Alternative interpretations of a stateless currency crisis

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Abstract - A number of economists warned that a political union was a prerequisite for a viable currency union. This paper disputes the feasibility of such a political union. A fully-fledged federal union, that would likely please peripheral Europe, is impracticable since it implies a degree of fiscal solidarity that just does not exist. A Hayekian minimal federal state, that would appeal to core-Europe, would be refused by peripheral members, since residual fiscal sovereignty would be surrendered without any clear positive economic and social return. Even an intermediate solution based on coordinated Keynesian policies would be unfeasible, since it would be at odds with German 'monetary mercantilism'. The euro area is thus trapped between equally unfeasible political perspectives. In this bleak context, austerity policies are mainly explained by the necessity of readdressing the euro area BoP crisis. This crisis presents striking similarities to traditional financial crises in emerging economies associated with fixed exchange regimes. Therefore, the ECB's delayed response to the sovereign debt crisis cannot be seen as the culprit of the euro area crisis. The ECB's monetary refinancing mechanisms, Target 2 and the ECB's belated OMT intervention impeded a blow-up of the currency union, but could not solve its deep causes. The current combination of austerity policies and moderate ECB intervention aims to rebalance intra-eurozone foreign accounts and to force competitive deflation strategy.

Keywords: European crisis, political and currency unions, ECB, balance of payments crisis, mercantilism

JEL classification: E11, F33, N14

> An economic transaction is a solved political problem. Economics has gained the title of queen of the social sciences by choosing *solved* political problems as its domain (Lerner 1972, p. 259).

1. Introduction*

A number of economists of different persuasions, including Nicholas Kaldor, Wynne Godley, Charles Goodhart and Martin Feldstein, warned that political and fiscal union was a necessary premise for a viable monetary union. However, creation of the European Economic and Monetary Union (EMU) was actually influenced, inter alia, by the then prevailing New Classical Macroeconomics doctrine of the separation of monetary from fiscal policy. For argument's sake, we use Goodhart's (1998) terms, Chartalist and Metallist, respectively, for the two views. This distinction is particularly relevant for assessing two alternative perspectives on the nature of the euro area crisis. On one hand, there are those who argue that the crisis is akin to a traditional balance of payment (BoP) crisis typical of fixed exchange rate regimes. In spite of their different theoretical background, many economists support this position, including Werner Sinn, Roberto Frankel, Peter Garber, Carmen Reinhart, Michal Bordo and, presciently, Fernando Vianello and Massimo Pivetti. Leading European mainstream economists have recently defined it 'consensus view' (Baldwin et al. 2015). On the other, there are those like Paul De Grauwe and Marc Lavoie who attribute the crisis to obstacles hindering resolute intervention by the European Central Bank (ECB). The ECB's belated intervention aggravated the fiscal crisis of peripheral euro area states, leaving fiscal adjustment to harmful austerity policies. According to this view, moreover, the existence of Target 2 (T2), a payment system with some analogies to Keynes's International Clearing Union (Cesaratto 2013a; Bordo 2014; Lavoie 2015a), protected the euro area from a classic balance of payment crisis. In this paper, I argue that although a proper BoP crisis cannot happen in a viable sovereign monetary union, it is still possible in a flawed, stateless monetary union like the euro zone, possibly concealed by T2 (Mayer 2011, Pisani-Ferry 2012).[1] In this regard, I also show that more timely and resolute central bank intervention, as we saw in the U.S., was impossible in the absence of greater political and economic union and related federal institutions

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(particularly a pro-active federal budget policy counterbalancing a stricter check on local budgets and supportive of a banking union). I argue that German 'monetary mercantilism' (Holtfrerich 1999; 2008) – exploiting fixed exchange-rate regimes by actively pursuing a lower domestic inflation rate – is not the only major obstacle to such a union. Another was European ruling class endorsement of the mainstream credo that monetary policy should be detached from politics and fiscal policy, leaving the task of full employment to labour market flexibility (Issing 2002). In this sense, the euro lacked a state, but not a deliberate political design. A further obstacle is that a parliament of a hypothetical European Federal Union with a significant command over federal resources would presumably soon be divided according to national interests, undermining the political cohesion of the Union. As suggested by Hayek (1939), this would leave a minimalist federal state, one that just fixes the rules, as an obligatory choice, a solution favoured by ordoliberals and conservative European élites. Inspired by Pivetti (2013a), I interpret the euro as part of a larger design to deprive national working class movements of their natural environment, i.e. the national sovereign state. As a result, the Metallist view prevailed over the Chartalist. In the long run, however, a stateless currency may not be socially and politically sustainable, vindicating the Chartalist view.

Section 2 recalls some prescient contributions about the priority of political and fiscal over monetary union, precedence sustained by economic logic and historical experience. Section 3 explains the role of the neoclassical restoration of the 1970s in setting the stage for a stateless euro. Section 4 points out some analytical deficiencies of the Metallist neoclassical background. Section 5 illustrates why the eurocrisis is a BoP crisis and why T2 marks a difference, albeit not substantial, with respect to a classic balance of payment crisis in a fixed exchange regime. Section 6 reviews the reasons of those who regard T2 as a mechanism that drastically differentiates the euro area from a fixed exchange regime and related BoP crises, and attribute the outbreak of the crisis to delayed and timid intervention of the ECB. Section 7 explains that more effective ECB intervention would require an American-style institutional framework. In this regard, I will return to the economic and political reasons why such a union is out of sight in Europe. In the conclusions, I sum up the logic of the paper. An appendix introduces a few technical aspects of T2.

1. State-based monetary unions: the Chartalist view

Numerous prescient economists of otherwise different persuasions were sceptical of the European monetary unification.[2] Although this is well known, a short review is useful here. Scepticism was evident in early contributions by Meade (1957), Mundell (1961)[3] and later Fleming (1971), when discussions about monetary unification were already in the air. Kaldor (1971) had the advantage of an earlier European Commission Plan (the Werner Report), while Godley (1992), Feldstein (1992) and Goodhart (1998) were able to discuss the final plan contained in the Maastricht Treaty.

Kaldor (1971, p. 204) points out that the 'harmonization' of social rights in the then European Community, asserted by the Werner Report, implied a redistribution of tax revenues among member countries, lest weaker members fall behind due to higher taxation. This redistribution presupposed a (democratic) political union, which however entails a will to reduce regional divergence, since 'growing inequalities between the different countries' were bound to break up the Union 'in a relatively short time' (ibid, p. 205). However, support for what was later known as a 'transfer union' in the German mass media, was likely to be high in weaker countries and low among prosperous members. Kaldor also had macroeconomic policies in mind when he warned that: 'Monetary union and Community control over budgets will prevent a member country from pursuing full employment policies on its own – from taking steps to offset any sharp decline in the level of its production and employment, but without the benefit of a strong Community government which would shield its inhabitants from its worst consequences.' (ibid, p. 206). The prescient conclusion was that 'it is a dangerous error to believe that monetary and economic union can *precede* a political union or that it will act (in the words of the Werner report) "as a leaven for the evolvement of a political union which in the long run it will in any case be unable to do without". For if the creation of a monetary union and Community control over national budgets generates pressures which lead to a breakdown of the whole system it will prevent the development of a political union, not promote it' (ibidem).[4] Commenting on the Maastricht Treaty, two economists of otherwise opposite convictions, Godley (1992) and Feldstein (1992), shared concern about countries losing monetary, fiscal and foreign exchange sovereignty, being reduced to the state of local authorities or colonies (Godley 1992), without a federal authority being responsible for full employment. Indeed, in the Treaty, 'anti-inflationary policies' clearly prevailed. Moreover, both authors criticized those who believed that the monetary union would abolish BoP problems, unless of course 'federal budgeting arrangements are made which fulfil a redistributive role … as Professor Martin Feldstein pointed out (…), this argument [that BoP problems would disappear] is very dangerously mistaken. If a country or region has no power to devalue, and if it is not the beneficiary of a system of fiscal equalisation, then there is nothing to stop it suffering a process of cumulative and terminal decline …' (ibid). Similar views were held by Vianello (see Cesaratto 2013a, pp.363-366) and Pivetti (1998, p. 8). The latter predicted that in the flawed EMU, as in the European Monetary System (EMS), the preservation of BoP equilibria would fall to the weaker countries, who would pay an interest rate differential to cover the persistent 'secession risk' (what Draghi in a famous speech of 2012 called convertibility risk), further reducing creditworthiness and imposing additional deflationary measures:

> without prior constitution of a unified polity and a common balance of payments, there is no monetary regime, established among the potential participants in EMU, that could be regarded as irrevocable. Indeed, without political union and the consequent establishment of a common balance of payments, the credibility of any state's continued participation in a fixed-exchange rate or a single- currency agreement would continue, ultimately, to depend on the course of its current account.
> Continued participation in the agreement would lack credibility if, for example, the current account tended to display a deficit whenever unemployment fell, irrespective of whether domestic inflation remained in line with that prevailing among the other member states. An interest rate differential would then have to be maintained, and it would have to be sufficiently large to compensate for the risk of secession and to keep attracting the net inflow of capital required by the equilibrium in the balance of payments … . But relatively high domestic interest rates, to attract capital inflows and equilibrate the country's overall balance of payments, would eventually further reduce the credibility of its participation owing to the increasing incidence of the outgoing stream of interest on the current account. ...
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> As shown by Italy's experience with the 'new EMS' and its outcome, the longer the period during which defence of the parity is achieved by a country through a piling up of its external liabilities, the higher the cost must eventually be, in terms of unemployment, of sticking to a central parity (…) Much the same would apply, following the creation of a single currency, to any European country that based its policy action on the belief that the 'smooth' financing of current account imbalances had made its current account constraint disappear.

Optimal Currency Area (OCA) theory has long been the benchmark for monetary union feasibility. Charles Goodhart (1998) was critical of this approach and stresses that the test of feasibility is political sovereignty.[5] He compared the Chartalist view of money as a creature of the state with the Metallist view that money has intrinsic value and is mainly introduced to facilitate trade - a creature of *laissez-faire*, so to speak.[6] Since the question that OCA theory addresses is the optimal regional space in which to adopt a single currency, he sees it as an extension of the Metallist view of money as instrumental to trade efficiency. Conversely, in the Chartalist view political sovereignty is the authority that enforces a certain currency over a certain regional space.[7] In the Chartalist view, the EMU, with its separation between sovereign political/fiscal agency and monetary authorities, is fundamentally incongruous. Extending Goodhart's reasoning, among the efficiency reasons adduced by Metallism, we may include the mainstream view that sovereign monetary policy has nominal but not real effects in the long run, so that it can be conveniently delegated to an independent super-national authority (Giavazzi and Pagano 1988).

Goodhart's argument about the political rather than merely technical nature of money is convincing. However, two qualifications can be made, both alluded to by Goodhart himself. The first points out a consistency between OCA theory and Chartalism; the second underlines that even a stateless currency is a political choice.

(i) OCAs probably coincide with sovereign states, since the latter may enforce policies, such as elimination of linguistic barriers and unification of the labour market, or fiscal federalism, that transform a collection of heterogeneous regions into an OCA. New sovereign States may well result from the political unification of existing ones – the examples of the Italian unification in 1860 and the reunification of Germany in 1989 come to mind. We may refer to these examples as political or sovereign OCAs, as compared to 'natural' OCAs that involve regions that are more homogeneous. A sovereign OCA emerges by political will and not by natural evolution (Goodhart 1998, pp. 423-24), as sustained by supporters of endogenous OCA theory (Frankel and Rose 1998). In this respect, the seminal OCA literature and Chartalism are not necessarily opposed, since OCA theory would admit that the viability of a currency area can often only be ensured by the backing of a sovereign state; symmetrically the long-run popular legitimacy of a state over its regional dominion can generally only be guaranteed if the dominion is either a natural (economically homogeneous) or political (economically heterogeneous, but politically cohesive) OCA. Monetary unions based on imperium would be unlikely to have much popular support. Notably, in the EMU the 'imperium' is the euro itself, since the unpredictable costs of leaving discourage open rebellion. In this regard, it is well documented (most recently by Mitchell 2015 and Lucarelli 2013) that the early European Commission's reports on monetary unification regarded it as the ultimate result of preliminary political and fiscal unification.

(ii) Although lacking a sovereign reference state, the euro was the result of a political design. In essence, by depriving euro member states of their currencies, most of their economic sovereignty was abrogated and assigned to borderless market forces. By ordoliberal inspiration (to which we shall shortly return), only residual regulatory power was left to the states, and even that was mostly delegated to Brussels. In this regard, Pivetti (2013a: 4) talks of the EMU as 'a machine born out of a deliberate continental project to undermine wage earners' bargaining powers', pointing out that:

> No social advance is conceivable if the nation state's sovereign powers in the economic sphere fade away, without being substituted for by supranational political institutions, capable of governing a group of nations' productive and distributive processes. Now, it is

> precisely the removal of the nation state, coupled with the absence of a supranational political power, that the establishment of the euro system has largely achieved (ibid, p. 8).[8]

A main purpose of the EMU was thus to deprive national working classes of a natural interlocutor, their respective sovereign state, now that capital has become more and more elusive through globalisation and outsourcing (e.g. Screpanti 2014, p. 76 and passim; Pivetti 2013b). Once domestic political dialectic is evicted from its natural environment, the nation-state, conflict over distribution of wealth is voided and democracy with it (see also Hirschman 1994, Pivetti 2011, Cesaratto 2015b). In this regard, though not backed by a state, a political design nonetheless supported the EMU.

2. Market-based currency unions: the Metallist view

The process of European monetary unification has contradictory aspects (Mitchell 2015). For instance, Feldstein (1992) observes that certain members of the EMS, complaining about the dominant role of Germany, pushed for monetary unification to regain some sovereignty over monetary policy decisions, at the same time surrendering monetary policy to an independent, German-style central bank. The political motivations for the euro also included the geo-political problems caused by a unified Germany and the influence of the elitist federal utopia. The feasibility of a stateless currency was also greatly influenced by the return of neoclassical dominance (as broadly juxtaposed to the Keynesian approach) in economic theory and policy in the 1970s. This meant the prevalence of the Metallist view of markets as a self-sufficient institutional fabric of a currency union, with monetary policy as the watchdog of the rules. As reported by Masini (2014), documents like the 'All Saints Day Manifesto for European Monetary Union' published by *The Economist* (Basevi et al. 1975), provided ideological support for the reaction to widespread labour indiscipline brought about by Keynesian full-employment monetary and fiscal policies, and elaborated the intellectual rationale for dismantling national monetary sovereignties on the basis of the proposition of the long-run (and possibly short-run) ineffectuality of monetary policy:

> There is no trade-off along the Phillips Curve: 'any attempt to drive the rate of unemployment below the 'natural' rate by means of expansionary monetary policies will be self-defeating and will engender a process of accelerating inflation' (Basevi et al. 1975, p. 34). Given the purchasing power parity assumption, a currency union implies a convergence between inflation rates but if no inverse correlation exists with unemployment, no country

> would incur real costs by tying its hands on monetary policy: 'There are no unemployment costs in monetary unification in the long run. The abdication of the national monopoly to print money has consequences only for the national rate of inflation, not for the long-run rate of unemployment' (ibid, p. 38) (Masini 2014, p. 1025).

The New Classical Macroeconomics (NCM) view transmigrated into the influential *One market one money* report (Emerson 1990), the Maastricht and subsequent Treaties and European policies up to the present austerian stance (e.g. Pivetti 1998; Mitchell 2015). These beliefs, rather than those of seminal OCA theory – which were more Keynesian in spirit or oriented by pragmatic monetarism (Mitchell 2015) – led public opinion to believe that a European currency without a federal state was a feasible possibility.

Possibly almost unknown to foreigners, the German ordoliberal influence over the euro set-up also attracted attention during the euro area crisis (Bonefeld 2012; Berghahn and Young 2012; Cesaratto and Stirati 2011; Allen 2005). To assess the influence of this tradition on the European monetary constitution is, however, difficult. According to some ordoliberal scholars (Feld et al. 2015, p.10) its influence should not be overrated, although many prominent German economists, including Hans Tietmeyer, Jens Weidmann and Hans-Werner Sinn shared this tradition. The main message of ordoliberalism is that the state has an essential function in economic policy as 'market policeman' (Biebricher 2014, p. 21), enforcing rules seen as necessary for efficient functioning of a free market economy. The first and foremost ordoliberal rule is price stability.[9] This is seen as a pre-condition for smooth working of the price mechanism according to neoclassical principles, about which ordoliberal exponents have no practical or theoretical doubts. In this sense, the European monetary constitution that targets price stability as a priority is faithful to the ordoliberal credo (Feld et al. 2015, pp. 11-12).[10]

Ordoliberalism prescribes a currency union backed by a robust set of rules rather than by a pro-active federal state. Hayek (1939) astutely suggested why this is the only way a currency union can actually work, although it probably did not directly inspire the economic constitution of the current euro area.[11] Discussing federalism rather than monetary unions, Hayek provides an additional key, beside the dominance of the NCM and ordoliberal doctrines, to explain why warnings from OCA and other literature were ignored. In brief, Hayek argues that a 'liberal economic regime is a necessary condition for the success of any interstate federation' (ibid, p. 269). This regime 'will have to take the form of providing a rational permanent framework within which individual initiative will have the largest possible scope' (ibid, p. 268). According to Hayek, this is also the only feasible interstate federalism because any significant fiscal empowerment of a federal state beyond a broad regulatory role soon leads to inter-state conflict over policy measures and distribution of federal resources (ibid, p. 266). According to Hayek, this is why interstate federalism is the Mecca of liberalism (and, notably, not of socialism).[12] Of course, if a fully-fledged federal state composed of culturally and heterogeneous countries is naïve utopia, the same countries might well refuse the perspective of a minimalist ordo-liberal state, as presently proposed by the European institutions (European Commission 2015). This conclusion, associated with the unknown costs of a euro break-up, quite well explain the current European political stalemate and tragedy.

We thus see broad convergence between different laissez-faire traditions (ordoliberal, NCM, Hayekian) and the agenda of the conservative European élites aimed at dismantling nation states as the natural contending terrain of social conflict, replacing it with an ethereal super-national entity beyond the reach of national working classes.[13]

4. The weak foundations ofthe Metallist view

Kalecki (1943) suggested that the ruling élites select from among contending economic theories on the basis of political considerations rather than on their real welfare efficacy and scientific value. In particular, capitalists prefer social discipline to full employment and therefore opt for policy options that lead to deflationary set-ups (conveniently defined as natural unemployment equilibria). This said, it is nonetheless a worthy exercise to briefly recall the analytical flaws of these doctrines, if only because it clears the decks of one aspect of the question.

Progressive mainstream economists basically share (and teach) the idea that free competition and independent monetary policy lead to full employment growth, at least in the long-run, when the forces of ‘thrift and productivity’, as D.H.Robertson famously defined them, are said to prevail. However, in line with Keynes’s celebrated practical remark about the long run, pragmatism leads progressive mainstream economists to assign a role to more Keynesian-oriented policies at least in the short run. This is nevertheless a limited role, mainly confined to periods of low business confidence or explained by price rigidities. There are, on the other hand, solid reasons to maintain that long-run neoclassical theory is wrong. The present author’s favourite critical approach hails back to the capital theory controversy. This showed that the demand curves for labour and capital – on which the mainstream relies to assert that labour and capital stocks are both fully utilized in the long run – are not ‘well behaved’, as mainstream economists acknowledge when faced with this theoretically irrefutable result.[14] As a consequence of the capital theory critique, we can now safely argue that it is aggregate demand (not factor supply) that drives economic growth, with saving adjusting to investment in the short run through fuller use of productive capacity and in the longer run through larger productive capacity.

In this context, fiscal, monetary and foreign exchange policies play a major role in sustaining aggregate demand. The policy suggestion is that balanced international growth requires that all countries be engaged in sustaining domestic demand through appropriate fiscal, monetary and distributive policies. Economic leadership, in the sense of Kindleberger, should be expected from the most competitive economies, while fixed, but adjustable exchange-rates would help to correct foreign imbalances. On the opposite side, 'monetary mercantilism' (Holtfrerich 1999, 2008; Cesaratto and Stirati 2011),[15] i.e. reliance on other countries' expansionary policy in fixed exchange-rate regimes, or mutually ruinous generalised external or internal devaluation strategies (competitive deflation) should be avoided.

Unfortunately, competitive deflation – a clumsy attempt at generalising German 'monetary mercantilism' – is deeply embedded in the economic constitution of the euro area, making it unable to deliver growth and constituting a destabilising factor at the global level. Competitive deflation and mercantilism are deeply embedded in the economic constitution of the euro area. Competitive deflation rests on the theory that domestic wage and price flexibility and international free trade are Pareto-improving (to use a conventional parameter) – making the BoP constraint irrelevant (Pivetti 1998, p. 8). Unfortunately, the capital theory critique invalidates these results (e.g. the Heckscher-Ohlin theorem), as well as the idea that free capital mobility leads to faster growth in catching-up countries (Cesaratto 2013b). Much to the surprise of Blanchard and Giavazzi (2002), capital flows from core to peripheral euro areas have destabilised in the long run, rather than re-equilibrating the currency union, as I recall below. By exploiting fixed-exchange rates, the dominant European power, on the other hand, has practised 'monetary mercantilism', a form of sophisticated competitive devaluation accompanied by a pro-active mercantilist state.[16] This introduces another aporia of the euro: in a stateless currency union, the strongest country prevails, and the strongest country is the one with the strongest economic institutions, in the German case represented by a pro-mercantilist state.

With this theoretical and practical background, there was little expectation that a monetary union deprived of federal pro-growth sovereign institutions would succeed, at least in terms of balanced full-employment growth. As noted above, however, such a progressive union was not the *political* objective. Be this as it may, while numerous prescient scholars foresaw the shortcomings of a stateless currency union, to the best of my knowledge no economist anticipated the similarities between the euro crisis and previous financial crises that involved peripheral economies.[17]

5. Balance of payment crises in fixed exchange regimes

Bordo and James (2013) trace a parallel between the gold standard and the EMU. In both cases a fixed exchange rate was a shortcut for catching-up countries to gain access to international finance, and in both cases this led to banking, sovereign and foreign debt crises, in that order. The difference between the financial crises in the gold standard and the EMU is that the rigidity of the latter – no country has dared to leave it yet, as the dramatic capitulation of Greece in July 2015 has shown – makes adjustment more painful. Roberto Frenkel (2014) and Carmen Reinhart (2015) extend this comparison to the crisis in emerging economies. In both cases, the liberalization of capital flows and financial deregulation, and the adoption of some kind of fixed exchange regime, led to a sequence of events, appropriately named by Reinhart (e.g. 2011) a 'series of unfortunate events', confirmed by various authors since the path-breaking contributions of Carlos Diaz-Alejandro (e.g. 1985) from which Reinhart (2015) draws inspiration. Typically, fixed exchange rate regimes encourage peripheral residents to borrow in a foreign currency, assuming the balance sheet risk of domestic currency depreciation. Inability to borrow in the domestic currency is often called 'original sin' (e.g. Eichengreen et al. 2005). Frenkel (2014, pp. 5-6) sums-up the sequence:

- capital inflows to peripheral countries feed financial and real estate bubbles; aggregate demand, output and employment surge, but so do prices;

- however, the expansion of aggregate demand leads to a trade imbalance, while capital inflows and inflation determine real exchange rate appreciation (given the nominal fixed exchange rate) that discourages exports;

- while the financial position of individual borrowers weakens, payment of interest on the foreign debt aggravates the current account balance; the imbalance is sustainable as long as foreign lenders continue to finance the external deficit; having borrowed in foreign currencies, the balance sheet of borrowers is exposed to exchange rate risk;

- eventually the financial fragility of borrowers and the country as a whole leads to a sudden stop in foreign lending, while creditors try to repatriate former loans; as financial and real bubbles begin to deflate, 'episodes of illiquidity and insolvency' emerge, 'first as isolated cases and then as a systemic financial crisis' (ibid). In fixed exchange rate regimes these financial tensions or crises precede currency crises 'in most cases' (ibid). With currency rate depreciation, the balance sheet risk of residents materialises, making default inevitable.

In the euro area, the sequence was favoured by long-term interest rates on government debt at the low levels formerly reserved for sovereign debt of core countries, and this was usually explained by tacit *belief* that a European bail out was guaranteed. These rates were relatively moderate, since the ‘one fits all’ ECB interest rate policy was tailored more to depressed core countries than to booming peripheral markets (Nechio 2011). Also, note that although foreign debt originates in the private sector, after the crisis markets scrutinise the cost to the state of baling out troubled banks.

To be sure, the ‘series of unfortunate events’ does not concern all European peripheral countries to the same degree; each of these countries is "unhappy in its own way", to borrow from Tolstoy's introductory reflection in *Anna Karenina.*[18] It best suits Spain (Dejuàn and Febrero 2010), Ireland (Dellepiane et al. 2013), Greece (Reinhart and Trebesch 2015) and pre-EMU Portugal (Leao and Palacio-Vera 2011). Although Italy was not actually a catching-up/peripheral country, it too joined the EMU, inter alia, to finance its huge public debt at cheaper interest rates. Italy did not participate in the financial party with Spain, Ireland and Greece, but the fall in her external competitiveness increased external debt, albeit much less than in true peripheral countries.

Despite consensus regarding the ‘series of unfortunate events’ (lately also by Baldwin et al. 2015), the sequence is better explained by a heterodox rather than a mainstream approach. The latter regards financial liberalization and international capital mobility as an equilibrium phenomenon, namely as a redistribution of saving from capital-rich to capital-poor countries conducive to faster economic growth in catching-up economies. Keynesian and Sraffian criticism of the marginalist saving-investment nexus led us to look at the phenomenon through different lenses. For instance, contrary to Ben Bernanke’s famous ‘saving glut hypothesis’, there is no such thing as ‘saving’ going around the world in search of the most profitable investment projects. ‘Saving’ does not have a life independent of the investment that generates it (Lerner 1974, p.38). For similar reasons, Werner Sinn’s attempt to depict Germany as the victim of the circumstances engendered by the euro is also disputable. The tacit bail out clause supposedly favoured the absorption of German saving by southern countries, thus shifting ‘economic vigour from northern to southern Europe and Ireland’ and plunging Germany ‘into a recession’ (Sinn 2013, p. 4).

So, while mainstream authors including Reinhart or Sinn refer to neoclassical international ‘loanable-fund theory’, an alternative, endogenous-money view suggests that in certain circumstances (financial liberalization and fixed exchange rate regime), the sequence of unfortunate events is triggered by credit-money creation by local and foreign banks, as suggested by the eminent international finance economist Borio (2014; see also Cesaratto 2013a, pp. 374-376).[19] Contrary to neoclassical expectations, most of this finance does not go to investment projects that enhance productive and export capacity, but to construction and consumption bubbles (both private and public) that fuel imports and inflation. This is followed by a current account surplus in northern countries which according to national accounting corresponds to the formation of saving (thus we can say ex post that northern saving is eventually lent to southern countries, Cesaratto 2013b, 2016).

Despite theoretical differences in the causality of events – the conventional Bernanke-Sinn story or Borio's less conventional sequence – the two views agree that the euro area crisis *is* a BoP crisis. The bursting of the construction bubbles triggered a banking crisis, which after government bailouts, generated a sovereign debt crisis. However, the sudden stop in foreign lending did not cause the exchange rate to collapse, as in a traditional fixed exchange rate regime, since T2 permitted ordered repatriation of foreign loans (see appendix). Nonetheless, increasing interest rates on government bonds of peripheral countries began to reflect a risk of euro break-up. The Outright Monetary Transactions (OMT) operation launched by the ECB in September 2012 had the effect of reassuring international investors about the solvency of peripheral states and therefore reduced the risk of those states being forced to reclaim their monetary sovereignty to ensure their solvency. This prompted various authors to conclude that the real origin of the euro zone crisis was

delayed ECB intervention, which compelled peripheral countries to make painful and counterproductive fiscal adjustments, imposing continuation of this policy even once OMT was in place. According to this view, moreover, the existence of T2 means that there cannot be a BoP crisis in a currency area. Let us now look at this view.

6. Is the crisis the fault of the ECB?

Paul De Grauwe (e.g. 2013) is the best-known exponent of the thesis that the euro crisis is a 'bad equilibrium' result of the lack of a clear mandate to the ECB as lender of last resort to EMU governments. His view can thus be summed up:

- In a currency union, governments of member countries lose their central bank as lender of last resort.
- If financial markets lose confidence and massive selling of governments bonds occurs, the absence of a lender of last resort may transform a temporary sovereign liquidity problem into a solvency crisis, allowing interest rates to reach unsustainably high levels. This is precisely what happened to some European peripheral countries. Massive capital flight from these countries made it unfeasible for them to roll over their debt at affordable interest rates.
- Deprived of a lender of last resort, those countries had to resort to tough austerity measures to secure their solvency in order to reassure the financial markets. Unfortunately, these pro-cyclic measures pushed these countries into a deflationary cycle, in which the fall of tax revenues

made their fiscal position even more fragile, inducing a further fall in market confidence.[20]

The sequence envisaged by De Grauwe therefore goes from investors' loss of confidence in the sustainability of a country's public debt due to the absence of a lender of last resort, to austerity programs to regain market confidence. These programs, however, damage the country's fiscal position so that an initial (presumed) liquidity crisis becomes a solvency crisis. Notably, however, De Grauwe does not explain the initial investors' loss of confidence, whereas the BoP view attributes this loss to growing intra-euro imbalances and to fear of a euro break-up, as in a classic BoP crisis. In fact, De Grauwe denies that there can be a balance of payment crisis in the euro zone 'in the sense as those that occurred in fixed exchange rate systems because in a monetary union internal foreign exchange markets have disappeared' (De Grauwe 2013, p. 26). In a similar fashion, the Post-Keynesian exponent Marc Lavoie believes that T2 makes the BoP irrelevant in a currency union (Lavoie 2015a, 2015b) and associates the crisis with 'the flawed design of the links between the national governments and the system of central banks, in particular the self-imposed prohibition to hold large amounts of government securities and to intervene on the secondary markets for bonds' (2015a, p. 17).[21]

I agree with De Grauwe and Lavoie that ECB intervention could have been more timely and that T2, accompanied by the ECB's refinancing operations that regenerated the euro-liquidity lost by deficit countries, avoided a traditional BoP crisis. Yet, this is not sufficient to prove that the euro area crisis is not a BoP crisis and that instead self-fulfilling panic drove countries without their own central bank close to default, so that better-timed ECB intervention could have avoided the crisis.[22] This thesis is not pertinent in a flawed, stateless currency union (Cesaratto 2015a).

7. Balance of payments crisis in a flawed currency union

To begin with, the euro area exchange rate crisis revealed itself to be a sovereign debt crisis once foreign investors panicked about borrowers' ability to redeem their debt (Merler and Pisani-Ferry 2012), i.e. *foreign* debt that accumulated because of the events narrated in section 5. The prohibitive levels reached by interest rates on peripheral sovereign debt clearly concealed a risk of redenomination, namely that a peripheral sovereign, being unable to refinance itself at prohibitive rates, would return to a national currency, as anticipated by Pivetti (1998). Of course, the combination of various European measures – including European bilateral and multilateral fiscal support, the various measures adopted by the ECB and T2 – averted a euro break-up.[23] The crucial question is whether more timely action by the ECB, that could have avoided counterproductive austerity policies, would in fact have prevented the crisis. Given the existence of structural foreign core/periphery imbalances in the euro zone, the question is whether or not there can be endlessly increasing indebtedness of peripheral countries towards core countries. The experience of past financial crises, triggered by a sudden stop in capital flows once foreign investors realized that debtors would be increasingly unlikely to service debt denominated in a foreign currency, suggests limits to such indebtedness. Is this behaviour irrational in the sense that borrowers, given more time (and loans), might achieve an external surplus and be able to redeem the debt? Unfortunately, it is doubtful that a country caught in a debt trap can resume a sustainable path by itself. After a sudden stop, IMF-led debt restructuring accompanied by fiscal austerity and currency devaluation have traditionally been necessary (albeit too often bluntly imposed).

In the euro area case, the combination of T2 and refinancing operations permitted smooth repatriation of former lending, replaced by official lending, with automatic recreation of the reserves lost by the national central banks (NCB). In principle, this provided support to endless current account deficits (see appendix). In this respect, Sinn (e.g. 2013) is fundamentally correct when he says that in the climax of the crisis the EMU provided peripheral countries with the electronic printing press to re-create foreign reserves that were used to regulate foreign payments (Febrero and Uxò, 2013, are of the opposite opinion). It is as if a peripheral country could print €-Drachmas that the core central bank had to accept for payments and transform into €-DM.

In theory the system could continue indefinitely, deferring a redress of foreign inter-euro zone disequilibria (Bordo 2014, p. 18).[24] In practice, however, faced with a lack of any peripheral foreign rebalancing perspective and mounting T2 imbalances, what actually happened in Europe was a sort of political halt to current account imbalances calling for correction through austerity measures (Cesaratto 2013a, pp. 379; 2015a, pp. 147, 150-151).[25] Since leaving the euro and redenomination of sovereign debt to avoid austerity measures was an alternative, an increase in sovereign spread without ECB intervention (which was only resolute enough in summer 2012) would have made a euro break-up inevitable. ECB support was, however, intolerable for core countries without reinforcement of austerity measures to avoid moral hazard by peripheral countries, that could otherwise rely on T2 and refinancing operations to endlessly increase their foreign imbalances. Implementation of OMT was thus made subject to an IMF-style conditionality clause (Cour-Thimann and Winkler 2013, pp. 17-8, 40; Mody 2015, p. 18). In a similar vein, Daniel Gros (2013, pp. 511-12) sees fiscal austerity as functional to external adjustment, so that it cannot be said to be 'self-defeating' in terms of public debt/GDP ratio, since the fall of domestic GDP addresses the current account deficit:

> The view that the euro crisis is at its core a balance-of-payments crisis implies also that the

> debate about austerity is misleading. It has often been pointed out that austerity can be self-defeating in the sense that a reduction in the fiscal deficit can actually lead in the short run to an increase in the debt- to-GDP ratio …. However, austerity can never be self-defeating for the balance-of-payments adjustment. To the extent that a fiscal adjustment (…) depresses domestic demand, it actually contributes to an improvement in the current account. A corollary of this observation is that a higher fiscal multiplier (…) might actually be beneficial for the resolution of a debt crisis because it accelerates the turnaround in the current account.

Gros invites us not to be deceived by the fact that many of the European policy prescriptions concern the public sector (e.g. setting primary surplus targets). This is only an intermediate target instrumental to the ultimate objective that concerns foreign balances.

We therefore conclude that, in the given circumstances, fiscal austerity is naturally associated with ECB intervention and cannot be said to be the result of delayed ECB intervention, as argued by De Grauwe-Lavoie. That this policy combination does not deliver growth and only helps to kick the can down the road should not surprise us, since the euro's real target was not growth, and precisely by exploiting the crisis, the EMU revealed its real disciplinary purposes (as Mundell is reported to have admitted, Palast 2012).

The alternative that De Grauwe, Lavoie and others may have in mind – determined ECB action as lender of last resort accompanied by fine-tuned fiscal reflation distributed among member states to repair foreign and fiscal accounts in the periphery – is in principle viable. These adjustments would be facilitated by core countries accepting a higher inflation rate: the inflation bias Mundell (1961, pp. 658-59) pointed out long-ago. Marshall-plan style investment projects especially aimed at southern members, debt restructuring and Eurobonds could enrich the recipe. In the meantime the resemblance of T2 to Keynes's clearing union would continue to avoid a traditional exchange rate crisis (Lavoie 2015a) and might even be modified to be closer to Keynes's original design (Bruni and Papetti 2015). The proposed adoption of an American-style institutional framework in the euro area would be the ultimate solution. This would include, inter alia, an adequate federal budget with a regional rebalancing objective, accompanied by balanced local state budgets, a central bank responsive to politics and with a full employment objective, and an American-style banking union.

Unfortunately, these reforms are out of reach, since they entail a degree of political cohesion and trust, as well as an institutional framework that are just not present in Europe, for two fundamental reasons: (a) reluctance of the dominant country to abandon its mercantilist model, which the élites of the other countries are eager to imitate; (b) European public opinion is not ready for the degree of political solidarity required by those policies. A more powerful European Parliament that controls a federal budget would therefore risk division along national lines rather than ideological/class lines. Historical experience suggests that any such union would be litigious and short-lived.[26] Similar scepticism was recently expressed by Mitchell (2015) and Pivetti (2013a, p. 6). It is worth quoting Pivetti (1998, p. 17) at some length in this regard:

> The advantages of a process of European integration that are being considered are rather of a meta- political nature. As has been pointed out (…), a major objective of integration consists of tying to- gether the nation states of Europe: in creating strong political links between them so as to avoid the possibility of a rivalry, especially between France and Germany… This very rationale for achieving po- litical unification in Europe reveals the project's idealistic content. Preoccupation with rivalry be- tween the nation states of Europe ultimately stems from the fact that the only common heritage of the Europeans is 'their mutual enmity, disunity and war' (…). From this historical heritage it is difficult to see how a 'European nation' can result. Europe has more than nine languages, with all the cultural disparities that this fact epitomizes, and, as has been pertinently observed (…), there are no success- ful precedents of federation among culturally disparate peoples such as those of Europe.

The result is that in the given institutional framework of the euro area, the current combination of policies – austerity moderated by some ECB intervention – is the only game in town. Consistently, the only proposal on the table is a European super-state that obliges euro members to surrender residual fiscal authority to Brussels, so as to reinforce the current model of reducing the power of local states without enhancing that of a federal state. This is a clear echo of the Hayekian minimalist federal state. This solution will not deliver growth to most of the periphery, and since the solution of a viable currency union is not in sight, a return to sovereign national states and to some looser European monetary coordination appears to many commentators the only realistic alternative. The monetary union as a shortcut for policy unification has thus alienated thisobjective, as Kaldor (1971, p. 206) and Pivetti (1998, p. 18) foresaw and opinion polls confirm (Guiso et al. 2015). Nonetheless, for two decades the final promised land of a political union has worked as a camouflage for the regressive objective of monetary union (Pivetti 1998, p. 14; 2013, p. 5).

Conclusions

Long-ago a number of economists warned that a political union was a prerequisite for a viable currency union. Building a stateless currency union was certainly the euro’s original sin. This paper, however, disputes the feasibility of such a political union. A fully-fledged federal union, that would likely please peripheral Europe, is impracticable since it implies a degree of fiscal solidarity that just does not exist. A Hayekian minimal federal state, that would appeal to core-Europe, would be refused by peripheral members, since residual fiscal sovereignty would be surrendered without any clear positive economic and social return. Even an intermediate solution based on coordinated Keynesian policies would be unfeasible, since it would be at odds with German 'monetary mercantilism', a strategy that Germany is not ready to give up.[27] The southern bourgeoisie can only blame itself for supporting a stateless currency union. This was certainly the euro's original sin, but it was deliberately committed in order to deprive national distributive conflicts of their natural environment, fully sovereign national states, and to make competitive deflation the only game in town.

The euro area is thus trapped between equally unfeasible political perspectives. In this bleak context, austerity policies are mainly explained by the necessity of readdressing the BoP crisis that, perhaps unexpectedly for many, blew up in the eurozone after ten years of apparent calm.

The euro area BoP crisis indeed presents striking similarities to traditional financial crises in emerging economies associated with fixed exchange regimes. Therefore, the ECB's delayed response to the sovereign debt crisis cannot be seen as the culprit of the euro area crisis, which has much deeper roots in the foreign imbalances brought about by the EMU. In spite of its deflationary NCM spirit, in 1999-2007, the EMU brought about deceptive growth in some peripheral countries. This growth led to foreign accounts imbalances, also as a consequence of the policy of monetary mercantilism practised by the leading country. The ECB's monetary refinancing mechanisms, T2 and the ECB's belated OMT intervention impeded a blow-up of the currency union, but could not solve its deep causes. The current combination of austerity policies and moderate ECB intervention aims to rebalance intra-eurozone foreign accounts and to force competitive deflation strategy.

From this point of view, the euro can be considered a success.

Appendix - Target 2 and the euro crisis

Target 2 (T2) is an electronic platform that allows payments in the euro area (and beyond, see Cour-Thimann 2013; Febrero and Uxò 2013; Cesaratto 2013a). At national level, when we make a payment from bank A to bank B, the domestic central bank transfers a corresponding amount of reserves from the reserve account of bank A to that of bank B; this allows bank B to credit the current account of the recipient of the payment. When we make a payment to bank C in another euro area country, our central bank removes reserves from (our) bank A, while the foreign central bank credits a corresponding amount to bank C. As compensation for this courtesy, the ECB records a T2 claim in favour of the foreign central bank, and transcribes a T2 liability in the records of our national central bank. T2 claims/liabilities are never settled (say in gold or dollars). Normally commercial banks of countries with a current account surplus find themselves with an excess of reserves, while the opposite happens to banks in deficit countries. Up until the onset of the eurocrisis, it was thus normal for the former to lend the excess reserves to the latter, so that T2 imbalances cancelled out. With the break-up of trust in the interbank market in 2008, core-country banks began to retain their excess liquidity, while peripheral banks took advantage of the licence that respective national central banks had to re-create reserves in favour of domestic banks. In principle, in this way peripheral countries could continue to finance any external payments or capital flight. The 3-year LTRO launched by the ECB in December 2011 reinforced this possibility. This funded the purchase of the troubled sovereign debts by the respective domestic commercial banks at the price, however, of deepening the 'doom loop' between banking and sovereign crises. Bankrolled by domestic banks, peripheral states could let foreign investors repatriate, through T2, funds previously invested in peripheral government debt (see Cesaratto 2013a, 2015a; Garber 2010, p. 3). After the OMT launched by the ECB in September 2012, private capital flows to the periphery resumed.

Let us compare a fixed exchange system with a currency union. In the former case, the traditional balance of payment identity for an open economy would read:

$$CA + FA = \Delta OR \qquad (1)$$

where CA and FA are the current and financial account balances, respectively, and ΔOR is the variation in official reserves held in gold or international currencies. Notoriously, if net capital flows (FA) are not sufficient to fund a CA deficit, the exchange rate can be defended only as long as the country has enough official reserves. If we now consider a currency union as a closed economy, we can write the balance of payment equation of each member country as:

$$CA + FA = \Delta T2 \qquad (2)$$

where $\Delta T2$ is the variation in net T2 balance (the net T2 position of a country is a stock, part of the net international investment position). Any time the capital flows (reflected in FA) are not sufficient to finance a CA deficit, by equation (1) the national central bank can create an international currency (euros) to finance it, allowing, in principle, T2 liabilities to grow indefinitely. By the same token, the national central bank can print euros to finance capital flight (again reflected in FA). It is as if the Federal Reserve allowed a Latin-American country involved in a balance of payment crisis to print dollars (that is OR) to satisfy equation (1).

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Footnotes

[1] The distinction between viable and flawed currency unions is proposed by Barba and De Vivo (2013).

[2] On the sceptical views of American economists, see Jonung and Drea (2009). That many economists from different theoretical backgrounds converge on certain policy issues is not surprising in my opinion. In this paper, I cite two cases: scepticism with regard to the EMU and the BoP view of the crisis. An even stronger case is widespread disapproval of European austerian policies. At the root of the consensus, there is a broad mainstream sharing of certain Keynesian views, at least as far as periods of deep depression are concerned. In addition, even the most

doctrinarian mainstream economists cannot escape the evidence, for example, that the origin of the European crisis was not primarily fiscal, that troubles arise from fixed-exchange rate regimes and financial liberalisation and that expansionary fiscal retrenchment failed. This explains why in many cases, original active support for the monetarist background of the EMU has recently given way to a more sceptical stance. This is typical of many leading European contributors to the influential Voxeu.org, see Baldwin and Giavazzi 2015; Baldwin et al. 2015. Convergence does not disprove that heterodox economists have often provided more consistent explanations of events.

[3] Mundell (1961) was rather Keynesian in spirit, talking of monetary unifications of non-optimal currency areas as a deflationary force. In the spirit of the time, Mundell later became a supporter of the disciplinary role of monetary unifications (see e.g. Masini 2014).

[4] On the functionalist idea, inspired by Jean Monnet, that the economic and monetary union could be a step towards deeper political union, as long as it led politicians to appreciate the advantages of greater cooperation, see Spalaore (2013). In this view, even crises may lead to enhanced cooperation.

[5] Charles Goodhart is a pragmatic and experienced mainstream economist worthy of careful consideration. However, I fully agree with one referee that although marginalism is apparently consistent with Chartalism and endogenous money theories, these are rendered innocuous by the neoclassical concept of natural interest rate. Indeed, marginal theory is basically the same with exogenous or endogenous money, and is in any case characterized by dualism between a monetary and a real sector. Endogenous money plays a more essential role in heterodox economics (Cesaratto 2016).

[6] According to Metallism, 'there should be a divorce between currency areas and the boundaries of sovereign states' (Goodhart 1998, p. 420).

[7] '[Chartalist] analysts would claim that the spatial determination of separate currencies has almost nothing to do with such economic cost minimisation and almost everything to do with considerations of political sovereignty' (ibid, p. 409). See also Lucarelli (2013, pp. 3-6).

[8] Albeit less forcefully, Goodhart too underlines the 'hidden agenda' of the EMU: 'There is… a disguised, but not hidden agenda of [Metallist] theory in advocating a reduced role for the state in economic affairs. By contrast, [Chartalist] theorists tend to believe that government intervention is an inevitable concomitant of the operation and organization of our political system, and many worry whether the prospective European Central Bank ECB may not suffer from a 'democratic deficit' (Goodhart 1998, p. 425).

[9] In the German model, the Bundesbank played a major role in keeping social conflict at bay (see Cesaratto and Stirati 2011, pp. 73-75).

10 Besides price stability, the other ordoliberal pillar that found a place in the euro area economic constitution is the no fiscal bail-out clause based on the 'principle of liability' that 'sovereign states within the monetary union have to be held responsible for their decisions, i.e. that they cannot impose the costs of their actions on others' (Feld et al, 2015, p. 14). In assigning prominence of the state over markets, almost as if the latter are a result of the former, Ordoliberalism touches some profound chords of German cultural tradition such as Cameralism, romantic nationalism and the organic state, and the Historical School (Riha 1985, Schefold 1999).

11 The ordoliberal view that price stability is a pre-requisite for ordered working of the price mechanism sounds influenced by Hayek (1931), although the Austrian scholar and the ordoliberals are generally regarded as two distinct traditions in liberal thinking (e.g. Riha, 1985, pp. 204, fn. 17).

12 As noted by Pivetti (1998, p. 9: 'what would actually be good for the Community as a whole may be easily perceived as bad by this or that national group (think of the permanent real resource transfer between the individual national regions of Europe and the difficulty of its being accepted by the populations of the surplus nations)'. Renunciation of super-national ideals is difficult for the progressive left. On the tormented relationship between socialism, nationalism and internationalism, see Szporluk (1988); Cesaratto (2015b).

13 See Huerta De Soto (2012) for a disquieting conservative view of the disciplinary role of the euro. Ordoliberals Feld et al. (2015, p. 12) approvingly quote Huerta De Soto, while an alleged progressive designer of the euro, Tommaso Padoa Schioppa, wrote that continental Europe had to undertake a full programme of structural reforms in order 'to attenuate the protections that in the course of the twentieth century progressively distanced individuals from direct contact with the hardship of living' (Padoa Schioppa 2003, my translation).

14 Mainstream economists do not deny the results of the capital theory controversy (Samuelson 1966), but perhaps rely on other, neo-Walrasian versions of neoclassical theory in which 'capital' does not appear as a 'value' but as a list of physical capital goods. This would however be a short-period version of the theory unable to sustain the long-run conclusions of modern macroeconomics, including for instance monetary policy, exogenous and endogenous growth models and conventional international trade theory (see Dvoskin 2014).

15 'Monetary mercantilism' is defined by the German historian Carl-Ludwig Holtfrerich as the strategy, adopted by Germany since the early 1950s, of keeping 'domestic demand restrained by monetary and fiscal policies, thus keeping imports and domestic inflation low and freeing production resources for more exports. This strategy was contingent on a system of fixed exchange rates…' (Holtfrerich 2008: 34), a clear reference to the Bretton Wood system.

[16] Ordoliberalism and mercantilism are only apparently antithetical in the German experience since both assign a central role in framing the institutional and policy context most favourable to private economic activity to a paternalistic state. As already noted, there is underlying continuity in German economic thinking from Cameralism to Ordoliberalism (Riha 1985, pp.7-8).

[17] Anticipating a construction boom in Spain, De Grauwe (1998) predicted that the euro could trigger the 'sequence of unfortunate events' described below. Unfortunately, he later denied the possibility of a BoP crisis in the EMU.

[18] Bagnai (2013) emphasizes similarities between the crises experienced by European peripheral countries.

[19] Borio (2014, p. 13, my italics) maintains that: '*Spending of any form, whether on pre-existing real or financial assets, or on goods and services for investment or consumption purposes, requires financing, not saving*. In a closed economy, saving is not a pre-requisite for investment, but materialises only once investment takes place if the necessary financing is available. In an open economy, by construction, a current account deficit somewhere must be matched by a surplus elsewhere. But countries running current-account surpluses are *not* financing those running current-account deficits. The underlying consumption and investment expenditures that generate those positions may be financed in a myriad of ways, both domestically and externally.' This reminds us of Keynes's famous dictum that the 'investment market can become congested through a shortage of cash. It can never become congested through shortage of saving' (1937, p. 222; see Cesaratto 2016).

[20] A quotation from De Grauwe and Ji (2015, p. 2) may be useful: 'What was not understood when the Eurozone was designed is that this lack of guarantee provided by Eurozone governments in turn could trigger self-fulfilling liquidity crises (a sudden stop) that would degenerate into solvency problems. This is exactly what happened in countries like Ireland, Spain and Portugal. When investors lost confidence in these countries, they massively sold the government bonds of these countries, pushing interest rates to unsustainably high levels. In addition, the euros obtained from these sales were invested in "safe countries" like Germany. As a result, there was a massive outflow of liquidity from the problem countries, making it impossible for the governments of these countries to fund the rollover of their debt at reasonable interest rate. This liquidity crisis in turn … forced countries to switch-off the automatic stabilizers in the budget. The governments of the problem countries had to scramble for cash and were forced into instantaneous austerity programs ... A deep recession was the result. The recession in turn reduced government revenues even further, forcing these countries to intensify the austerity programs. Under pressure from the financial markets, fiscal policies became pro-cyclical pushing

countries further into a deflationary cycle. As a result, what started as a liquidity crisis in a self-fulfilling way degenerated into a solvency crisis.'

21 A more nuanced position is taken by Frenkel (2014, pp. 13-14). On one hand, he regards the eurocrisis as a balance of payment crisis; on the other, he denies that there can be 'exchange rate risk' (the typical manifestation of a BoP crisis) in the euro zone, presumably because of the combination of T2 and the ECB refinancing operations. The increasing sovereign default risk is then attributed to the absence of a lender of last resort. Notably, however, with OMT the ECB began to act as a lender of last resort precisely to defuse what Draghi (2012) called 'convertibility risk', that is, the risk of a euro break-up.

22 Modern Money Theory (MMT) also stresses that there cannot be sovereign default with full monetary sovereignty. This presupposes a central bank that backs a public debt denominated in a sovereign currency, without commitment to convertibility at a fixed exchange rate (e.g. Nersisyan and Wray 2010). While this is true, it should not be forgotten that peripheral countries give up full monetary sovereignty precisely to get access to international capital markets (e.g. Bordo and James 2013). Often, a peripheral country cannot have both. Full monetary sovereignty would be helpful, but only through a competitive exchange rate, which accompanied by industrial policy may provide an alternative to ruinous external debt-led growth. Bordo et al. (2005) explore how some countries, typically former British colonies, overcame the 'original sin' of being unable to borrow in domestic currency. These countries also avoided default to foreign creditors (Reinhart and Rogoff, 2010, p.44).

23 Greece was first supported by a package of direct European and IMF loans in 2010, and later, along with Portugal, Ireland and Spain, by the newly constituted European funds (EFSF, ESM). After the first Greek rescue, in the famous Deauville walk in October 2010, Merkel and Sarkozy decided to end the tacit bail out clause of member states, agreeing upon so-called private sector involvement. One after the other, the remaining peripheral sovereign debts and Italy were involved in the crisis. The ECB directly sustained these countries through the Security Market Program (2010-11) and the 3-year Long Term Refinancing Operation (2011-12) (see the appendix). The OMT program launched in summer 2012 and quantitative easing inaugurated in early 2015 provided a more decisive stop to the Italian and Spanish sovereign debt crises.

24 According to ECB rules, NCBs and the ECB provide unlimited and uncollateralized credit facility to each other (Ramanan 2012). Conversely, Keynes envisaged some limits to the clearing union (Cesaratto 2013a). Garber (1998) indicated the limits of T2 in a monetarist direction, namely Bundesbank preoccupation with accumulating liquidity corresponding to T2 claims. Actually, this liquidity is left dormant in reserve facilities (ECB 2011, p.38), so Garber is incorrect in assuming

that in providing credit, the central bank loses control of its monetary policy, as noted by Ramanan (2012).

25 Since 2011, European Commission control on the formation of national budgets has become more intrusive through the European semester, Six-pack, Two-pack and Fiscal Stability Treaty (i.e. Fiscal Compact) in a sequel of suffocating regulations that challenge the understanding of the most learned European citizens.

26 There is some evidence that currently European MPs often vote along ideological rather than national lines (Scully et al. 2012). It should, however, be considered that: (a) the European Parliament (EP) mostly ratifies economic decisions reached by inter-governmental negotiations; (b) most MPs – at least from Italy – are ideologically blinded by European rhetoric and have poor economic grounding and understanding of the national interest (unfortunately this is also true of the officials and politicians who take part in inter-governmental bargaining). Growth of nationalist parties will reinforce the nationalistic bias of the EP. On the whole, European countries will never surrender too much power over national resources to federal institutions, let alone to the EP. If we look at the ECB, votes along national lines are clearly dominant, prompting the conservative German economist Burda (2013) to request Fed-style reform of the Eurosystem in order to break the association between regional CBs and single states.

27 Unfortunately, German political parties are somewhat unanimous about the German export-led model (Dullien and Guérot 2012), once defined the 'sacred cow' of German economic policy (Wallich 1955), and would certainly not challenge public opinion or the popular press by proposing the dreaded 'transfer union'.