

## Beyond orthodoxy: understanding money to understand the Eurozone crisis

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### Theme<sup>1</sup>

The Eurozone Crisis has shown that money is not a neutral veil, but rather a social relation between creditors and debtors.

### Summary

This paper argues that Optimum Currency Area (OCA) theory is limited in its capacity to help understand the Euro crisis because it emanates from the orthodox theory of money and therefore it underestimates the necessity of a political authority to underpin any given monetary space. It will show that a chartalist conception of money is more useful to grasp the fundamental weaknesses in the European Monetary Union (EMU). Overall, the argument is that the EMU will remain a fragile edifice as long as the Eurozone fails to create a centralised and legitimate political authority capable of taxing Eurozone citizens at the European level.

### Analysis

The asymmetric shock generated by the Global Financial Crisis (2007-09) has divided the European Monetary Union (EMU) into creditor and debtor countries. The large current-account imbalances created during the first decade of the single currency have proved to be unsustainable. However, the adjustment costs are falling mostly upon deficit countries. Locked in EMU –and hence without the possibility of devaluing their currencies–, weaker and consequently more indebted peripheral Eurozone countries have in recent years endured painful internal devaluation processes. These reductions in purchasing power are eroding popular support for the European integration process and threaten to tear apart the social fabric of these countries. In parallel, among the citizens of the stronger creditor countries there is the feeling that they have to pay –through the rescue packages– for what they perceive to be the profligacy of their southern neighbours, and this is fuelling support for populist parties with anti-immigration and anti-euro discourses.

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<sup>1</sup> This paper is a condensed version of the following academic article: M. Otero-Iglesias (2015), 'Stateless Euro: The Euro Crisis and the Revenge of the Chartalist Theory of Money', *Journal of Common Market Studies*, forthcoming.

The crisis appears to vindicate OCA-theory-informed Eurosceptic economists. In Krugman's (2012) words, this is a 'Revenge of the Optimum Currency Area' theory which 'was right to assert that creating a single currency would bring significant costs, which in turn meant that Europe's lack of mitigating factors in the form of high labour mobility and/or fiscal integration became a very significant issue'. While it is true that, in contrast to the US, the Eurozone has lower labour mobility and lacks a central budget to overcome asymmetric shocks, in the following I shall point out the shortcomings of OCA theory in understanding the Eurocrisis and consequently in proposing policy solutions to overcome it.

### *The origins of money*

First, it is important to realise that there are two historic schools on the origins of money. The first is the commodity-exchange school, which can be traced back to Aristotle and is endorsed by contemporary orthodox economic theory. Following Adam Smith's account of an imaginary village, Economics textbooks explain that money emanates *spontaneously* in the market to avoid the problem of the 'double coincidence of wants' that arises from barter. At some undefined point in history, the village butcher, baker and blacksmith decide to use a commodity that has intrinsic value and which is durable, divisible and portable. Thus, over the centuries, gold and silver became the monies that minimised transaction costs and fostered trade. This is the reason why this conception of money is generally referred to as the metallist school of money (Goodhart 1998).

In this conventional analysis, money is just another commodity which follows the rules of supply and demand. Its principal function is to be a medium of exchange which lubricates the process of exchange of goods and services. The meta-theory which supports this view is the 19<sup>th</sup> century neoclassical assumption that through continuous 'higgling' rational utility-maximising individuals are able to 'transform the myriad bilateral exchange ratios between all the different commodities, based on individual preferences, into a single price for any uniform good'. Money is introduced as a technical device to facilitate this process. Hence, according to orthodox theory, money is neutral, which means that 'not only can it be discarded whenever we are analysing the fundamental features of the economic process but it must be discarded just as a veil must be drawn aside if we are to see the face behind it' (Ingham, 2004, p. 17).

This conventional explanation of the origins of money has been challenged by the heterodox school of money. According to this view, the essence of *moneyness* is not to be found in its 'exchangeability' (its medium-of-exchange role) but rather in its capacity of measuring abstract value, thus in becoming the money of account. For this school –which can be traced back to Plato, and to which most of the historians, sociologists and anthropologists who have studied money adhere–, orthodox economic theory has failed to explain how the unit-of-account function is generated. The rational utility-maximising 'higgling' is not able to demonstrate the spontaneous appearance of a stable yardstick to measure value. As Ingham (2004, p. 25)

explains, 'it is difficult to envisage how a money of account could emerge from myriad bilateral barter exchange ratios based upon subjective preferences. One hundred goods could possibly yield 4,950 exchange rates'. Consequently, the very *idea* of money, that is to say, of the abstract accounting for value, is *logically anterior and historically prior to market exchange*.

How was the money-of-account function generated, then? According to historical analyses, there are two explanations, which are not mutually exclusive. The first considers that money emerges from the prehistoric *wergild* institutions. By establishing a value scale of the debts that offenders owed to their communities and their ancestors, the leaders of ancient tribes created the unit of account. Thus, money has its origin in law. The second theory claims that money appears around the third millennium BC in the command economies of ancient Mesopotamia and Egypt, where the political and religious authorities introduced clay tablets to record agricultural production and taxation and its redistribution. Here, money is closely related to administrative control and taxation.

Both historical explanations provide support for the state theory of money, and consequently bear important theoretical implications for understanding the shortcomings of EMU. Under this conception, developed by Knapp in 1905 (cited in Ingham, 2004, p. 47), it is absurd to understand money 'without the idea of the state'. Money is not a medium that emerges from market exchange, but rather 'a means for accounting for and settling *debts*, the most important of which are tax debts'. Thus, for Knapp, all money, regardless of its form, is a token which bears and carries the money of account of the state. The Latin word for token is *charta*, so he defined money as 'a Chartal means of payment', which explains why his conception is generally referred to as the chartalist theory of money (Goodhart 1998).

This theory is more convincing than the orthodox metallist explanation of the origins of money for it is able to explain logically the creation of the money-of-account function. This device does not emerge spontaneously from market exchange, but is rather introduced by a political authority. Therefore, money has always been related to sovereignty. This is the reason why historically silver and gold coins had the faces of the sovereigns impressed on them. Ultimately, they guaranteed the stability of the system at times of war and default.

### *The orthodoxy of OCA theory*

Despite the numerous flaws in the orthodox understanding of money, it is striking to see how this theory still dominates modern economic analysis. In fact, contemporary OCA theory –the theoretical device used to analyse EMU– emanates from the commodity-exchange theory. It applies the same logic on the spatial dimension. Optimum currency areas thus emerge spontaneously through market activity, which always seeks to reduce micro-level transaction costs and macro-level adjustment costs based on the efficient mobility of the factors of production (labour and capital).

Money under this conception is neutral, and therefore irrelevant, because the focus of the analysis should remain on the factors of production that make the real economy. Consequently, politics plays no role in establishing which currency is used in a particular geographical area. As Goodhart (1998, p. 420) puts it, 'under the (pure) OCA theory there is no reason why currency domains need to be co-incident and co-terminous with sovereign states'. However, the reality is that we live in a world of 'one country, one currency'.

Thus, the case of EMU is certainly unique. For the first time, powerful sovereign nation-states have decided to pool monetary sovereignty and, most importantly, have relinquished the capacity to create money –and thus to monetise sovereign debt– by giving by treaty full independence to the European Central Bank (ECB) and banning it from bailing out any EMU member state. From a chartalist point of view, this is a flawed development. Sovereignty and money go hand in hand.

Surprisingly, at the time of the creation of the single currency, this weakening of the link between the currency and the sovereign was seen as a positive development. As Otmar Issing (2008, p. 234), founding member of the executive board of the ECB, put it: 'the euro represents depoliticised and hence stable money'. However, political economists such as Goodhart (1998, p. 425) criticised the theoretical underpinnings of the euro because 'OCA theory has little, or no predictive or explanatory capacity. Unlike the [chartalist] theory, it is unable to account for the close relationship between sovereignty and currency areas – a relationship that tenaciously persists through the course of the creation, and break-up, of federal states'. It is precisely this relationship, or the lack of it, that explains the severity of the Eurozone crisis.

#### *OCA theory's (non) solutions to the Eurocrisis*

One of the main problems of OCA theory is that it ignores the 'political economy' factors that make currency areas. In other words, by focusing mainly on the *real* economy, OCA theory overlooks credit relations and their inherent power struggles. The avoidance of political economy factors is observable in the proposals to solve the euro crisis put forward by Krugman (2012), one of the leading OCA theorists. In his view, the option of creating an American-style United States of Europe, which would be a fully-fledged transfer union, 'does not seem like a reasonable possibility for decades if not generations to come'. Nonetheless, he says that there can be some more limited solutions that can make the Eurozone workable. Specifically, he proposes three developments: (1) creating a banking union with a supranational supervisor and a federalised deposit insurance and bank resolution scheme; (2) assigning a Lender-of-Last-Resort (LOLR) function to the ECB for member states; (3) establishing a higher inflation target for the Eurozone to allow indebted peripheral countries to undergo a less painful internal devaluation process and thus make creditor countries share the costs of the macroeconomic adjustment necessary to unwind the current-account imbalances.

Here we see how Krugman remains loyal to the orthodox theory of money by proposing technical solutions without considering the political economy inherent to them. He thus excludes any notion related to democracy, legitimacy, sovereignty and power. The question, however, is whether these solutions are feasible without the initial premise of the necessity of a federal union (a European sovereign).

### *The creation of a banking union*

The creation of a complete European banking union, as initially agreed by the European Council in June 2012, with a supranational supervisor, a single resolution and a common deposit insurance mechanism would essentially mean the establishment of a fiscal union by the backdoor. This is the reason why, in September 2012, the Ministers of finance of Germany and the other two AAA creditor countries (Finland and the Netherlands) decided that legacy debt would not be included in this banking union and therefore that direct bank recapitalisation through the ESM would not be allowed.

Apart from the mutualisation of legacy debt, a banking union would have other major implications connected to sovereignty, legitimacy, redistributive outcomes and democratic control. The ECB, as the new single supervisor, will have to develop its supervisory tasks under a concrete regulatory framework that needs to be legitimised by democratic institutions. In real concrete terms, one wonders whether the newly created European single resolution mechanism (SRM) will have the legitimate capacity to close down a big bank in France. The most likely outcome is that the French sovereign will fiercely resist such a non-legitimised supranational intrusion, especially if it implies a take-over by a rival Spanish or German bank.

This danger was acknowledged by the ECB's President, Mario Draghi (2012a), when he said at the end of 2012 that for EMU 'to succeed, institutional reforms must extend to the financial system, to the fiscal and economic policy framework and to the area of *democratic legitimacy and accountability*'. The ECB knows that the bail-in framework adopted by EMU member states for future bank rescues is not enough. Several board members have repeatedly argued that to break the doom-loop between national banks and national sovereigns, a single supervisor needs a SRM with a joint *and potent* fiscal backstop. History shows that if there is a systemic financial crisis, as in 2008, bail-ins will not work. Some European banks are just too big to fail. Thus, bail-outs will be necessary to prevent panic and bank runs. The European taxpayers' money will have to be used to calm the financial markets. However, in the absence of a European treasury, the non-democratically elected ECB will have a preponderant role in deciding how to use these funds. Yet again, the question arises: can there be an unlimited European fiscal backstop without a European sovereign to legitimise it?

### *The ECB as the lender of last resort*

A similar conclusion can be drawn from the second of Krugman's technical preconditions for the sustainability of the euro: to make the ECB the lender of last resort (LOLR) for EMU member states. Again, the discretion of deciding why and when to finance the debt of an EMU member state has such political-economy ramifications that, arguably, it cannot be done without democratic legitimacy. This is indeed what has allowed the FED and the Bank of England to monetise debt through quantitative easing, and why the ECB has been so reluctant to do so.

Of course, the ontological principles of money cannot be avoided. Due to the severity of the crisis, the ECB has had to overcome its orthodoxy by adopting first the Securities Market Programme (SMP), then the Long Term Refinancing Operations (LTROs), more recently the Outright Monetary Transactions (OMT) programme and eventually, after five years into the crisis, Quantitative Easing (QE). With this the ECB has *de facto* (if not legally) become a LOLR for both banks *and* sovereigns. Hence, the unfolding of the crisis has given further support to the chartalist school. For many it was only when Draghi said that 'the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough' that the financial markets regained confidence in the single currency. However, a central bank is not a legitimate sovereign. It was not Draghi's words that saved the euro, as is widely believed. It was the endorsement of those words by Chancellor Merkel, representing the full weight of the German taxpayer, which saved the euro –for now–. As Draghi (2012b) acknowledges:

'The ECB cannot replace the actions of national governments with respect to either economic policy effectiveness or democratic legitimacy. Ultimately, it is up to governments to dispel once and for all the persistent uncertainties that markets and citizens fear. The ultimate goal is political union, a stable and integrated Europe with a common destiny'.

Ultimately, the question is whether the ECB can function in the long run as a LOLR in the absence of a European sovereign with the legitimate capacity to tax its subjects. Both the OMT and QE programmes of the ECB are looked upon with suspicion in the creditor countries, especially Germany. German concerns are understandable. By applying OMT or QE the ECB will buy, for instance, large amounts of Italian debt, which will mean the *de facto* mutualisation of substantial risks (and their redistributive outcomes) in the ECB's balance sheet. At the same time, however, there will be no mutual control regarding the collection of taxes in Italy to repay the debt. This is why the mutualisation of risks under the recently proposed QE programme has been capped at 20%, with the remaining 80% sitting on the balance sheets of the Eurosystem's national banks. It remains to be seen whether this capped mutualisation will do the trick or whether a full joint sharing of risks will be required to convince the markets of the euro's irreversibility.

In any case, we appear to be entering dangerous ground, in which there is an increased mutualisation of debt at the supranational level but tax collection remains at the national level. Considering that there is a strong view among the populations of the creditor countries of the north that tax evasion is widespread in the south, it is unlikely that they will accept such redistributive effects on a permanent basis. To avoid moral hazard, the populations of the north will either want to go back to their national currencies or ask for certain tax collection to be controlled at the supranational level, which would require the creation of a European sovereign.

Equally, a legitimised central authority might also be required for the populations of the indebted periphery to accept the conditionality attached to a possible ESM/OMT programme, in what political scientists call the 'consent of the losers'. By being part of the Troika, the ECB would have the enormous power to decide when it starts and stops to be a LOLR. This would give it the power to influence the economic policies of the member states and thus how the adjustment costs between creditors and debtors are distributed. Given recent mass protests in the rescued countries, and the appearance of radical movements such as Syriza in Greece and Podemos in Spain, who contest the legitimacy of the Troika, there are serious doubts that the ECB can do this in the long run without the legitimacy of a European sovereign. Ultimately, economic reform programmes need to be negotiated with what should be the equivalent of the Ministry of Finance of the Eurozone and not the ECB.

### *Sharing the adjustment costs*

Krugman's last proposal is the increase of the ECB's inflation target to perhaps 4% to facilitate a more symmetric adjustment process between creditor and debtor countries in the Eurozone. While this proposal is economically and ethically sound (for every irresponsible debtor there is an irresponsible creditor) as the analysis above shows this suggestion is inherently laden with notions of power. The current Eurozone crisis demonstrates graphically how money is always a social interaction (and in numerous occasions a social struggle) between creditors and debtors. Krugman's proposal is therefore not economic, it is political, and thus it needs to be analysed.

The problem with it is that it is opposed by the main creditor, and the most economically powerful, country in the Eurozone: Germany. The matter is even more complex. An increase in inflation is not only opposed by creditor nations, there is also a generational and class power-play occurring in the Eurozone. Older generations, across countries, with assets, savings and pensions in the banking system, are more prone to favour the continuation of a low inflation policy by the ECB, while the newer generations with few assets, perhaps even indebted and unemployed, especially in the south, might desire higher inflation to reduce their debt levels and stimulate economic activity. Similarly, capital might in general favour sound money, while labour might see a higher level of inflation with good eyes.

Normally, these social struggles around the value of money are resolved through a democratic process. Unfortunately, the Eurozone lacks fully-legitimised democratic institutions that can function as the democratic arena to come to a cross-country, cross-generational and cross-class compromise. Lacking this framework, what tends to happen in the EU is that powerful states determine the agenda, and usually these states are France and Germany, and recently more Germany than France.

As the main creditor country, Germany has early on realised that the shock emanating from the global financial crisis would hit the debtor countries asymmetrically, and thus Berlin would be in a strong bargaining position vis-à-vis the other Eurozone capitals. Thus, since the start of the crisis we are witnessing a 'game of chicken' between the creditor and debtor countries in the Eurozone, and for now the debtors have been forced to give in first. Most of the adjustment is falling upon them, with Germany and the other creditor countries conceding only what is absolutely necessary to preserve the integrity of the Union. It is important to point out that most of the EFSF/ESM rescue money offered to the indebted nations has not been used to bail out their populations, but rather to save the banks of the creditor countries. As mentioned above, money is the struggle of creditors against debtors, but it is also the stuff that has the potential to bind them together. Under a reluctant German leadership, the response to the crisis has been to create more Europe, not less.

Nonetheless, Merkel's brinkmanship has its limitations. Socially, the emerging 'executive federalism' can backfire. In the debtor countries, fiscal austerity and internal deflation over a number of years have triggered social unrest, anti-German feeling and the emergence of populist movements demanding debt cancellation. Perhaps more importantly, politically, Merkel faces a major obstacle: France. The political leaders, and even the populations, from indebted large Eurozone states like Spain and Italy might be disposed, although reluctantly, to side with Merkel when she says 'We need more Europe, we need not only a monetary union, but we also need a so-called fiscal union, in other words more joint budget policy. And we need most of all a political union – that means we need to gradually give competencies to Europe and give Europe control' (cited in *EurActiv*, 2012). The question is whether the political establishment in Paris is prepared to give up fiscal sovereignty to Brussels. This is doubtful. Hence, the ultimate struggle will be between Paris and Berlin.

## **Conclusions**

Yet again, as in the discussions about political union in the 1970s and 80s, Europe is in a deadlock between France and Germany. While Germany wants to create first a political union of stability, and only later share the costs of the crisis, France proposes first to create a union of solidarity to overcome the crisis, and only afterwards discuss the possibility of a more centralised political union. Again this is a game of chicken. France wants the mutualisation of debts via eurobonds, a banking union with an unlimited fiscal backstop and an ECB with the capacity of LOLR, while

Germany desires centralised control of national budgets (both at the level of expenses and taxation). It is difficult to know who will give in first (by agreeing to QE, Germany might have been softer than is usually thought), but what seems increasingly evident is that for the euro to survive, the broken link between money creation and sovereignty will have to be reunited at the European level. In this regard, the euro crisis is not the revenge of OCA theory, but rather the revenge of the chartalist theory of money.