy of the lead (rather than iron) rule that sculptors on the island of Lesbos used to cut curved lines: "When the law speaks universally, and a case arises on it which is not covered by the universal statement, then it is right, where the legislator fails us and has erred by oversimplicity, to correct the omission-to say what the legislator himself would have said had he been present, and would have put into his law if he had known." In this spirit, here are some proposals for greater flexibility.

1. Currency Innovation

In 1992-3, the EMS crises almost destroyed the path to the Euro, but the crisis was resolved by instituting greater flexibility: through wider (15 percent) margins in the exchange rate bands. The modern equivalent to the band widening of 1993 would be keeping the Euro for all members of the Eurozone but also allowing some of them (in principle all of them) to issue – if they needed it – national currencies. The countries that did that would find that their new currencies immediately trading at what would probably be a heavy discount. California adopted a similar approach at the height of the recent financial crisis, issuing IOUs when faced by the impossibility of access to funding. The success of stabilization efforts could then be read off from the price of the new currency. If the objectives were met, and fiscal stabilization occurred and growth resumed, the discount would disappear. In the same way, after 1993, in a good policy setting, the French franc initially diverged from its old level the band but then converged back within the band. Such a course would not require the redenomination of bank assets or liabilities, and hence would not be subject to the multiple legal challenges that a more radical alternative would encounter. There would also be the possibility that the convergence did not occur. The two parallel currencies could then coexist for a very much longer time period. This is not a novel thought. It was one of the possibilities that was raised in the discussions on monetary union in the early 1990s, that there might be a common currency but not necessarily a single currency.

2. Minimizing Financial Vulnerability

What is now termed a banking union – that is common European regulation with some fiscal capacity for resolution in the case of failed banks – is a very belated but necessary completion of the monetary union. Even this step is only partial, and has excited a great deal of opposition from Germans who do not want to bailout south European banks. Thus while there is European supervision, the resolution process is predominantly national. Critics have correctly identified the problem, that some sort of permanent fiscal mechanism is required in order to pay for the bailouts and thus in fact implies a move to a real political union which regularly redistributes resources.

In the analysis of the trilemmas, financial vulnerability provided the key linkage by which instability is transferred from the primarily technical domain of currency arrangements to the large fundamentally political problems of democracy and the international order. Taking the fangs out of a dangerous financial system – for instance moving along the path from a bank-based system to a greater orientation toward capital markets – is thus an important element in rectifying flaws.

3. Transfers without Politics

Problems of transfers in a large unit are at the heart of the political process of building federations or federalism. The better way of discussing transfers within a large and diverse political order is to think of them as individualized or personalized. In particular, a European-wide social security system would not only be a logical completion of the labor mobility requirements of the single European market. It would indicate that the insurance principle is not just one which it is appropriate to apply to financial institutions. It would provide an important buffer in that booming areas would pay in more, and shrinking areas would draw out more – without these payments going through government bodies and appearing as transfers from North to South – whether in a country such as Italy or in the whole of the European area. Defusing the political problem requires less statehood, rather than necessarily requiring the erection of a European super-state. But like the problem of designing better bank insurance, it also depends on making more adaptable labor markets so that the threat of large-scale unemployment swamping and destroying the insurance system is minimized.

4. Thinking Globally

The management of cross-national problems and the containment of nationalistic quarrels certainly require technical fixes. But it also needs more. Disaster: there is plenty of potential for it! The core of the argument presented this evening has been the linkages between currency and monetary and large political issues. The fatal loops that tie badly managed currencies to the destruction of the international economic and political order inevitably conjure up memories of the disasters of the 1930s, the Great Depression and the drive to war. Currency wars are now making their reappearance.

The rise in the exchange rate risks choking off an incipient strong US recovery. Unusually, Federal Reserve officials now sound worried about the currency. The unpleasantness created by the strong dollar additionally interacts with the vulnerabilities of the political system with a President committed to a significant trade agenda faced by a hostile and increasingly obstructionist Congress. The fierce debates about dispute settlement in the Trans Pacific Partnership as well as in the Transatlantic Trade and Investment Partnership play into the hands of trade skeptics. We should remember that there can be global disaster, as well as merely European disaster.

A politically legitimate mechanism for solving the problem of international adjustment was the unsolved problem of the twentieth century. In Europe and elsewhere it generated enormous conflict. There is an urgent need for ways of constructing currency stability that go beyond the narrow framework suggested by the OCA literature. Fixing this issue is a European but also a global agenda for the twenty-first century.