Eurobondage
The Political Costs of European Monetary Union

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Chapter Two

The Political Costs of Monetary Union

Most arguments for creating a monetary union in Europe rested upon three important beliefs: 1) a monetary union would generate economic growth by reducing risk and transaction costs; 2) a monetary union would create a greater sense of union or community in Europe; and 3) the political costs of joining a monetary union were small, as individual member states had already lost their capacity to pursue an autonomous monetary policy (as witnessed most dramatically by the failed Mitterrand experiment).

Although each of these beliefs was widely held at the birth of the Eurozone, they have become much more difficult to embrace in light of recent developments. The first two beliefs are challenged in the daily headlines of the world's press, where the inadequacies of the Eurozone are blamed for the continent's economic malaise and the growth of a xenophobic nationalism that threatens the European project. The third belief will be tested in the pages that follow: whether small European states managed to maintain a degree of monetary policy autonomy outside the Eurozone, and whether this autonomy was used to secure political (popular and just) objectives. This chapter lays the groundwork for that test by describing the political costs of monetary union, and how these can be operationalised.

This chapter is divided into three parts. I begin by justifying a more political approach to monetary policy. This is necessary, if only because so much of the policy discussion (and its supporting academic analysis) has focused on questions of efficiency. By ignoring or downplaying the distributional consequences of their decisions, policy makers can threaten the legitimacy and stability of democratic regimes. While austerity and internal devaluations may generate economic growth over the long run, they can also create the sort of political instability that will jeopardise those long-term economic gains. As di Muzio and Robbins (2016: 99) point out, 'what leading economists and banks call "austerity" is, in reality, a "taking" from others.' To secure long-term, sustainable and stable outcomes, policy makers must balance the needs of both efficiency *and* justice.

The second part of the chapter focuses-in on the political effects of monetary policy. It does this by defining monetary policy in very broad terms and then elaborating on the distributional consequences of various monetary policy choices. While economists tend to argue that monetary policy needs to focus on aggregate demand (and fiscal policy should be used to affect distributional outcomes), this section points to the important distributional consequences associated with monetary policy decisions. At a time of rising inequality and radicalisation, it is important to be aware of these distributional consequences.

The chapter's third part leverages this discussion to reveal the potential political costs of membership in a monetary union. In joining a monetary union, political authorities effectively jettison their political responsibility for economic management (at the regional/national level). Consequently, their citizens become more exposed to markets and the burden of economic adjustment lands most heavily on the shoulders of society's weakest members. Regional adjustments are secured by (downward) wage flexibility, market-driven labour mobility, and shrinking (local) budgets for public services. On the other hand, the main beneficiary of this change is a small, elite and international group of mobile asset holders. This opens up an important distributional gap with significant political consequences.

In light of this discussion, we can generate expectations about the political costs of joining a monetary union: members of a monetary union must adopt a one-size-fits-all form of monetary policy that prioritises the interests of traders and money changers. States that avoid monetary union enjoy the opportunity to pursue more popular and just policies, to the benefit of their constituents. They can, of course, use their autonomy to deliver poor and inappropriate policies as well. We can measure this political effect in two ways: by comparing the capacity of states to deliver economic outcomes for society's most vulnerable members; and by seeing which states are able to deliver popular policies (those embraced/demanded by their constituents).

In the end analysis, Europeans may wish to prioritise the potential for economic gain that is promised by monetary union. In doing so, however, we need to be aware of the significant political costs involved.

Balancing efficiency with justice

By the political costs of monetary policy, I mean the loss of democratic influence on economic decisions (and outcomes). Beneath this definition lies a belief that elected officials should be held responsible for economic outcomes, that they are responsible for protecting the most vulnerable segments of their population, and that they need the appropriate tools to secure those outcomes. When democratic officials are unable to direct economic policy in accordance with national/domestic demands or needs – or worse, when they willingly discard those tools in the name of market freedoms – then we face a significant challenge to democratic governance.

Our willingness to ignore the political effects of monetary policy is remarkable, given the important role that monetary policy played as a central measure for taming the business cycle in the post-war economy. There are probably three reasons why we have let our elected officials jettison this responsibility. First, and as hinted in the introduction, there was a growing consensus that changes in the international economy had undermined the scope for autonomous monetary policy. This important belief will be tested in the chapters that follow. Second, many economists are ideologically predisposed to believe that the political effects of a policy decision are irrelevant to the cost/benefit analysis. Although

this is slowly changing, and it is possible to find a renewed interest in inequality and distributional issues among economists and policy makers, the analytical approach of many economists still makes a false distinction between economic and political spheres (with their analysis being limited to the former). In order to maximise economic gains, politics is often side-lined in exchange for more rule-based and technocratic solutions.[1] A majority of economists honestly believe that re-distributional issues are best secured by fiscal policy, and that monetary policy should be dedicated to influencing aggregate demand.[2] In the doing it is implied that the distributional consequences of monetary policy are insignificant. Also, when countries join a monetary union, they lose the capacity to wield many of these additional policy tools. Finally, many analysts simply (albeit implicitly) assume that the political benefits of monetary policy follow directly from the economic benefits.

For the democratic citizenry, however, there are at least two good reasons to maintain political influence over monetary policy. The first reason is normative and the most important: governance is not just about efficiency; it is also about justice and vision. Because decisions about monetary policy have important distributional consequences, constituents should expect the polices of *their* elected officials to reflect democratic priorities (and that there will be political repercussions for unpopular policies). After all, some of the most pressing political issues of the day (e.g. unemployment, debt-relief, income inequality, economic stagnation) are affected by monetary policies. When policy decisions result in significant political repercussions, they should not be isolated from political influence, and policy makers should not pretend that they can be resolved by the application of technical expertise. Alternatively, if central banks are to be independent, they should be independent of the financial interests whose fate they help to secure. It is precisely because monetary policy has the potential to generate outcomes with significant consequences for the relative material well-being of different groups of citizens that it cannot, and should not, be isolated from democratic influence (yet should be isolated from narrow economic interests).

In arguing that monetary policy should generate fair outcomes, I mean that it needs to reflect the interests of the broader population and the most vulnerable among us. In democratic states, we do this (in part) by creating institutions that depend on votes and other expressions of preference.[3] To ensure just and

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1. The choice between rules and discretion has been central to the academic literature on the conduct of monetary policy since Simons (1936). See also Kydland and Prescott (1977) and Fischer (1990).

2. Many also harbour rather patronizing views of elected officials, who 'pander' to voters. Sinn (2014: 59) is exemplary: 'This is apparently the problem with democracy. A government commits to agreements and sticks to its promise of fulfilling them, but its successor dumps the commitments in favour of pandering to the current needs of voters, instead of doing something for future generations, perhaps even secretly speculating on its neighbours' eventually accepting joint liability for its debts.'

3. For example, Robert Dahl (1971: 1) holds that the fundamental democratic principle is 'the continuing responsiveness of the government to the preferences of its citizens, considered as

democratic outcomes, the authority to conduct monetary policy should lie in institutions that matter and are responsive to their democratic constituents. There are two components to this argument, as elaborated below: 1) removing popular control over monetary policy is inherently problematic from a democratic perspective; and 2) removing democratic control over monetary policy has distributional consequences – it benefits some groups, at the expense of others. Should democratic institutions prove to be less efficient than other arrangements, the political community needs to balance the desire for democratic legitimacy against the desire for increased efficiency.

We should expect democratic policy makers to pursue policies that deliver just outcomes. As a rough surrogate for just outcomes, we can measure the results of that policy on the most vulnerable members of society.[4] In short, economic analysts and the finance sector prioritise the need to secure economic growth, minimise inflation, public deficit and public debt levels. Consequently, this is where most of public attention has been focused. But it is also legitimate to consider the effects of the crisis on another set of indicators, such as the levels of inequality, unemployment, social expenditures and emigration. These indicators are particularly interesting as they reflect the ability and willingness of a state to take care of its most vulnerable citizens. Of course, the two types of indicators (efficient/just) are related to one another, and connected by a significant lag. Hence, it may take some time before the economic gains trickle down to society's most vulnerable members; in the meantime, we need to know how they fare.

There are no simple answers to the questions being asked. If a policy decision (such as central bank independence) can be shown to generate superior economic outcomes (for the benefit of the people), is it legitimate to insulate central bank governors from democratic pressure? What if the resulting economic gains benefit one group of people more than others (e.g., lenders over borrowers)? If there is a trade-off between economic efficiency and democratic responsiveness, should we always prioritise economic gain? Cannot the same argument be made about fiscal policy? Or governance in general? Think of the money, time and effort we could save if we got rid of regular elections and instead chose our governors by way of an algorithm (or some other measure of technical or expert competence)!

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political equals.' Dahl's eight institutional arrangements for securing democracy include: freedom to form and join organisations; freedom of expression; right to vote; right of political leaders to compete for support; alternative sources of information; eligibility for public office; free and fair elections; and *institutions for making government policies depend on votes and other expressions of preference*.

4.   Operationalising justice in this way will be familiar to readers of Rawls (1970), in that it employs a (max-i-min) approach to justice. But Rawls arrives at his position in a radically different way: by way of a thought experiment that involves the veil of ignorance. In short, for Rawls, individuals would rationally choose a society that maximises the position of those who are most vulnerable (as they don't know which rung in society they will occupy, when deciding on the social contract behind a veil of ignorance). What I am proposing is much different: a simple attempt to measure the degree to which policy outcomes benefit (or not) the most vulnerable groups, and use this as a surrogate measure for just outcomes.

In opening up this Pandora's Box, I aim to demonstrate that difficult trade-offs are involved, and that we need to make people more aware of the political costs associated with those trade-offs. Making such difficult decisions is precisely the strength of democratic forms of governance: they allow communities a peaceful, legitimate and just means of resolving tricky decisions.

This brings me to the second argument for a more political approach to monetary policy. While the first argument rests on a normative embrace of democratic values, the second argument is more instrumental, as it concerns political stability. This argument draws on Karl Polanyi's (2001 [1944]) caveat about the necessity of embedding economic exchange in their requisite social and political contexts. When the values of economic exchange are allowed to trump political and social conventions, especially as they regard the markets for 'fictitious' commodities (such as labour and capital), we can expect strong political and social reactions.

Every attempt to create 'free' and unfettered markets has clear and detrimental political consequences, as spelled out by Fred Block in his introduction to Polanyi's *Great Transformation*:

'The fictitious commodities explain the impossibility of disembedding the economy. Real market societies *need* the state to play an active role in managing markets, and that role requires political decision making; it cannot be reduced to some kind of technical or administrative function. When state policies move in the direction of disembedding through placing greater reliance on market self-regulation, ordinary people are forced to bear higher costs. Workers and their families are made more vulnerable to unemployment, farmers are exposed to greater competition from imports, and both groups are required to get by with reduced entitlement assistance. It often takes *greater* state efforts to assure that these groups will bear these increased costs without engaging in disruptive political actions. This is part of what Polanyi means by his claim that "laissez-faire was planned"; it requires statecraft and repression to impose the logic of the market and its attendant risk on ordinary people' (Block 2001: xxvi-xxvii, emphasis in original).

I'm sure readers will recognise that Block is describing precisely the sort of populist backlash that now tears Europe asunder. Long-term economic solutions that exacerbate income inequality, and demand greater austerity from those who can least afford it, are not sustainable over time. They will be met by political opposition and increased radicalisation, even the threat of revolution. The rise of fascism and communism, in response to the failures of the liberal interwar regime, are examples of this type of radical reaction. Between 1929 and 1933, German wages plummeted by 27 per cent, while unemployment rose to 30 per cent (Sinn 2014: 139). While other countries used devaluations to de-link from the Gold Standard (and, with them, the austerity plans and internal devaluations required of that commitment), Germany chose the more austere route and its internal devaluation pushed the country to the brink of civil war and its eventual embrace of Fascism. Europe today faces a similar challenge. To navigate these

tricky economic waters, policy makers need to steer a middle course that balances economic and political objectives.

To generate fair, stable and legitimate outcomes, it is necessary to secure democratic influence over important policy decisions (and the institutions in which they are made). When a country abdicates political control of its monetary policy to distant (and politically isolated) institutions, it pays a significant political cost – in that it loses influence over outcomes that can be seen as unfair, resulting in increased political instability.

In the end, the political costs of monetary policy decisions, whether large or small, still need to be weighed against the potential gains (both political and economic) from that decision. It is possible to imagine four possible outcomes, as outlined in the matrix below (Figure 2.1).

Figure 2.1: The policy makers' decision matrix

		Political	
		Costs	**Benefits**
Economic	**Costs**	1 (Inferior)	2 (Embedded)
	Benefits	3 (Faustian)	4 (Superior)

Of the four options, the first (option 1) is not very attractive, and will be avoided at all costs. On the other hand, option 4 is superior in the sense that the country's economic and political objectives are seen to go hand-in-hand. This implies that a state can chose a monetary regime that secures both economic and political gain. As suggested above, this seems to be the implied position of many policy makers today. In option 2, a state chooses to prioritise the domestic needs of its constituencies over the price of greater economic reward. With a nod to Polanyi, I refer to this as an Embedded Strategy, where economic exchange is a means to achieve (more just) political ends.[5] Option 3 embraces an inverse set of priorities. This option is akin to a Faustian Bargain, where states are willing to sell their democratic autonomy in exchange for the promise of greater economic reward.

This larger cost/benefit analysis lies beyond the scope of the current study, but I see it to be the rightful task of elected policy makers, responding to their democratic constituents. It is entirely possible to recognise the political costs of monetary union, and still believe in the desirability of a currency union in Europe – because (for example) the economic, political and ideological gains are sufficiently large to cover any potential political costs. But I worry that the pursuit of these economic gains will result in significant political costs that will, eventually, dwarf any promised returns.

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5.   This option could also be called a Conservative Strategy, as it is reminiscent of the logic of American Federalists who consciously designed an inefficient constitutional structure, in order to protect against the possibility of capture by a particular faction (or tyrant). In other words, policy makers may find that there are more important concerns than the promise of economic gain, and choose a less efficient regime in order to optimise the political benefits.

Chapter Three

Debt and Distribution

This chapter provides a comparative snapshot of the financial crisis in four countries, and then contrasts these snapshots against the Euro-area (EA) average. There are many ways to measure the costs of economic crises and our success in fighting them. The first part of this chapter examines a number of headline indicators, such as economic growth, government debt and inflation levels. These indicators can provide useful information about long-term economic trends and potential – and they are often heard on the tongues of economic commentators and investors – but they are not very useful for gauging the human and social costs of the crisis. To gauge these costs, we need to consider whether the authorities have pursued policies that deliver more immediate relief for their citizen constituents. For this reason, the second part of the chapter considers four alternative measures of economic well-being: unemployment, social spending, income inequality and emigration. Together, these two sets of indicators provide us with a fuller understanding of who benefited (or didn't) from the decision to stay within the Eurozone, or to pursue more independent monetary policies.

More than any of the others, this chapter relies on an array of figures and tables. These descriptive statistics are necessary for two reasons: they help to establish the severity and nature of the crisis in all four states under study, and they allow us to see that a state's response to the crisis can have complex effects on different groups within that country. In examining these figures we become aware of how policy makers face two important trade-offs.

On the one hand, they need to decide whether to prioritise the needs of international markets or domestic constituents. This is the main trade-off with regard to political autonomy, as states abandon their capacity to respond to domestic needs when they jettison their monetary policies. On the other hand, policy makers need to balance short-term versus long-term responses to the crisis. Over the long-run, of course, there may not be a conflict between the interests of international and domestic constituents. But it is still too early to measure these potential long-term effects. In the meantime, we *can* measure the shorter-term effects of these policy decisions, and consider whose interests tend to benefit (or not) from those decisions. In the doing we can get a better sense of which policy makers are able to prioritise the interests of their domestic constituents. In the final analysis, readers can gauge for themselves whether the promise of long-term economic gain is worth the substantial short-term costs/misery that domestic constituents are often expected to pay.

Conventional indicators

We begin by gauging the severity of the crisis in our four cases, relative to the EA average. To do this, we examine developments in three of the most common

economic indicators: the effect of the crisis on the country's aggregate economy; its government debt level; and its level of inflation. These indicators are often used as shorthand for success/failure when evaluating policy responses to the crisis, and they can be useful in outlining the seriousness (and the underlying nature) of the crisis in each of the cases.

GDP/capita

One of the most common and obvious measures of the crisis is the effect it has had on a country's Gross Domestic Product (GDP). To compare the severity of the crisis across cases, this section employs three related indicators. The first simply compares countries in terms of their per capita GDP, from 2000 to 2014. This indicator provides us with a sense of the general trend over time, and the levels of wealth that separate the four cases. We then turn to a measure of the country's annual change in GDP, in order to compare the depth of the crisis across countries, and to mark the economic nadir in each case. Finally, by measuring and comparing the size of the economic fall, from top to toe, it is possible to rank the depth of the crisis in each state.

Figure 3.1 compares GDP/capita, in a common currency (the euro), since the year 2000. From this figure, three trends are especially noteworthy. The first concerns the relative level of wealth across our four cases. In effect, the sample can be divided in two: there are two relatively wealthy states (Ireland and Iceland) – where GDP per capita is currently equivalent to about €40,000; and two relatively poor states (Hungary and Latvia) – where the GDP/capita level is about a quarter of that in the richer countries (or currently around €10,000). The EA average lies roughly in the middle, at about €30,000 per person in 2014.

Figure 3.1: GDP/capita in four cases, 2000–2014
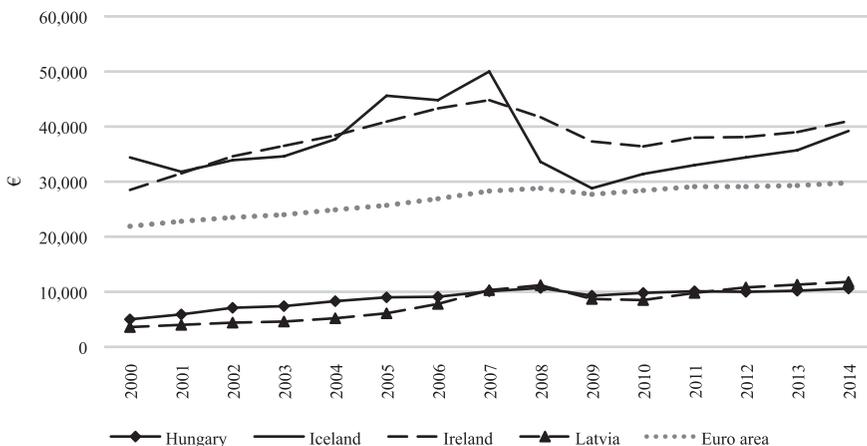
Note: Gross domestic product at market prices. The Euro area (EA) aggregate includes 19 countries.
*Source:* Eurostat [nama_10_pc].

The second noteworthy trend concerns the relatively smooth and positive trend in the EA-average indicator. The smoothness itself is not surprising, as it results from the aggregation of nineteen (more volatile) national indicators, including (among others) Germany and Greece. But any lessons derived from data, when aggregated at this level, can be very misleading. If policy makers were to use this level of aggregation to gauge the state of Europe's economies (and this *is* the level of aggregation at which Eurozone policy makers at the ECB must focus!), there would be little cause for concern: GDP/capita of the EA-average grew slowly over most of the period, with only a slight dip in 2008 (though it has lumbered under a mostly flat trajectory ever since).

Third, and finally, the Icelandic case seems to be more volatile than the others: its economy experienced a quick and long fall in 2007, before recovering slowly after 2009. This volatility is a result of comparing in euros, and reflects the króna's strong devaluation in response to the crisis (as we will see in Chapter Four). If we compared per-capita growth rates converted into US dollars, then the trends in Iceland and Ireland would have been much more similar (and smoother), while Latvia's trend would become the most volatile.

Because two of the countries in this figure have an independent currency (and hence comparisons require the use of an exchange rate that can be leveraged as a policy instrument), it is easier to compare the effect of the crisis by looking at the annual change in GDP (using their own, national currencies). This comparison is shown in Figure 3.2, and it reveals a very different picture.

*Figure 3.2: GDP in four cases, per cent change, 2000–2013*
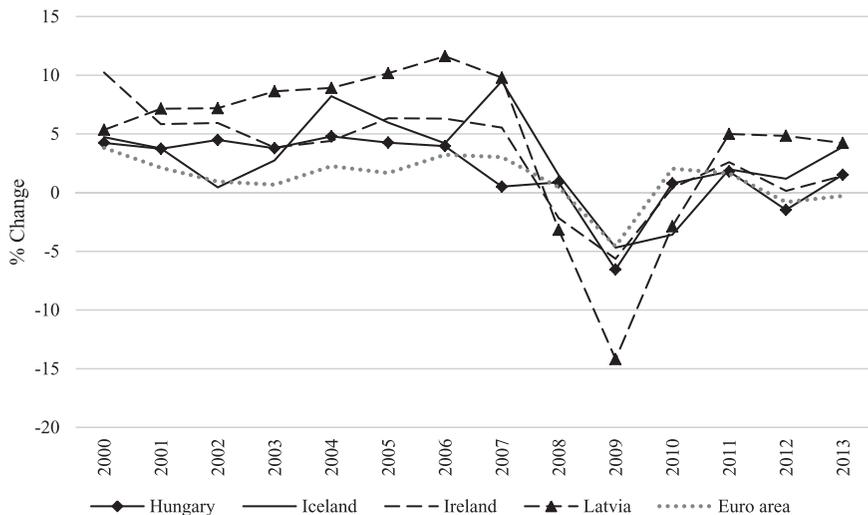
Note: Annual percentages of constant price GDP are year-on-year changes; the base year is country-specific. The Euro area (EA) aggregate includes 19 countries.
Source: IMF (2015a)

From Figure 3.2 it is clear that most countries begin to experience the effects of the crisis in 2007, and that these effects were felt hardest in 2009. In that year, Latvia experienced a remarkable 15 per cent decline in its GDP from the previous year. In the following two years, 2010-2011, all the economies in this study begin to grow again. Several states (including the EA average) experienced another dip in 2012 – and two of the cases again suffered from negative growth (the EA average and Hungary; while Ireland grew by a miserly 0.15 per cent). Finally, none of the states has managed to return to their pre-crisis growth levels, although Latvia (at roughly 5 per cent) has improved more than the others.[1]

From Figure 3.2, then, we can see that the depth of the crisis might be measured by comparing a country's GDP level in 2007 with that in 2009.[2] The results of this simple calculation are shown in Figure 3.3.

Figure 3.3: Per cent change in GDP, EU States and Iceland, 2007–2009
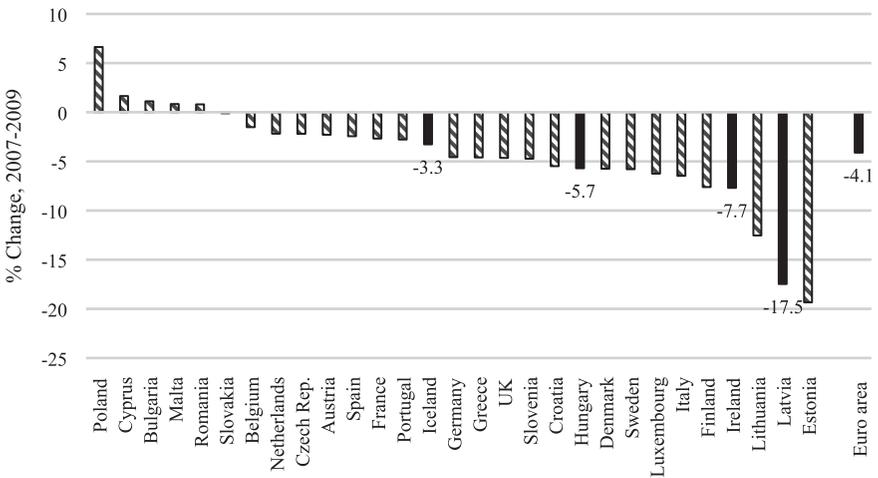
Note: Countries ranked by their change in GDP levels. The four cases under study (and the EA average) are marked solid. This indicator is created by using Eurostat [nama_10_gdp], which relies on an index (2010=100) based on chain-linked volumes, at market prices. The Euro area (EA) aggregate includes 19 countries.
Source: Eurostat [nama_10_gdp]

From Figure 3.3, and given the depth of the crisis depicted in Figure 3.2, it is clear that Latvia suffered the worst crisis – at least with regards to the effect on the country's GDP. Indeed, of the EU countries, only Estonia appears to have fallen further by this indicator. In just two years (2007–2009), the Latvian economy fell

1. But, as was seen in Figure 3.1, the aggregate economy in each state has grown, in per capita euro terms, from 2000 to 2014, even if they have not yet returned to their pre-crisis heights (in 2007).

2. This is actually a conservative measure when applied to Latvia, as its economy began to shrink already in 2006. Hence, we are not capturing the full extent of its economic decline.

by a harrowing 17.5 per cent! This is a phenomenal drop in economic activity, especially in light of the fact that Latvia had relatively little debt (*see* below), and its financial sector required relatively less support (c.f. Table 1.1, above). Ireland and Hungary both experienced deep drops in their GDP – worse than the EA average. Iceland, by contrast, seems to have weathered the storm remarkably well: its economy shrank less than the EA average.

Sovereign debt

Contrary to much public commentary, and as clearly demonstrated by Streeck (2014), Europe's sovereign debt burden – for most states – was not the result of economic mismanagement or an overly burdensome welfare state.[3] For most states – and for three of our four cases – sovereign debt was the cost of rescuing financial firms from collapsed markets. To see whether a country's debt was long-standing (e.g., the result of unsustainable social spending), or a more immediate need to shore up a failed industry, Figure 3.4 compares the level of government gross debt, as a percentage of GDP, for the same four countries and the EA average.

Figure 3.4: General government gross debt in four cases, per cent of GDP, 2000–2013
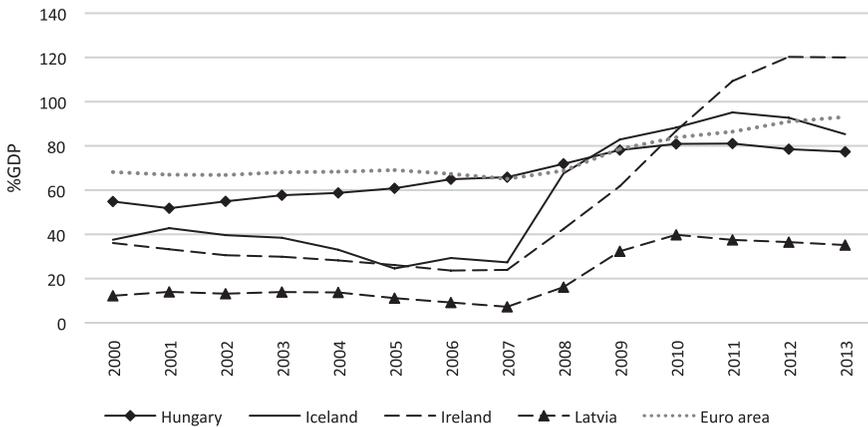
Note: Gross debt consists of all liabilities that require payments of interest and/or principal by the debtor to the creditor at a future date. This includes debt liabilities in the form of SDRs, currency and deposits, debt securities, loans, insurance, pensions and standardised guarantee schemes, and other accounts payable. See original source for more details. The Euro area (EA) aggregate includes 19 countries.
Source: IMF (2015a)

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3. Of course, this hasn't stopped international lenders from using the debt crisis as an excuse to tie the hands of economic policy makers and/or to limit welfare state expenditures. It would seem that others were heeding the advice of Rahm Emanuel, President-elect Obama's appointed chief of staff in 2008, who (in)famously noted: 'You never want a serious crisis to go to waste. And what I mean by that is an opportunity to do things you think you could not do before' (Emanuel 2009).

Figure 3.4 is revealing in at least four different ways. First, the overall level of debt in the (19 country) EA average is remarkably high over the entire (2000– 2013) period. Recall that the EU's Stability and Growth Pact (SGP) requires states to keep their general government debt levels below 60 per cent of GDP.[4] Using the IMF's indicator,[5] the Euro-average debt level surpasses the 60 per cent ceiling for the entire period, and it grew slowly but steadily in response to the crisis (after 2007).

Second, most of our cases were remarkably frugal. Before the crisis, each of the cases was located below the EA average mentioned above, and all but Hungary were well beneath the 60 per cent ceiling. In response to the crisis, only two of the cases (Ireland in 2010; and Iceland in 2009) punctured through that average level (although Hungary's debt level exceeded the EA average, very slightly, in 2008).

Third, in three of the four cases, the debt levels grew very quickly, in response to the crisis. Only in Hungary was the government's debt level relatively high before the crisis, and it remained high throughout the entire period. As we already learned in the introduction, and shall investigate in more detail in Chapter Seven, Hungary did not experience the same sort of financial crisis as the other three cases: Iceland, Ireland and Latvia were all forced to borrow money to bail out their financial sectors; Hungary wasn't. Figure 3.4 reveals that three of the four cases in this study maintained conservative (read balanced) public accounts prior to the crisis, and only got into trouble after responding to the crisis. Hungary's public accounts tell a very different story: here is a state that has long struggled to live within its budget.

Finally, the general trends revealed here are a little different from the change in GDP trends shown in Figure 3.2. In these government debt figures we see that the effects of the crisis (the jump in debt levels) reverberate for some time and produce long-term effects: after increasing, the debt-levels flatten out – at a higher level. Hence, to calculate the severity of the crisis using this measure, it makes more sense to contrast the 2013 and 2007 levels of debt. This is done in Figure 3.5.

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4. The Maastricht Treaty (signed 7 February 1992) applies to all EU members and established the Maastricht criteria (often called the convergence criteria). The SGP was adopted in 1997 and applies specifically to those countries participating in the European Monetary Union. Both sets of requirements include a three per cent (of GDP) limit on annual general government budget deficits, and a 60 per cent (of GDP) ceiling on national debt.

5. As years of haggling have revealed, there is much disagreement about how to actually measure the general government debt level. Ideally, I would prefer to use Eurostat debt indicators, but these do not include Iceland for the entire period. It is for this reason that I employ the IMF indicator.