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Balance of payments or monetary sovereignty? In search of the EMU's original sin – a reply to Lavoie[*]

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Abstract - In a recent paper Marc Lavoie (2014) has criticized my interpretation of the Eurozone (EZ) crisis as a balance of payments crisis (*BoP view* for short). He rather identified the original sin "in the setup and self-imposed constraint of the European Central Bank". This is defined here as the *monetary sovereignty view*. This view belongs to a more general view that see the source of the EZ troubles in its imperfect institutional design. According to the (prevailing) *BoP view*, supported with different shades by a variety of economists from the conservative Sinn to the progressive Frenkel, the original sin is in the current account (CA) imbalances brought about by the abandonment of exchange rate adjustments and in the inducement to peripheral countries to get indebted with core countries. An increasing number of economists would add the German neo-mercantilist policies as an aggravating factor. While the BoP crisis appears as a *fact*, a better institutional design would perhaps have avoided the worse aspects of the current crisis and permitted a more effective action by the ECB. Leaving aside the political unfeasibility of a more progressive institutional set up, it is doubtful that this would fix the structural unbalances exacerbated by the euro. Be this as it may, one can, of course, blame the flawed institutional set up and the lack an ultimate action by the ECB as the culprit of the crisis, as Lavoie seems to argue. Yet, since this institutional set up is not there, the EZ crisis manifests itself as a balance of payment crisis.

JEL: **B51:** Socialist, Marxian, Sraffian.
E58: Central banks and their policies.
F32: Current account adjustment.
F34: International lending and debt problems.
F45: Macroeconomic issues of monetary unions.

[*] This version September 2014.

Introduction[*]

Within a general appreciation of my work on TARGET2 (T2) (Cesaratto 2013a), Marc Lavoie (2014) has criticized my interpretation of the Eurozone (EZ) troubles as a balance of payments crisis (*BoP view* for short). He would rather identify the original sin "in the setup and self-imposed constraint of the European Central Bank" (ibid: 12). Lavoie is not alone in this interpretation as it is shared by economists like Paul De Grauwe (2011; 2013), according to whom the EZ crisis is largely a liquidity crisis that became a solvency crisis. This stance is also accompanied by the idea that there cannot be a BoP crisis in a currency union endowed with payment mechanisms such as T2 and the ECB liquidity refinancing instruments. We shall define this interpretation as the *monetary sovereignty view*. This view belongs to a more general view that see the source of the EZ troubles in its imperfect institutional design (or *institutional set up view*).[1]

I am not alone in supporting the *BoP view* that can in fact be seen as prevalent. International monetary historians like Michael Bordo, heterodox economists like Roberto Frenkel, conservative students like Werner Sinn and even official sources (EU 2009, 2010) all share this view – with different shades of course. According to the *BoP view* there can be a BoP crisis in a flawed currency union (CU)[2] like the European Monetary Union (EMU) since it still shares some features of a fixed exchange rate regime – in particular what Draghi called the "convertibility risk" - the role of T2 in slowing down the redde rationem notwithstanding. The definition of flawed CU includes, of course, the "self-imposed constraint" to the ECB action which does not seem, however, sufficient to explain the crisis. According to the *BoP view*, the original sin is in the current account (CA) imbalances brought about by the abandonment of exchange rate adjustments and in the inducement to peripheral countries to get indebted with core countries. While this kind of events is reminiscent of former BoP crises in

[*] I thank Ernesto Screpanti for valuable comments, and Giancarlo Bergamini for help in improving the exposition.

[1] In a similar vein, Sinn and his associates at CESifo (2012: 69) maintain that: "there [are] widely contrasting interpretations of the crisis: one interpretation [stresses] self-fulfilling erosion of confidence, whereas another [emphasizes] fundamental macroeconomic imbalances". The "erosion of confidence" can be attributed to the absence of a pro-active central bank.

[2] The definition "flawed" (and "viable") CU is due to Barba and De Vivo (2013).

fixed foreign exchange regimes, according to an increasing number of economists (lately Wren-Lewis 2014) the German neo-mercantilist policies have made the basic problems even worse.

Section 1 deals with the analogies between Keynes's International Clearing Union and T2. Section 2 dwells upon the pros and cons of the conservative *BoP view* held by Werner Sinn. Section 3 reviews some less orthodox support to the *BoP view*. In the conclusions I will enlist some main analytical results.

1. International Clearing Union and Target2: no reserves, no cry

Lavoie sets a parallelism between Keynes' proposals of an International Clearing Union (ICU) and T2.[3] In both cases, in synthesis, foreign deficit countries are automatically financed by increasing their net debt position at, respectively, the ICU and the T2 account with the ECB, while surplus countries see their net credit position correspondingly augmented. Since international payments do not require international reserves (say a reserve currency issued by a third country or by the surplus country), there is no possibility in this setting for a balance of payment and financial crises. Therefore the deficit country albeit short of international reserves is *not* obliged (a) to pursue restrictive economic policies aimed at restoring a current account equilibrium or, (b) to incur financial default if the shortage is such that she cannot fulfill her international debt commitment. Indeed, Lavoie (2014: 10) points out:

> *TARGET2 is less constraining than Keynes's Plan, since TARGET2 has no limits as to the size of the advances that can be taken by national central banks from the European Central Bank, which acts here as the international clearing agency, whereas Keynes's Plan imposed a ceiling on the amounts that could be normally borrowed by the national central banks from the International Clearing Bank, in addition to imposing limits on the length of time during which the ceiling could be exceeded.*[4]
>
> — Lavoie (ibid: 12-13, 17)

[3] He kindly acknowledges that I was the first to propose the analogy (Cesaratto 2012, 2013a/b). This is alluded also by Bordo (2014).

[4] Referring to Cesaratto (2013a), Lavoie (2014: 10-11) adds: "one can view the TARGET2 balances as means to *create* the equivalent of the lost foreign exchange reserves for countries within the Eurozone which are suffering from a crisis of confidence. … TARGET2 balances can be interpreted as the current account surplus recycling device that Keynes had envisaged in his Plan, and hence that these compensating balances can be created 'ad libitum'" although, he concurs, "there are of course limits to what Minsky defined as Ponzi finance". On these limits we shall return.

also downplays the absence of sufficient infra-European fiscal transfers and of an adequate banking union,[5] although "these may certainly be important factors". The "true problem – he writes - lies elsewhere", namely "in the setup and self-imposed constraints of the European Central Bank", in particular "the self-imposed prohibition to hold large amounts of government securities and to intervene on the secondary markets for bonds".

Similarly, De Grauwe (2013: 9) argues that the missing backing of a sovereign central bank might cause a liquidity and then a solvency sovereign crisis:

> *member countries of the monetary union had to issue debt in a currency they had no control over. As a result, the governments of these countries could no longer guarantee that the cash would always be available to roll over the government debt. Prior to entry in the monetary union, these countries could, like all stand-alone countries, issue debt in their own currencies thereby giving an implicit guarantee that the cash would always be there to pay out bondholders at maturity. The reason is that as stand-alone countries they had the power to force the central bank to provide liquidity in times of crisis. 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 position is associated to a denial of the possibility of a BoP crisis in the EMU (ibid: 26):

> *There can be no balance of payments crises in the sense as those that occurred in fixed exchange rate systems because in a monetary union internal foreign exchange markets have disappeared.* [6]

2. The BoP crisis view: Sinn's view

The *BoP view* has many supporters. Appropriately, Lavoie mentions Werner Sinn, the influential conservative German economist that first raised the T2 affair (e.g.

[5] Since Spring 2014 the EZ has a semblance of a banking union. Opinions diverge about its adequacy. Cf. Posen and Veron (2014) are for a full half-glass view; Merler (2014) for a pessimist one.

[6] Close to this view is also Andrea Terzi (2014; 2) who acknowledges that "[e]xchange rate risk was coming back to the single currency area and this widened spreads in a similar fashion just as, during ERM, spreads had reflected the risk of exchange rate realignments". He does not however attribute a major role to the intra-EMU foreign imbalances. He would rather explain the return of the redenomination risk as a result of the divorce between monetary and fiscal policy in the EMU and regards the EZ sovereign debt increase as the result of "cyclical factors" (the global crisis of 2008-9, ibid: 22) arguing that if "the ECB had been allowed to trade member states' bonds, targeting their yield, we would not have seen any sovereign debt crisis" (ibid: 21). Terzi does not discuss the existence of the foreign imbalances although in a cryptical footnote he notes that the "fact that net exports largely originate from a specific geographical area within the eurozone makes internal imbalances appear problematic" (ibid: 22).

Sinn and Wollmershäuser, 2012), as one of its most vocal advocates. In Lavoie's (correct) reconstruction Sinn regarded T2 as a device that, somewhat artificially, interrupted the natural adjustment of the BoP disequilibria within the EZ.[7] Before dwelling on Sinn's version of the BoP crisis view, let us say that it is very far from satisfactory to reply to Sinn that T2 was not a "stealth bail out" since "the unlimited and unconditional character of TARGET2 balances is at the very heart of monetary union." (Bindseil and Winkler, 2012: 37; Febrero and Uxò 2013). This is of course true. However, it does not disprove the argument that, at the end of the day, T2 avoided the blast of a classical BoP crisis that, therefore, only remained latent in spite of the increasing capital flights from the periphery over the period 2010-12 (until, as we shall see, other policies were imposed to restrain the T2 imbalances).

A useful synthesis of Sinn's own interpretation of the BoP crisis view can be found in the annual report of CESifo – the influential German institute that see Sinn as the prominent figure:

> *we emphasised that the root of the euro area's current problems lies in the external imbalances between its core and periphery countries. In the run-up to the crises optimistic expectations about income convergence generated an investment boom in the periphery, particularly in construction, accompanied by ballooning current account deficits financed by private capital inflows. This expansion in demand generated a faster rise in prices, including real-estate prices, in the periphery than in the core. The rapid price rise eroded the competitiveness of the periphery countries, which reinforced the increase in their current account deficits. Importantly, the boom was also accompanied by a misallocation of resources across different activities and firms. Both relative prices and allocations were therefore misaligned on the eve of the crisis. After its onset, private capital flows stalled, and in some cases even reversed, and the investment boom collapsed, leading to a recession. Since it takes time to reallocate labour, for example from oversized construction industries to other industries, this shock has had a long-lasting impact.* (CESifo 2014: 75)

The misallocation of resources the report is referring to likely regards the expansion of domestic non-tradable sectors vis-à-vis the relative suffering of the tradable sectors hit by an over-valued real exchange rate.

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[7] In a hyper-gold-standard regime such as the EMU, such an adjustment would rely on domestic price deflation mechanisms without any possibility of relying on exchange rates corrections.

As to the causes, the CESifo experts refer to "two primary and interrelated causes of current account balances":

> *Firstly, … the introduction of the euro eliminated the exchange rate risk and induced investors to disregard country-specific bankruptcy risks, given the unlimited firing power of the ECB. Secondly, the Eurosystem created optimistic expectations regarding the rapid convergence of the periphery countries (Greece, Ireland, Portugal and Spain) with the core of the euro area. Both causes generated an investment and credit boom in the periphery and imply that there was a catching-up process, with international capital movements from the core to the periphery that materialise as current account imbalances. The periphery countries, which are catching up, run current account deficits as imports grow together with incomes, and as inflation undermines export competitiveness.*
> (CESifo 2013: 58)[8]

While this account of the BoP crisis is broadly shared by the supporters of the *BoP view*, the CESifo authors acknowledge (ibid: 56) that few years earlier the EZ core-periphery capital flows were seen as an equilibrium phenomenon (famously by Blanchard and Giavazzi 2002) such that capital-rich countries were lending to capital-poor fellows helping their catching-up process. This view reflected the neoclassical saving-investment nexus extending the loanable-fund theory to explain international capital flows (see Cesaratto 2013c for a criticism).[9]

In spite of the discredit of this theory, a similar neoclassical stance leads CESifo authors (which include Sinn) to argue that the relative stagnation of the German economy during the EMU years up to the crisis should be attributed to the exports of savings to the periphery:

> *As the euro had lured capital from the core to the periphery, the periphery grew via stronger investment at the expense of the core, and thus brought about convergence.*
> (ibid: 59).[10]

[8] CESifo economists point out that the Basel banking regulation system that freed banks from the obligation of holding capital against government bonds supported the conviction that all the EZ government bonds were equally safe or, implicitly, the European bail-out belief (CESifo 2012: 62; Sinn and Wollmershäuser, 2012: 12).

[9] An alternative view would argue that autonomous spending in peripheral countries was financed by endogenous credit/money creation by local and foreign banks. Larger imports from core countries generated foreign savings in these countries so that, ex post and only ex post, we can say that core countries lent excess savings to peripheral countries.

[10] See also CESifo (2012: 72), and CESifo (2011: 76) where we read that "the stagnation [in Germany was] caused by the capital exports".

Rather than beneficiary of the expansion of the periphery, Germany is thus depicted as the victim of the circumstances. In truth, the EMU perfectly suited the German deliberate continuation of the monetary mercantilist model it pursued since the early fifties (see Cesaratto and Stirati 2010-11). In this respect CESifo authors (2012: 73) candidly admit that:

> *Germany also depreciated by 22 percent against its euro area trading partners in the period from 1995 to 2008... This process coincided with a period of stagnation, unemployment and outflows of capital. Only 3 percentage points of Germany's real depreciation were due to exchange rate adjustment before the currency parities were fixed within the euro area. The remaining 19 percentage points of the country's depreciation were due to pure price adjustments within the euro area, with most of the gains coming from higher price dynamics abroad, rather than price compression at home.*

This strategy of keeping the domestic inflation rate lower than that of the trade partners in a fixed exchange rate regime precisely suits the long-run strategy of monetary mercantilism outlined by the leading German economic historian Carl-Ludwig Holtfrerich (2008: 3):

> *when Germany itself was likely to profit from European and worldwide trade liberalisation, a different way of achieving mercantilism, namely export surpluses, had to be found. The solution was to keep 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, without a self-regulating gold standard including freedom of capital movements. The early Bretton Wood system, without fully convertible currencies and with restrictions on international capital movements, left countries the opportunity to gain in international competitiveness by realising relatively more price stability at home than abroad.*

To implement this strategy it was enough for Germany to keep its inflation rate below that of its competitors (as she duly did between 1999 up to recent years). In this regard, Holtfrerich 1999: 345) quotes Erhard, the famous German finance ministry during the German "economic miracle":

> *Erhard fully supported this approach, writing to Vocke on 2 August 1950 that 'a great opportunity for the future of German exports has arisen out of the current situation. If, namely, through internal discipline we are able to maintain the price level to a greater extent than other countries, our exports strength will increase in*

> *the long run and our currency will become stronger and more healthy, both internally and with respect to the dollar'*. [Vocke was the President of the Bank deutscher Länder as the Bundesbank was named before 1957].

In the light of Kaleckian theory, 'Monetary Mercantilism' is a perfect strategy for capitalists: low domestic wages (relative to productivity) imply a high surplus (i.e. capitalists' profits) that can be successfully sold in the uncompetitive periphery. The financial capital flows provide the periphery with the purchasing power required to absorb the core capitalists' surplus. More specifically, mercantilism regarded the trade surplus as the only net wealth source for the nation. This is a nebulous idea, but it makes sense in a Kaleckian/Rosa Luxemburg context (Cesaratto 2011, 2013c). The surplus (S) in a Classical-Marxian-Sraffian approach is that part of the social product (P) left to the capitalists as profits, once the 'necessities' (N) to the workers have been paid: $P – N = S$ (Garegnani 1984). Exports are a way to realise (in a Marxian sense) the surplus. Assuming that the social product is composed by the necessities N and net exports E-M, then: P=N+ (E-M). It follows that: S=E-M, net exports are equal to capitalists' profits. According to Kalecki the central countries must 'export' financial capital first in order to export physical goods later.[11] Of course, the limit is that deficit countries may not be able, in the long run, to redeem the debt (but, paraphrasing Kalecki, capitalists do many things as a class, yet they do not plan the international economy as a class).

Be this as it may, CESifo economists also condemn the proposal of an EZ fiscal expansion policies as they would forgive the misallocation of resources in the periphery due to excess capital inflows; austerity is thus seen as the painful but proper cure (e.g.

[11] Kalecki (1934) adds the 'domestic exports' constituted by government deficit spending to the realisation of the social surplus in foreign markets. In his great paper on Tugan-Baranowsky and Rosa Luxemburg (1967) both markets were subsumed to the label of 'external markets', i.e. markets outwith the conventional 'income-spending circuit'. According to Kalecki (1934: 18-9), spending by external markets, as well as investment spending induced by the expected rate of expansion of external markets, is financed by the creation of purchasing power by the financial sector, or by the acceptance by the seller of bonds issued by the buyer:

> Financial processes connected with securing a surplus in foreign trade and with 'domestic exports' are …very similar in character. The analogy is obvious in the case when the capitalists of a given country grant a foreign loan or a loan to their government which is used for purchase of commodities in that country. The capitalists lend money abroad or to their government in return for bonds. Funds obtained by a foreign country or by the government flow back through the purchases of commodities to the capitalists… As a result, the profits of the capitalist class in a given period increase by an amount equal to the value of the government or foreign bonds received, which is equal in turn to the surplus secured in foreign trade or to 'domestic exports' respectively.

CESifo 2014: 79-82).[12] For similar reasons they reprimand the "unlimited" T2 balances as a procrastination of the peripheral structural adjustment (Sinn and Wollmershäuer, 2012: 31).[13]

Despite the profound theoretical and policy divergences, I have found Sinn and his associates basically persuasive where they argue that the existence of T2 impeded the blast of a classical BoP crisis. For memory's sake, not only does T2 allow the continuous payment flow from deficit peripheral to surplus core countries that manifests itself in larger T2 entries without any necessity of transferring international currencies (or species), but the euro-reserves lost by the peripheral commercial banks are automatically re-created by the national central banks through the various refinancing operations (e.g. ibid: 10-11; ECB 2013: 107-8; Cesaratto 2013a).[14] In a fixed exchange rate system capital flights of the magnitude of those increasingly seen in the EZ between 2010 and 2013 would have led to the abandonment of the system by the deficit countries, as in the EMS case in 1992 (CESifo 2012: 69-70). Bear in mind that, T2 notwithstanding, a redenomination or "convertibility risk" lasted in the EMU at least until the ECB President famous speech of September 2012. To be remarked here is that in the absence of a legal limit to T2 imbalances, a political limit has been set by core countries by imposing a reversal of the current account position of the peripheral countries (albeit not to themselves!) through a paraphernalia of fiscal regulations (European semester, Six pack, Two pack, Fiscal compact etc.). Although the rules of T2 cannot be changed, which would imply the destruction of the currency union, policies

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[12] True, they admit that higher inflation in the core would help, but this would clash with the German public opinion (CESifo 2012: 72-73). On the likely fabricated myth of the German fear of inflation see Cesaratto and Stirati 2010-11: 70).

[13] Sinn and his associates argued that in the US there are yearly automatic full settlements of the American analogue of T2 balances among the regional Feds. Of a different opinion are Cour-Thimann (2013: 31-33) and Barba and De Vivo (2013: 91-93).

[14] This is well summed up by Cour –Thimann 2013:12, 17-18:

The presence of Target balances is …strongly correlated to the non-standard measures taken by the Eurosystem (fixed rate, full allottment, expanded collateral framework, long term refinancing operations). Other Eurosystem operations, which are not part of the implementation of the single monetary policy, also contributed to the increase in liquidity provision, such as emergency liquidity assistance… Target balances as such are a manifestation of the internal macroeconomic tensions within EMU that have surfaced with the crisis. Some argue that these tensions are similar to those which, in the absence of a monetary union, would have resulted in balance-of-payments crises, which in fixed exchange rate regimes would imply a need for exchange rate realignments similar to those that occurred with the collapse of the Bretton Woods system (Sinn and Wollmershäuser 2012). It has been argued that Target balances would then be similar to quasi-unlimited foreign exchange reserves.

have been imposed to stop a further expansion of the peripheral foreign debt (and therefore of further T2 imbalances). The OMT program announced by Draghi in summer 2012 returned some confidence to the financial markets so that a renewed flow of funds accrued again to sustain the peripheral sovereign debt reducing the T2 imbalances. However, from time to time there are signs that the persistence of the crisis in most EZ peripheral countries, particularly in Italy, might weaken the financial markets' confidence.

Does the fact that the ECB's intervention (or menaced intervention) halted the blast of the sovereign crisis in 2012 confirm Lavoie's (and De Grauwe's) thesis that "the Eurozone crisis is not a balance-of-payment crisis, but rather a crisis related to 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" (Lavoie 2014: 17)? What can be said at this point is that the ECB's intervention cured the symptoms but did not solve the underlying causes of the EZ unbalances.

3. The BoP crisis view: not only Sinn

Sinn's arguments, in their essence, have found support in the ultimate assessment of the T2 controversy by the ECB economist Philippine Cour-Thimann (2013: 23-4, my italics) that is worth quoting at some length:

> *With the financial and sovereign debt crisis, private foreign investors were no longer willing to roll over the financing of the cumulated current account deficits.*[15] *... The monetary authority, as a consequence of the ECB's decisions to accommodate the liquidity needs of solvent banks in dysfunctional markets, took on a major intermediation function. The emergence of Target balances within the euro area countries' balances of payments can be interpreted as the monetary authority having largely substituted for private money flows in the financing of the cumulated current account deficits of certain countries or beyond, when financial inflows reversed direction as in the case of Ireland. …*
>
> *Eurosystem liquidity support as reflected in the associated Target balances – and this is one of the hypotheses of this paper – has helped to smooth the balance of payments adjustments in EMU. Target balances are not a separate mechanism. The*

[15] Contrary to many initial convictions, the capital flights from the EZ periphery roughly correspond to the repatriation of former EZ core-countries loans that financed the current account deficits of the peripheral fellows (see Cour-Thimann 2013: 21; Cesaratto 2013a: 370-71).

> *Eurosystem liquidity support was given to the normal counterparties in central bank operations, namely banks, to support their liquidity position. 'In no way was there any aim to provide funds to finance current account imbalances – these are all indirect effects of a monetary policy aimed at maintaining price stability in the euro area.'*
>
> *The 'shock absorption' by the central bank is inherent in the construction of a monetary union where, firstly, the payment system ensures the smooth flow of capital in a currency whose value is the same everywhere in the monetary union; and 'secondly, the central bank takes decisions, within its policy mandate, that contribute to the preservation of the monetary union.'*

In one key passage the ECB economist unequivocally acknowledges that an "indirect effect" of the action aimed at preserving the working of the monetary union was, de facto, "to provide funds to finance current account imbalances". Of course, (a) this "stabilizing action gave time for policymakers to address the underlying causes of the imbalances – the question is whether this time it is being used effectively" (ibid: 24; see also Cesaratto 2013a: 378); and (b) the existence of T2 renders the EZ BoP crisis atypical compared to more standard fixed-exchange system crises.

In this last regard Michael Bordo and Harold James (2013) and Roberto Frenkel (2012) compared the EZ crisis to other classical episodes of crisis of fixed exchange regimes. Bordo and James particularly focus on the gold standard. In both the EMU and the gold standard "access to capital markets (overcoming 'original sin' that made financially immature economies unable to borrow abroad except in foreign-denominated currency)" and "reduction of borrowing costs" (Bordo and James 2013: 3) made these regimes attractive to peripheral countries. In both cases the "flows almost … produced an *expansion of the banking system* in the importing country. That expansion could turn into a source of instability if banks became unable to repay credits, either because of a liquidity or a solvency problem. …Sudden stops were sometimes caused by banking sector weakness, and sometimes lead to bank collapse" (ibid: 9 italics in the original). In both cases an "international diplomatic commitment" that private and eventually public credit flows would not reverse enhanced (up to a point) the financial market confidence (ibid: 12-13, 23). In both cases, painful adjustments after the crisis fuelled social protests (ibid 17, 24).

Roberto Frenkel (2012) compares the EZ crisis to those that have taken place from the 1980s until the early 2000s in the emerging economies.[16] He concludes that "the same factors (i.e. capital inflows and swift private credit expansion) have planted the seeds (i.e. the appreciation of the real exchange rate and the generation of important current account deficits) of the turning point [of the booming phase] and the second [contractive phase] of the cycle in both emerging markets and the …Eurozone economies" (ibid: 2). Frenkel differentiates between the culmination of the crisis in the emerging economies and in the EZ. In the former the crisis manifests itself as an exchange rate crisis:

> *The persistent increase in the current account deficit – and from a certain point the contraction trend in international reserves – reduces the credibility of the exchange rate rule, on the one hand, while increasing, on the other hand, the probability of default of the debt issued in international currency… At the end of the process there is no interest rate high enough to sustain the demand for local financial assets. There are runs on central bank foreign exchange reserves, which ultimately lead to the collapse of exchange rate regime.* (ibid: 8)

In the EZ the combination of T2 and of the refinancing operation of the ECB would eliminate the exchange risk so that:

> *'The role of the default risk premium in the sustainability of public debts in the Euro Zone is similar to the role it plays in the sustainability of foreign currency debts (public and private) in emerging market economies.' …the main source of negative feedback effects in the second phase of the cycle is the evolution of public debt ratios and sovereign risk premiums, throughout their effects on the portfolio decisions of the private sector. (ibid: 13, my italics; see also Artus 2014)*

The exchange rate risk (Draghi's convertibility risk) precisely manifests itself in the sovereign risk, the risk that a country obliged to refinance her sovereign debt at prohibitive costs had to leave the currency union. The two risks, convertibility and sovereign, should not therefore be seen as antithetical but concurrent.

In this regard in Cesaratto (2013a) I quoted Simonazzi and Vianello (1999: 247, my translation and italics) that in 1998 pointed out that in a CU the "exchange rate risk"

[16] On these crises, see the path breaking paper by Diaz-Alejandro (1985) and also Kaminsky and Reinhart (1999). They point out the linkages between financial liberalization-*cum*-fixed exchange rates *and* banking and BoP crises. Following Reinhart (2011) in Cesaratto (2013b) I defined this sequence as the "unfortunate sequence of events". See also Bagnai (2013).

might be temporarily suspended, and the financial market attention be concentrated on sovereign risk, to reappear again once the sovereign debt is considered unsustainable:

> *[M]onetary unification eliminates one of the two causes of interest rate spreads, that is, exchange rate risk, but not the other, linked to trustworthiness of debtors. If markets sometimes seem to forget this, it depends on the (usually justified) confidence of big operators in their ability to get out of the market in time …A heavily indebted country that wants to avoid austerity policy may therefore enjoy phoney credibility for a certain period, allowing it to borrow at cheap rates, but it will not escape judgment day, and the later it comes, the harder it will be. 'Financial speculation, unable to target exchange rates, concentrates on the sovereign bond market, determining a fall in bond prices, making servicing of debt unsustainable and exposing the country to risk of insolvency. In the market word goes round that the country would be better off leaving the currency union' and using inflation as a way out of its difficulties; these rumours aggravate the crisis, giving credibility to the rumours.*

Contrary to Lavoie's (2013: 12) reading, Simonazzi and Vianello believed that an exchange rate crisis was perfectly possible in a (flawed) currency union.[17] The question is, of course, if a pro-active CB can avoid this outcome.

In line with our argument at the end of the previous section, Frenkel adds that a sovereign risk "would not occur if the Euro Zone governments had a credible lender of last resort."(ibid: 9), but he warns:

> Even if the ECB had performed from the beginning of the crises as a credible lender of last resort for governments and the negative feedback mechanisms had been consequently neutralized, the GIPSI countries would be anyway trapped in contexts of debt deflation and low international competitiveness. (ibid: 14)

In this respect it should be noted that even in the US (a viable currency union) the Fed would not support local States but only a federal budget – although local States might expect support by the federal budget that would also take care of local banking crisis. Only a European federalization of the sovereign crisis – through Eurobonds and a

[17] A similar story is exposed by Whelan (2013). In the classical currency crises narrative of the 1980s and 1990s ultimately it is "the government's concern about its ability to repay foreign borrowings …that leads to governments being unwilling to do 'whatever it takes' to defend a fixed exchange rate. In this sense, concerns about sovereign default lay behind both fiscal and current-account devaluations" (ibid: 480). The devaluation risk apparently disappeared in the EMU with yields on sovereign debt first converging and later dramatically diverging once a sovereign default risk reappeared (ibid: 484-85). Although T2 accommodated the capital flight from the periphery, the crisis would not basically differ from the classical ones: countries might leave or be expelled by the CU once the inability to honour their T2 commitment becomes apparent (ibid: 2013: 498).

federal budget – could therefore legitimize an ultimate ECB intervention. This should be accompanied by intra-EZ fiscal transfers – the German scared "transfers union" – to mitigate the local fiscal adjustment efforts, and by a domestic expansion of surplus countries. In Europe, in the absence of a progressive and redistributive fiscal union, the ECB has displayed her "big bazooka" (the OMT program) just to keep the crisis at bay (complementing, so to speak, T2),[18] while the moral hazard arguments limited its intervention justifying the continuation of austerity measures in a pro-cyclical fashion.[19] As Frenkel (ibid: 13) puts it, the EZ has a potential lender of last resort but the present EMU institutional set-up bounds this role. In this respect Merler and Pisani-Ferry (2012: 16) noted that: "Contrary to common belief, a monetary union of this sort is closer to a fixed exchange-rate system among independent countries than to a fully integrated economy. Financial-market participants have realized this and certainly will not forget it. Only closer policy integration will preserve the euro area from the risk of further attacks."

Though, many supporters of the *BoP view* are still skeptical the *institutional set-up view* that stresses both the necessity of rebalancing macroeconomic policies and of regional transfers to re-balance the original sin of the monetary unification (e.g. Bibow 2014; Hein and Detzer 2014). Of course, this set up would be difficult to digest for the core-countries' public opinions. Moreover, it would not avoid the risk of a "mezzogiornificazione" of Southern Europe, unless one naively believes –after the decades of regional policies failures in Italy and Germany - in the rapid and miraculous effects of the various proposed European "Marshall plans" on competitiveness.

For completeness, it should be noted that the European BoP crisis has not emerged in the same way in all countries (in many we have evoked in this respect the

[18] In 2012 as a result of the repatriation via T2 of core-EZ loans to peripheral countries and of the 3years LTRO operation by the ECB, most of the peripheral public debt was transferred into the coffers of domestic commercial banks. Yet the renationalization of the public debt did not lead to lower interest rates, that is the spread with the German Bund continued to rise until the announcement of OMT in Summer 2012. Commercial banks were indeed buying peripheral treasuries employing loans from the Eurosystem denominated in euros, thus incurring a redenomination risk. This remained high up until Draghi's famous reassuring statement. The renationalization of peripheral debt was indeed only apparent: following Sinn's logic, it is as if the Eurosystem was officially lending to the periphery the funds withdrawn by the core-EZ private sector. Indeed, the net international investment position of the periphery did not change at all, just reshuffled with lower private and higher official loans.

[19] The moral hazard refers to an alleged tendency by profligate peripheral countries to profit from a a pro-active ECB and a relaxation of the fiscal rules.

unalike unhappy families of *Anna Karenina*). The most typical case of a Diaz-Alejandro/Frenkel unfortunate sequence of events is that of Spain and Ireland in which capital inflows fuelled a housing bubble and a mounting current account deficit. This was followed by a banking crisis that, via banks bail out, lately became a sovereign crisis (Lane 2011; Dejuàn and Febrero 2010). The Greek case might be comparable although in this case foreign capital directly financed the sovereign debt.[20] The banking crisis had an additional feature in Ireland and Cyprus, that is an oversizing of the bank international intermediation functions with respect to the GDP (Lane 2014). Portugal entered the EMU in 1999 having already had its "unfortunate sequence", that is after a foreign financed boom on the eve of its entry into the EMU culminated in a large current account deficit. The entry was followed by a long stagnation characterized, however, by an inflation rate above the EZ average, so that the current account did not adjust and the external debt service increased (Leao and Palacio-Vera 2011). Italy entered the EMU with a positive but declining current account surplus. It certainly did not participate in the sequence of unfortunate events but, in spite of the long stagnation, its competitiveness was slowly eroded by an above EZ-average inflation rate and by stagnating productivity, a result of low aggregate demand. Therefore also Italy, albeit to a smaller extent than the rest of the periphery, had to resort to foreign loans to fix the emergent CA deficit.[21] The Italian case resembles the UK case in the Bretton Wood system, the "'persistent imbalances between countries' analogy" that Bordo (2014) considers the most relevant for the "Eurozone's ongoing problems"[22] and that various economists participating to the Optimal Currency Areas (OCA) debate predicted (including Meade 1957 and Fleming 1971).

[20] An unfortunate sequence of events took certainly place in the non-EZ Baltic States and in Hungary which pegged their currencies to the euro.

[21] Up until the years 2011/12 nobody would have included Italy (and perhaps Spain) in the EZ periphery. It is in those years that the PIGS became PIIGS.

[22] Sinn and Wollmershäuer (2012: 30) compare the recreation of liquidity by the Eurosystem to the American "printing dollars" financing of the US current account deficit that preceded the collapse of the Bretton Woods system. Bordo (2014) rejects the comparison because T2 and the liquidity facilities are institutional features of the EMU (whereas Bretton Woods did not adopt Keynes' International Clearing Union). He would rather compare the current account difficulties of the EZ periphery to those of the UK in the Bretton Woods age concluding that "the 'Bretton Woods breakdown' analogy is less relevant than the 'persistent imbalances between countries' analogy."

To sum up, a widespread opinion I share is that, rebus sic stantibus, the EMU worked similarly to a fixed exchange rate system with de-stabilizing capital flows and external structural imbalances between non-homogeneous countries. In this context T2 and the ECB's OMT have impeded a dramatic increase of the redenomination risk, that is a classical BoP (or currency) crisis. An external structural adjustment has been imposed via austerity policies. The opposite road would be a fully integrated, progressive and redistributive federal union, currently way out of sight.

Conclusions

The EMU created serious imbalances among the EZ economies as predicted by the literature on the OCA, due for instance to different rates of productivity growth and inflation. Notably, the seminal contributions to OCA literature were written in the Keynesian years, as it is evident also in Mundell (1960),[23] let alone Meade (1957) and Fleming (1971). The imbalances have been in some cases exacerbated by core-to-periphery lending favoured by the fixed exchange rate regime that gives rise to a well-known "unfortunate sequence of events" typically culminating in a BoP crisis. T2 and the concomitant ECB refinancing operations impeded a blast of the BoP crisis. Incidentally, by accepting the analogy of T2 and Keynes' ICU – a device aimed at preventing BoP crises – Lavoie (2014) implicitly accepts an underlying BoP crisis in the EZ. While there are no definite limits to the T2 imbalances, a political limit has been set by the imposition of harsh austerity measures to the peripheral countries in order to obtain positive CA balances. This "imparts a recessive tendency" to the CU, as Mundell (1961: 658) warned long ago.

The redenomination risk did not show itself in the foreign exchange market – that by definition does not exist in a CU – but in the sovereign bonds market. T2 and the non-conventional ECB monetary policies notwithstanding, the sovereign debt crisis in 2011/12 involved Italy and Spain leading the EMU to the verge of a blast. The ECB's

[23] For instance, Mundell (1960) assimilated a currency union to the gold standard that "many economists blamed for the world-wide spread of depression after 1929" (ibid: 660) and censured the non-cooperative behaviour of the surplus countries, the U.S. and France in the 1920s and Germany in the 1950s, as sources of troublers for the international monetary order.

(menaced) action as a lender-of-last-resort through the OMT was effective to avoid it. However, OMT carries with it the ambiguity of being targeted at local States debt, which limits its objectives (in view of the moral hazard argument) and not at a Federal debt as in the U.S., where individual States are supposed to stay balanced and do not expect a Fed support. The EMU should therefore move in an American direction, obliging member States to stick to balanced budgets, federalizing the existing debts (through Eurobonds or the like) and creating a Federal budget, the last two measures with the full backing of the ECB. Federal revenues and spending should aim at rebalancing the intra-EMU imbalances. The political likelihood of such a move is, of course, nil. That a more satisfactory institutional set up would represent a full remedy to the unbalances brought about by the euro or just sanction a "mezzogiornificazione" of the EZ is also a matter of concern.

To conclude, since the EZ is closer to a fixed exchange rate regime rather than to a viable, U.S.-style CU, the euro-crisis is akin to a classical BoP crisis. True, the existence of T2 and the possibility of some ECB backing to troubled local sovereign debts make some difference. However, the limits to an ultimate action by the ECB in connection to the absence of other institutions that compose a viable CU render its action necessarily restricted. One can, of course, blame the lack of these institutions and of an ultimate action by the ECB as the culprit of the crisis, as Lavoie and De Grauwe seem to maintain. Yet, since those institutions are not there, the EZ crisis manifests itself as a balance of payment crisis.

The euro was the original sin.

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