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ARTICLE

'Euro 2.0': a preliminary assessment of the European Banking Union and a market-oriented monetary alternative

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Abstract The architecture of the original euro was flawed, and so was the commitment of the EU member states to abide by fiscal orthodoxy. However, both did convey sound monetary principles, these being (1) to preserve the purchasing power of the euro and (2) to isolate it as much as possible from political pressures. As evidenced in the euro crisis, both EU member states and European institutions have committed to maintaining the euro via further integration and the growing centralisation of monetary and fiscal powers in EU institutions. The European Banking Union is one example of this commitment. This article argues that these changes have paved the way for the creation of another modern-state currency: a currency that belongs to a supranational state and that is ultimately linked to an ever-growing supranational treasury that works hand in hand with the central bank. This article offers a more market-friendly monetary alternative to such an arrangement.

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Introduction: the European Banking Union as 'euro 2.0'

The recent global financial crisis has shown quite strikingly the weaknesses in the eurozone's original institutional architecture. Moreover, the crisis has revealed—to put it mildly—the deficiencies of the eurozone as a fully functional currency union. The institutions and rules that governed the eurozone before 2007 have for the most part been neglected or superseded since then. In fact they have been substituted for a new set of rules and instruments in the aftermath of one of the most severe financial crises experienced in the last century, and the subsequent sovereign debt crisis in Europe (i.e. the 'euro crisis'). It was in this troubled and very much uncertain environment that the European institutions and the EU member states agreed on the establishment of (1) tighter fiscal discipline, (2) macroeconomic surveillance of all member states by the European Commission (the 'Fiscal Compact'[1] and the 'Six-Pack') and (3) the creation of the European Banking Union (EBU). On top of this, the desperate actions that the European Central Bank (ECB), European Commission and member states took during the crisis to rescue the euro actually had the effect of—by the back door—watering down, if not completely neglecting, some of the key pillars of the constitution of the European Monetary Union. This applies, in particular, to two of the main rules approved in the legal foundations of the euro (see Articles 123 and 125 of the Treaty on the Functioning of the European Union): the prohibitions on bailing out a member state in crisis and on (direct) lending by the ECB to public institutions and governments, that is, the monetisation of public deficits.

The EBU was instituted to tackle two major destabilising phenomena experienced during the euro crisis. The first was the vicious circle triggered by a failing banking sector and the deterioration in public finances. This problem arose because governments bailed out banks in crisis with taxpayers' money, resulting in higher borrowing costs and poorer macroeconomic performance, and ultimately leading to sovereign-debt crises. The second phenomenon was the contagion effect of banking and sovereign-debt crises across the eurozone. The Greek crisis (2009–present) provides a clear example. With its relatively small economy (amounting to less than 2% of the GDP of the eurozone), Greece posed a real threat of liquidation to the euro as a whole. As explained later in this article, the contagion of the crisis was neither unforeseeable nor unavoidable. It occurred, to a great extent, because the crisis was very badly managed, but also because the EU institutions and member states chose to tackle the crisis by creating a highly 'political' euro[2] as a means to foster a more politically integrated and, indeed, centralised EU.

[1] See a summary in European Central Bank (2012, 101–102).

[2] Of course the euro always was, above all, a political project (see Schwartz 2004).

The rationale of the EBU: centralisation and bail-ins rather than bailouts

The EBU's new institutions and procedures have assigned to the supranational level, first, banking supervision and regulation powers, but also responsibility for dealing with the recovery or the resolution of a bank in crisis. Very briefly, the main elements of the EBU are as follows:

- The establishment of the European Banking Authority, which oversees the implementation of the new Basel III[3] bank capital ratios and the liquidity ratio across all member states.
- A new banking regulator (governed by the Single Supervisory Mechanism) for 'big banks' and transnational banks in the eurozone, which is in the hands of the ECB in Frankfurt. These banks represent around 80% of the total in the eurozone, and the remaining national banks will continue to be supervised by the national central banks or by other national institutions.[4] In addition, the new Single Resolution Mechanism has been established to deal with the recovery or resolution of a bank in crisis. Thus it is no longer the national government or the national institutions where the bank in crisis is based that will make the decisions as to its recovery or final resolution, but a supranational body, the Single Resolution Authority (SRA).
- To fulfil the new EU Recovery and Resolution Directive (European Parliament and Council 2014), every bank must draft a resolution plan (a sort of 'bank will'), to be approved by the regulator, so that, if need be, banks can be resolved in an orderly and timely manner. Most importantly, should a bank under the jurisdiction of the Single Supervisory Mechanism need to be resolved, the member state will not be able to resort to using taxpayers' money to fund a bailout. Rather, the resolution and the recovery procedures will be handled by the SRA, and only when the bank's shareholders and creditors' money have been mostly exhausted—that is, when they have absorbed losses of at least 8% of the total liabilities—will the bank be eligible for other sources of funding (such as the new Resolution Fund, see below). This is what the literature calls a bail-in approach, in contrast to the idea of bailing out the banks with taxpayers' money in the first place, as we have seen happen in the recent crisis.
- Member states have agreed to guarantee deposits of up to €100,000 per depositor per bank. While this is consistent across the EU, it is a national guarantee backed by the member states and not a mutualised pan-European insurance scheme, such as the Federal Deposit Insurance Corporation established in the US during the Great Depression (1933). The distinction is very important, as a pan-EU mutu-

[3] Basel III is a set of tighter bank capital and liquidity regulations approved by the Basel Committee on Banking Supervision (Bank for International Settlements) in the midst of the global financial crisis. For further information, please see Bank for International Settlements (2017).

[4] Regardless, the national regulators would make these decisions in cooperation with the ECB, which would be able to directly supervise these banks at any time if it deemed it necessary.

alised insurance scheme would mean that all member states would contribute to a common fund, which would be used to support the depositors of any bank based in their own country or elsewhere in the EU.

- There is a final element of the EBU that is tantamount to the definition of an effective modern central bank in a fractional reserve banking system: the lender of last resort function of central banks. If a bank is solvent but illiquid, and thus is temporarily unable to pay its liabilities, the bank can always request extraordinary lending from the central bank. This is how Bagehot (1873) put it in his seminal book, *Lombard Street*: if a liquidity crisis occurs, the central bank should readily provide unlimited lending to the bank in crisis, but always against collateral and at a penalty rate (i.e. the so-called discount rate, which is higher than the normal policy interest rate).
- However, we should not forget that this competence is still in the hands of the national central banks in the eurozone. Provided that there is no objection from the ECB, these central banks can lend money to the bank in crisis on request (Lastra 2016). This division of competences between the ECB and the national central banks needs to be properly coordinated so that a banking crisis cannot be artificially ‘hidden’ or unnecessarily postponed by the provision of liquidity from the national central bank; this would only delay the necessary injection of capital into the banking system.[5]

It is clear that the new institutions and regulations listed above imply the delegation of greater competences to supranational institutions, and thus opting for the creation of a more centralised currency union. We will elaborate further on what this means and the alternatives in the sections below.

A functional Banking Union?

It is worth mentioning that, whether the preference is for a more market-friendly, decentralised form of monetary integration that is in favour of currency competition or a more conventional one currency–one state model, we must consider the following caveats as regards the EBU. First of all, the banking union as a whole, and more crucially the new Resolution Fund (paid for by the banks and totalling no more than 1% of the banks’ guaranteed deposits), will not be completed and thus will not be fully operational until 2024. Should a banking crisis occur in the meantime, the banking sector itself will not have raised enough funding to cover the banks’ liabilities, and thus will not be able to fund or pay for the actions dictated by the European regulators. Consequently, at least until its full implementation, we cannot dismiss the idea of taxpayers’ money being used in the eventuality of a banking crisis.

[5] Moreover, the misuse of the provision of liquidity at the national level may well affect the outcome of the decision of the Single Resolution Mechanism later on as regards the recovery or liquidation of the bank (see Huertas 2016 for further details).

But even if the Resolution Fund were readily available in full, the procedures approved to deal with a crisis have yet to be tested, and may turn out to be too complicated and impracticable; they involve many policy actors and both national and supranational institutions. As has been very well summarised by Huertas (2016, 28–33), when the SRA adopts a resolution scheme, if the Commission objects to all or some of the points under the scheme, it has only 12 hours to draft an alternative proposal, which the European Council then has to make a decision on. Finally, the SRA has only eight hours to revise the new scheme. The test to prove the commitment of these new institutions to both the application of the bail-in option, and the timely resolution of insolvent banks, will not be definitive until we experience the next banking crisis.

Finally, and most importantly, the EBU does not resolve the fundamental underlying problems of the eurozone. As measured against any conventional economic standards, the euro is a malfunctioning currency or, in technical jargon, a ‘non-optimal’ currency *à la* Mundell[6] or Fleming. This is evidenced by the volatility of a wide range of indicators, including consumer price index inflation, real GDP growth, unemployment rates, labour costs, real exchange rates, and public deficit and debt figures across all the eurozone member states. By considering the dispersion of these indicators as a whole, Castañeda and Schwartz (2017) have produced several indices of monetary integration in Europe which conclude that the euro area did not become more integrated between 1999 and 2007, as it had been presumed would be the case by the architects of the euro, and that it has become less integrated since (these are the so-called internal asymmetries amongst member states).[7] If the EBU is successful, it may well contribute to breaking the fiscal–banking crisis loop and thus to better public finances in a banking crisis. However, it does not tackle the differences in competitiveness and productivity—and, in turn, the dysfunctional labour and goods and services markets—in the eurozone; these are problems that the EBU cannot and is not designed to tackle at all.

‘Euro 2.0’: the ‘one currency–one central bank–one treasury’ model

As José M. González-Páramo (a former member of the ECB Executive Council) put it very recently,[8] what the EBU actually means is the strengthening of the euro, ‘euro 2.0’ as it were, as it remedies some of the operational flaws and institutional weaknesses of the original euro as designed in the 1990s. True, the EBU adds consistency and predictability to the supervision and resolution of big or systemic banks in the eurozone. At least on paper, it will also make the banks pay for the losses resulting from a bank failure before resorting to any other funding, let alone taxpayers’ money. In this sense,

[6] One of whose articles became the founding basis for the literature on optimal currency areas (see Mundell 1961).

[7] A good indicator to capture these imbalances is the Target-2 balances across the member states. See European Central Bank (2017).

[8] See his introductory words in González-Páramo (2017).

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technically speaking, it is an improvement, as it helps to create a more consistent and credible institutional setting. However, it comes at a cost that must not be overlooked.

The original euro (i.e. 'euro 1.0', 1999–2011, when the new institutions and rules were mainly launched) meant the birth of a new—pan-European—currency, with no single treasury backing the currency or any truly credible governing rules, particularly ones related to maintaining fiscal discipline across the member states.[9] It heralded the establishment of a single currency with no fiscal counterpart nor—as shown in the mid-2000s and even more so during the euro crisis—any credible fiscal discipline, and thus it was a recipe for disaster. This is a key point that we need to clarify before proceeding further: a supranational currency without full fiscal backing, such as the euro, can only succeed over the long term if member states in crisis are not bailed out. Without this rule, there are no credible incentives not to overspend, so the costs of the deficit are ultimately shared by all member states. Crucially, it is this rule that EU institutions and member states failed to implement both before and during the euro crisis.

In view of this, the solution adopted with the 'new euro', supported by the EBU, of more fiscal discipline and more surveillance from supranational institutions, fits much better with the creation of a national currency for a more centralised EU state, and thus has paved the way for more fiscal integration in Europe. Within this rationale and this overriding political aim, the new euro consolidates the establishment of a truly national currency working hand in hand with the other political institutions of the EU and the national treasuries. However, while technically more consistent—in fact, the model used by any other modern nation-state—it also means the definitive abandonment of the founding economic principles of the original euro, which focused on preserving its purchasing power and, crucially, ensured it was isolated as much as possible from political interference and the financial pressures of the national and EU treasuries. We will return to this key debate in the final section of the article.

Currency models in dispute: the weaknesses of a 'political' euro

It is true that no *currency union* has survived for long without a political union or a supranational treasury with the powers to back the currency. However, this applies specifically to currency unions ultimately aimed at establishing a national currency in a single state, and not necessarily to *monetary unions* of sovereign states. This difference is at the core of the debate surrounding the definition of the type of euro we want, and indeed explains the flaws of the euro during the 2008–2009 global financial crisis and helps us to understand the policy decisions taken afterwards.

The classical gold standard (1870s–1913) has been taken as a benchmark for comparison with the current 'euro standard' (see, amongst others, Crafts 2014; Morys

[9] The reform of the Stability and Growth Pact in 2004, which actually meant the relaxation of fiscal discipline even more, was proof of the failure to apply credible fiscal rules across the member states.

2014). However similar the regimes, the gold standard was clearly a monetary union, where sovereign member economies fixed their currencies against gold, but crucially retained their national currencies in circulation. In contrast, the euro takes the process a step further, as it is effectively a currency union, in which the participating countries have completely eliminated their national currencies and adopted a *single* currency for all. This distinction is not at all trivial and particularly matters in times of severe crisis: a currency union is more stringent and demanding, since member states have no room to alter the parity of the currency. Even more significantly, according to current EU legislation a member state cannot abandon the eurozone, either on a temporary basis or permanently, without also leaving the EU itself. This makes the adjustment to a major crisis very much limited to what has been called an 'internal devaluation': in a nutshell, member states have no other option but to cut costs and prices in an effort to gain competitiveness and thus reduce trade deficits.

Based on the calculations provided in Castañeda and Schwartz (2017) as to the differences in competitiveness across the eurozone, an internal devaluation was indeed necessary to address the fundamental competitiveness problems in those EU economies which suffered the most from the crisis. Some of these economies, with Spain being a positive case study to consider so far, have successfully cut internal costs and prices and have turned a double-digit current account deficit into a surplus within a few years. Nevertheless, as seen in the euro crisis, this is an option that has proven not just painful but politically unfeasible if applied for a long time; EU populations do not seem prepared to accept such situations any longer. Economies' structural weaknesses cannot be addressed in a timely manner by simply applying internal devaluation measures such as a fundamental restructuring of prices and costs in the economy. To give an idea of the scale of the problem, in 2012, at the time of the negotiations for the third bailout, the price and cost adjustments required in the Greek economy were estimated to be in the region of 40%–60% (as quoted in Schwartz et al. 2013). And this is where the distinction with other, more flexible, monetary arrangements matters: under a monetary union, countries can temporarily suspend the exchange rate commitments, change the terms of the commitments and even abandon them more easily if need be. Such suspensions and realignments[10] did occasionally happen during the classical gold standard years and helped countries to overcome major disequilibria in a smoother and more timely manner.

An alternative system: a more solid currency, governed by the market

Under free-floating and competing currencies—for example, a parallel monetary system, with the circulation of both the national currency and the *common* euro—cost and

[10] This is not at all a plea for inflationary devaluations; all devaluations achieve is to ease the adjustments that the economy must go through anyway. If the suspension of the parity or currency devaluation is not followed by fiscal adjustment, cuts in costs and a monetary policy committed to maintaining the purchasing power of the currency, the devaluation will soon result in even higher inflation and greater losses in competitiveness.

price adjustments would be made on a daily basis by market participants, preventing the accumulation of such structural disequilibria amongst member states. The fluctuations in the exchange rate of the national currency and the euro would convey the markets' assessment of the credibility of the currencies. As we have seen, such diverse economies as those in the eurozone, with clearly insufficient labour mobility across borders, as well as such different monetary traditions and economies, find it extremely difficult to remain operational under a fixed—and irrevocable—exchange rate. The accumulation of internal imbalances in such a scenario is inevitable and thus, from time to time, there is a need to bail out economies unable to commit to the euro standard. The original euro (1999–2011) did offer a solution for this: the prohibition of both bailouts and the monetisation of the deficit, which meant that a member state unable to fulfil its monetary and fiscal commitments would have to leave the euro. But of course we have seen an overriding political desire in Europe to rescue all eurozone countries in need, which worsened[11] the euro crisis and ultimately paved the way for more centralisation and political union.

Alternatively, under a more decentralised and competitive monetary system, such as a parallel currency system (see Vaubel 1978; Schwartz et al. 2013 for a restatement), money users would choose one or another currency according to their credibility and purchasing power. And by so doing, they would be imposing the discipline needed to ensure that the central bank (either the ECB or the national central banks) did not overissue the amount of money in circulation. In such a system, agents may well use a different currency for different purposes; there are plenty of examples of such regimes in modern monetary history, as well as in the present.[12] Within this system, it would be for the national governments to choose how to regulate the banking sector, and to decide whether the central bank could or could not monetise the deficit. Ultimately, it would be the greater or lower demand for the currency that would keep governments and central banks in check. Of course in such a competitive system no banking union or bailouts would be needed, as each country would bear the consequences of its own policies in the form of a failing currency and an inflationary economy. In the event of a member state inflating its national currency, money holders would switch to the common currency and leave the government with no seigniorage (i.e. the money issuer's revenues, broadly defined as the difference between the nominal value of the currency and its cost of production). Ultimately, this would lead to the depreciation of the national currency and a government with virtually no access to capital markets in that currency; a severe crisis indeed, but one without contagious effects for the rest of the member states. Following Vaubel's (1978) seminal book, even if the will of the architects of the euro was—as it was—to create a *single* currency for all, it would have been better to introduce it

[11] Arguably, a timely and firm decision by the member states in 2009 to abide by these rules would have enhanced the credibility of the eurozone institutions, and very probably aborted the long-lasting contagion effect of the Greek crisis.

[12] See, for example, Castile in the modern era, with the 'maravedí' used as a unit of account for international trade, both in silver and gold coins and the newly-minted silver-copper coin in the early seventeenth century; and the 'vellón' coin, which was used for smaller payments and was later devalued as it was entirely made of copper. Today there is effectively a two-currency monetary system in Peru, with the US dollar used for saving, trade and investment, and the Peruvian sol used for smaller payment transactions.

through currency competition with the circulation of a *common* currency alongside the national ones, as this would have eventually allowed for a smoother transition and the non-political selection of the members of the eurozone. If not to the existing eurozone economies, this system could be usefully applied to eurozone candidate countries in the future.

There are other—'milder'—options that would achieve a more flexible, more functional and stronger euro over the long term. For example, there are many countries where agents can write a contract or make a payment in any currency accepted by the parties (amongst others Guatemala, which enjoys a remarkable inflation record in Latin America). If only this measure were used, it would provide an incentive both for central banks to run a sound monetary policy and for governments to keep public spending in check and not monetise recurrent deficits. In the absence of a legal tender currency, but with several currencies readily available with which to make payments, money holders (ultimately creating the demand for different currencies) would choose one or another currency for use in their contracts, depending on each currency's purchasing power. And the less stable the value of the currency and the more inflationary the currency becomes over time, the less attractive it would be to businesses and households, which would ultimately reduce the demand for the currency and thus the monetary profits of the issuer (the seigniorage), whether the government, the central bank or any other money provider. This market discipline would ensure that governments would not overspend nor ask 'their' central banks to monetise public deficits, as people would quickly stop using their currency.

Concluding remarks

The architecture of the original euro was flawed and incomplete, and so was the commitment of the member states to abide by fiscal orthodoxy. However, both did convey sound monetary principles, these being (1) to preserve the purchasing power of the euro, and (2) to isolate the euro as much as possible from political pressures. As evidenced in the euro crisis, member states and European institutions have committed to maintaining the euro 'whatever the cost', mainly via further integration and the growing centralisation of monetary and fiscal powers in EU institutions. While this has clarified and enhanced the institutional robustness of the euro, it has also meant a profound change in the economic foundations of the euro as established in 1999. It has revealed once more the willingness that has always existed to create a modern state with its own currency, ultimately linked to an ever-growing supranational treasury that works hand in hand with the central bank—that is, just another modern-state currency.

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