

INCREDIBLE COMMITMENTS:
WHY THE EMU IS DESTROYING BOTH
EUROPE AND ITSELF
George Selgin

When the merits of a European Monetary Union were first being debated, many skeptics fell into one of two camps. The first camp consisted of “Keynesians” (for example, Eichengreen and Bayoumi 1997, Salvatore 1997) who, referring to the theory of optimal currency areas, doubted that Europe constituted such an area, and believed that the proposed monetary union would eventually fall victim to country-specific (“idiosyncratic”) shocks. Unemployment and other burdens stemming from such shocks would, these critics argued, eventually force the monetary authority to either abandon its commitment to price-level stability in order to offer relief to adversely affected members, or cause the members to abandon the union so as to be able to realign their exchange rates.

The other camp was comprised of “Hayekians” who, drawing upon theories of international currency competition, claimed that monetary unification, by reducing the extent of such competition, would give rise to a relatively high seignorage-maximizing eurozone inflation rate, and therefore result in a level of actual eurozone inflation that was bound to disappoint the monetary union’s more

Cato Journal, Vol. 33, No. 1 (Winter 2013). Copyright © Cato Institute. All rights reserved.

George Selgin is Professor of Economics at the University of Georgia. This article was first presented at the General Meeting of the Mt. Pelerin Society session on “The Contribution of the Euro to the European Crisis,” Prague, September 4, 2012.

inflation-phobic members.¹ It was in light of such reasoning that British Prime Minister John Major made his alternative proposal for a parallel European currency—the “hard ecu”—to supplement rather than supplant the British pound and other established European currencies.

Today the euro is indeed failing. But its failure has in large part been the result of fundamental shortcomings other than those pointed out by either of these prominent camps of early euroskeptics. Rather than merely being wrenched apart by pressure from idiosyncratic shocks, or by disappointments stemming from the ECB’s temptation to profit from its monopoly status, the euro is unraveling because commitments upon which its ultimate success depended—commitments that had to be credible if it was to work as intended—have instead proven to be perfectly or almost perfectly *incredible*. The euro, in other words, was built upon a set of promises that the authorities concerned were unable to keep. Orthodox theory—theory that is neither particularly Keynesian nor Hayekian in flavor—suffices to explain (with the help of hindsight) why the promises in question *could not possibly have been kept* so long as the EMU’s members enjoyed substantial fiscal sovereignty. The combination of effectively unconstrained fiscal sovereignty and a lack of credible commitments to avoid both centralized debt monetization and outright member-state bailouts created a perfect storm of perverse incentives.

The Time-Inconsistency Problem

The theory in question builds upon Kydland and Prescott’s (1977) well-known treatment of the time-inconsistency problem that confronts ordinary central banks. That analysis, it bears observing, takes for its starting point a benevolent (social-welfare maximizing) though discretionary central bank, while making no

¹“Though I strongly sympathize,” Hayek (1978: 20) wrote, “with the desire to complete the economic unification of Western Europe by completely freeing the flow of money between them, I have grave doubts about doing so by creating a new European currency managed by any sort of supra-national authority. Quite apart from the extreme unlikelihood that the member countries would agree on the policy to be pursued in practice by a common monetary authority (and the practical inevitability of some countries getting a worse currency than they have now), it seems highly unlikely that it would be better administered than the present national currencies.”

reference to region-specific shocks or imperfect factor mobility. Greg Mankiw (2006) offers the following summary of the standard time-inconsistency problem:

Consider the dilemma of a Federal Reserve that cares about both inflation and unemployment. According to the Phillips curve, the tradeoff between inflation and unemployment depends on expected inflation. The Fed would prefer everyone to expect low inflation so that it will face a favorable tradeoff. To reduce expected inflation, the Fed might announce that low inflation is the paramount goal of monetary policy.

But an announcement of a policy of low inflation is by itself not credible. Once households and firms have formed their expectations of inflation and set wages and prices accordingly, the Fed has an incentive to renege on its announcement and implement expansionary monetary policy to reduce unemployment. People understand the Fed's incentive to renege and therefore do not believe the announcement in the first place.

Monetary policy will also tend to be time-inconsistent when unanticipated inflation is capable of lowering the real value of outstanding nominal debts, thereby reducing the government's fiscal burden. In this case the central bank has an incentive to announce a low inflation target so as to achieve a favorable inflation-taxation trade-off. Once again, were the central bank able to establish low inflation expectations, it would have an incentive to exploit those expectations so as to reduce the debt burden. Consequently the announced, low inflation target is not credible.

Monetary Free Riders

In the context of a monetary union whose members enjoy unlimited fiscal sovereignty, the usual time-inconsistency problem is compounded by a free-rider problem, with far more serious consequences. Here, as Chari and Kehoe (2007: 2400) have shown, a discretionary monetary authority's optimal (benevolent) policy consists of setting "high inflation rates when the inherited debt levels of the member states are high and low inflation rates when they are low." Assuming that costs of inflation are borne equally by the member states, the ability to free-ride off of other members of the union

causes member states to become more indebted than they would in a cooperative equilibrium, thereby bringing about an excessively high rate of inflation. Moreover, the free-rider problem gets worse as the number of countries gets larger, with the noncooperative inflation rate rising, other things equal, as union membership increases (Chari and Kehoe 2008). The incentive to free ride will, finally, be especially great for relatively small participants, and for participants with relatively high debt ratios, other things being equal, for these participants will be capable of externalizing a relatively large share of the cost of any deficits they incur.

Observe that, although the suboptimal outcomes predicted here—excessive government deficits and higher inflation—resemble those predicted by Hayek and his followers, the causal mechanism is much different. For here a benevolent authority, concerned only with maximizing social welfare, is led inadvertently to engage in undesirable levels of debt monetization. Were there no externalities, or were the authority capable of committing to a policy invariant to the extent of union indebtedness, the problem would not arise.

Hostage Taking

Chari and Kehoe (2007: 2400) first establish the presence of a free-rider problem for the case in which national fiscal authorities issue nominal debt only to lenders who live *outside* the monetary union to which they belong. They then go on to show that the problem holds as well in the case where governments borrow from within the union. The latter case, however, raises the additional possibility that union members can hold the union hostage, and thereby ultimately undermine it, by threatening either to default on their debt or to quit the union if it does not ease their debt burden by means of higher inflation or outright transfers (bailouts) or both. In the words of Thomas Mayer (2010: 51), if heavily indebted member countries “pose a threat to eurozone financial stability, they can blackmail their partners into open-ended transfers to cover both fiscal and external deficits. Or they can press the ECB to buy up and monetize their debts so as to avoid default.”

The threat to monetary stability can develop in several ways. First, foreign commercial banks may hold substantial quantities of the debt of the hostage-taking country, so that its decision to default would threaten the rest of the zone with a financial crisis. Second, the central monetary authority may itself hold substantial amounts of a

troubled member's debt, and so may also need to be recapitalized, at other participant countries' expense, in the event of a default. Alternatively, the bad debts would have to be reduced by means of more aggressive monetization and consequent, higher inflation (Mayer 2010: 52). In either case, the decision to avoid the danger in question by instead supporting member governments in fiscal difficulties will tend to undermine public support for the monetary union while increasing the likelihood of further ransom demands.

Philip Bagus (2012) explains the particular course by which Greece was able to take the European Monetary Union hostage. Banks throughout the eurozone, he says, bought Greek bonds in part because they knew that either the ECB or other eurozone central banks would accept the collateral for loans. Thus a Greek default threatened, first, to do severe damage to Europe's commercial banks, and then to damage the ECB insofar as it found itself holding Greek bonds taken as collateral for loans to troubled European banks.

In short, in a monetary union sovereign governments, like certain banks in single-nation central banking arrangements, can make themselves "too big to fail," or rather "too big to default." As Pedro Schwartz (2004: 136–39) noted some years before the Greek crisis, "It is clear that the EU will not let any member state go bankrupt. The market therefore is sure that rogue states will be bailed out, and so are the rogue states themselves. This moral hazard would increase the risk margin on a member state's public debt and if pushed too far could lead to an Argentinian sort of disaster."

Indeed, the moral hazard problem as it confronts a monetary union is all the worse precisely because sovereign governments, unlike commercial banks, can default without failing—that is, without ceasing to be going concerns. This ability makes their ransom demands all the more effective by making the implied threats more credible. A commercial bank that tries to threaten a national central bank using the prospect of its own failure is like a suicide bomber, whereas a nation that tries to threaten a monetary union is more like a conventional kidnapper, who only threatens to harm his innocent victim.

Another "Impossible Trinity"?

The free-rider and hostage-taking problems present in a monetary union that combines discretionary monetary policy with unrestricted national fiscal sovereignty have led some experts to speak of a new

“Impossible Trinity” or “Trilemma,” complementing the classical Trilemma long recognized in discussions of alternative international monetary regimes. The original Trilemma refers to the fact that a country cannot pursue an independent monetary policy while both adhering to a fixed exchange rate and dispensing with capital controls. According to Beck and Prinz (2012), in the context of a monetary union it is impossible for authorities to adhere to all three of the following commitments: (1) monetary independence, including a commitment on the part of the monetary authority to avoid either excessive inflation or the monetization of sovereign debts; (2) no bailouts, meaning no outright loans or grants to national governments in danger of defaulting; and (3) fiscal sovereignty, meaning a commitment to refrain from interfering with member nations’ freedom to resort to debt financing.

As we have seen, so long as unlimited fiscal sovereignty prevails, member states can find themselves in a position to take the monetary union hostage, forcing the central authorities to renege on one or both of their other commitments. It follows that either the principle of fiscal sovereignty must be abandoned in favor of something like an outright fiscal union, or that the union must abandon its commitment to an independent monetary policy or the no-bailout clause, exposing the union to the consequences of unconstrained fiscal free-riding, with all the regrettable consequences that must entail.

Nor is the EMU’s experience the first to bear out these claims. Having reviewed the lessons taught by previous monetary unions, in a work published between the signing of the Maastricht Treaty and the actual launching of the euro, Vanthoor (1996: 133) concluded that

monetary union is only sustainable and irreversible if it is embodied in a political union, in which competences beyond the monetary sphere are also transferred to a supranational body. In this respect, the Maastricht Treaty provides insufficient guarantees, as budgetary policy as well as other kinds of policy . . . remain the province of national governments.

The Costs

The euro’s flawed design and the poor incentives created by it have not merely caused the scheme itself to fail but have done extensive damage to the European economy. Philip Bagus (2012)

supplies an excellent summary of its more regrettable consequences, including “an inflationary, self-destructing monetary system, a shot in the arm for governments, growing welfare states, falling competitiveness, bailouts, subsidies, transfers, moral hazard, conflicts between nations, centralization, and in general a loss of liberty.” The euro, Bagus adds, has allowed European governments generally, and those of the peripheral nations in particular, “to maintain uncompetitive economic structures such as inflexible labor markets, huge welfare systems, and huge public sectors. . . . Multiple sovereign-debt crises have in turn triggered a tendency toward centralization of power in Brussels [bringing us] ever closer to a more explicit transfer union.” The Greek government, in particular,

used the lower interest rate to build a public adventure park. Italy delayed necessary privatizations. Spain expanded the public sector and built a housing bubble. Ireland added to their housing bubble a financial bubble. These distortions were partially caused by the EMU interest-rate convergence and the expansionary policies of the ECB.

In light of all of these ill consequences, Bagus concludes, “The project of the euro is not worth saving. The sooner it ends, the better.” In other words, given the other consequences stemming from the euro’s poor design, it is just as well that that design is also causing the euro to self-destruct.

Perhaps the gravest of all consequences of the euro’s demise is also the most ironic, to wit: the harm done to inter-European relations. Instead of cementing European unity, as its proponents claimed it would do, the euro is bearing out Feldstein’s (1997) prediction that it would ultimately supply grounds for new inter-European squabbles, culminating in the emergence of a new and vehement nationalism, all too reminiscent of the nationalism that twice set Europe aflame during the previous century. As former U.S. ambassador to Germany John Kornblum (2011) has noted, with the outbreak of the Greek crisis, “the polite tone cultivated for decades by E.U. partners” has given way to “a tirade of insults”:

Germans have called the Greeks lazy, corrupt and just plain stupid. The news media in Germany gleefully point out Greek billionaires who pay no taxes, workers who retire at 50 and harbors filled with the yachts of the idle rich. German

politicians have suggested that Greece sell some islands to repay its debt. In return, Greeks have pulled out the Nazi card, claiming that the Germans owe them billions in wartime reparations.

This outcome, Kornblum observes, has its roots in the euro's basic design:

Rather than being kept free of politics, as was originally intended, management of the currency has become a political football knocked back and forth by the growing resentments between richer and poorer Europeans. The poorer countries reject the austerity measures necessary to meet German standards. The Germans refuse to take the steps necessary to build a true economic community. The result is a standoff. . . . If the euro hadn't been implemented as a political project in a Europe not ready for a common currency, experts could probably clean up such a situation fairly fast. But now, they can't. Because in the end, such decisions are still about the war.

Why the Euro Lasted

In examining the cause of the euro's failure, it may seem that I've only succeeded in raising a different question, namely, How did the euro manage to survive for so long?

The answer hinges on the fact that the credibility of various commitments made at the time of the euro's launching was not something that could be ascertained in advance. Instead, it had to be discovered. In particular, the public had to discover whether European authorities had avoided the Impossible Trilemma by adequately limiting participants' fiscal independence.

That such limits were necessary if the common currency was not to fall victim to the free-rider problem was recognized by several authorities before the euro's actual establishment (e.g., Goodhart 1995: 467). Indeed, it was generally understood that the EU would not allow any of its member states to go bankrupt, and that special steps would therefore have to be taken to guard against members' tendency to free-ride on the union.

In principle, the time-inconsistency problem that sets the stage for free riding in a monetary union might have been avoided by means of a credible commitment to an independent ECB, unresponsive to

European fiscal crises. Such credibility might have been achieved by means of explicit rules, with corresponding incentive-compatible sanctions, or it might have been the result of a reputation for independence established over time. But neither solution was actually realized. As Chari and Kehoe (2007: 2401) observe, “notwithstanding the solemnly expressed intent to make price stability the monetary authority’s primary goal, in practice, monetary policy is set sequentially by majority rule. In such a situation, the time inconsistency problem in monetary policy is potentially severe, and as our analysis shows, debt constraints are desirable.”

The euro’s capacity for escaping the new Trilemma, and hence for long-run survival, therefore depended entirely on effective constraints being placed upon member states’ indebtedness. For a time the 1997 Stability and Growth Pact appeared to impose such constraints: the Pact appeared to provide for either the prevention or the timely correction of “excessive” government deficits (that is, deficits exceeding 3 percent of national GNP), thereby ruling out “even the slightest possibility that a fiscal crisis in one country affect the entire eurozone” (Mayer 2010: 49). But it was not long before the Pact began crumbling. The first fissures appeared in 2003, when France and Germany both exceeded the 3 percent target, and ECOFIN failed to impose sanctions on either. By the outbreak of the current crisis, the Pact had ceased to be credible (Mayer 2010: 50). Though fiscal restrictions remained in effect *de jure*, the *de facto* situation was one of unlimited fiscal sovereignty. That change meant, in effect, that either the ECB’s independence or the no-bailout commitment or both would have to give way, as both have indeed done.

Once any of the commitments essential to a monetary union’s success has lost its credibility, that credibility cannot be easily or quickly restored. In light of this truth, the EU’s decision, earlier this year, to sanction Hungary for its excessive deficits, seems an exercise in futility—an attempt, as it were, to close the stable door after the PIGS have bolted.

Solutions

Most recent proposals for saving the EMU—resort to eurobonds, the establishment of a “European Monetary Fund,” raising the ECB’s inflation target—fail to address the free-rider problem that is the root cause of the current crisis. Indeed, the proposed reforms

appear likely to aggravate the problem by formally acknowledging collective responsibilities that were until now formally (though unconvincingly) repudiated.

In truth there are but two ways in which the EMU can be made viable without sacrificing monetary stability. These are (1) the establishment of a genuine European Fiscal Union, that is, outright rejection of the principle of fiscal sovereignty that has thus far tended to undermine both the ECB's independence and the EU's "no bailout" commitment, or (2) replacement of the present politically constructed monetary union with a spontaneous or voluntary one based on the principle of free currency competition. As Schwartz (2004: 190) explained several years ago,

There are two types of monetary union. The first is based on a single money imposed by central authorities. Such a monetary union requires centralized political authority. . . . The other form of "monetary union" arises from the free choice of individuals predominantly using one out of a range of alternative currencies. The latter model does not require centralized political authority and is a better model for ensuring that monetary discipline is maintained.

The new Trilemma exists for imposed monetary unions only—it is only such an imposed monetary union that calls for a corresponding fiscal union. When participation in a monetary union is voluntary, there can be no question of participants taking advantage of their fiscal autonomy to hold the union as a whole hostage. Consider, for example, the monetary union consisting of the United States, its trust territories, and those independent nations that have chosen to either officially or unofficially dollarize, such as Ecuador. The Federal Reserve and the U.S. government played no essential part in Ecuador's decision to join the U.S. dollar zone, and take no responsibility at all for macroeconomic conditions there. They would presumably be able to regard Ecuador's decision to leave the dollar zone with the same equanimity or indifference with which they reacted to its decision to adopt the dollar in the first place. Although it's true that the extent of participation in the dollar zone might serve as an indication of the dollars' relative soundness, a foreign country's decision to quit the dollar zone poses no serious threat to the integrity of the dollar or to the prosperity of either the United States or any other dollarized economy. In short, in a regime of free currency choice,

monetary authorities can gain nothing by letting their currencies deteriorate further for the sake of addressing the macroeconomic problems of particular dollarized countries. Doing so would only tend to further undermine those currencies' overall popularity.

Such considerations appear, in light of experience, to vindicate former Hayekian proposals for a "hard" ecu or parallel European currency that would (initially at least) have supplemented, instead of replacing, Europe's established national currencies. In retrospect, as Schwartz (2004: 183–84) has observed, we have every reason to regret missing the chance of having the euro as a parallel rather than an imposed currency:

If the EU had accepted the British proposal of a "parallel ecu," rules guaranteeing the stability of the common currency and its independence from European governments would have been a part of the offer to users of the money by the European bank. There would have been no need for constitutional rules to be made (and broken) by member states, and no need for a Growth and Stability Pact, since the euro would not have been seen as a possible instrument of state finance.

Conclusion

There is, of course, no turning back the clock. But should the euro begin to disintegrate, the occasion, for all the disruption and damage it must cause, will at least renew the prospect for implementing the Hayekian alternative. That, to be sure, is a rather meager bit of silver by which to line a very large, dark cloud. Yet the ability to choose freely among competing currencies remains Europeans' best hope for a monetary regime that is both stable and sustainable.

References

- Bagus, P. (2012) "The Eurozone: A Moral-Hazard Morass." *Mises Daily* (April 17). Available at <http://mises.org/daily/6008/The-Eurozone-A-MoralHazard-Morass>.
- Beck, H., and Prinz, A. (2012) "The Trilemma of a Monetary Union: Another Impossible Trinity." *Intereconomics* 1: 39–43.
- Chari, V., and Kehoe, P. J. (2007) "On the Need for Fiscal Constraints in a Monetary Union." *Journal of Monetary Economics* 54: 2399–2408.

- _____ (2008) “Time Inconsistency and Free-Riding in a Monetary Union.” *Journal of Money, Credit, and Banking* 40 (7): 1329–55.
- Eichengreen, B., and Bayoumi, T. (1997) “Shocking Aspects of European Monetary Unification.” In B. Eichengreen (ed.) *European Monetary Unification: Theory, Practice, and Analysis*, 73–109. Cambridge, Mass.: MIT Press.
- Feldstein, M. (1997) “EMU and International Conflict.” *Foreign Affairs* (November/December): 60–73.
- Goodhart, C. A. E. (1995) “The Political Economy of Monetary Union.” In P. B. Kennan (ed.) *The Macroeconomics of the Open Economy*. Princeton, N.J.: Princeton University Press.
- Hayek, F. A. (1978) *Denationalisation of Money: The Argument Refined*. Hobart Paper Special No. 70. 2nd ed. London: Institute for Economic Affairs.
- Kornblum, J. (2011) “Without the Euro, Would Europe Have Turned to War?” *The Washington Post* (24 September).
- Kydland, F., and Prescott, E. C. (1977) “Rules Rather than Discretion: The Inconsistency of Optimal Plans.” *Journal of Political Economy* 85 (3): 473–92.
- Mankiw, G. (2006) “Time Inconsistency.” *Greg Mankiw’s Blog* (19 April): <http://gregmankiw.blogspot.com/2006/04/time-inconsistency.html>.
- Mayer, T. (2010) “What More Do European Governments Need to Do to Save the Eurozone in the Medium Run?” In R. Baldwin, D. Gross, and L. Laeven (eds.) *Completing the Eurozone Rescue: What More Needs to Be Done?* London: Centre for Economic Policy Research.
- Salvatore, D. (1997) “The Common Unresolved Problem with the EMS and EMU.” *American Economic Review* 87 (2): 224–26.
- Schwartz, P. (2004) *The Euro as Politics*. Research Monograph No. 48. London: Institute of Economic Affairs.
- Vanthoor, W. F. V. (1996) *European Monetary Union since 1848: A Political and Historical Analysis*. Cheltenham: Edward Elgar.