Europe’s Financial Crisis: 
The Euro’s Flawed Design and the Consequences of Lack of a Government Banker

Abstract

This paper argues the euro zone requires a government banker that manages the bond market and helps finance country budget deficits. The euro solved Europe’s problem of exchange rate speculation by creating a unified currency managed by a single central bank, but in doing so it replaced the exchange rate speculation problem with bond market speculation. Remedying this requires a central bank that acts as government banker and maintains bond interest rates at sustainable levels. Because the euro is a monetary union, this must be done in a way that both avoids favoring individual countries and avoids creating incentives for irresponsible country fiscal policy that leads to “bail-outs”. The paper argues this can be accomplished via a European Public Finance Authority (EPFA) that issues public debt which the European Central Bank (ECB) is allowed to trade.

The debate over the euro’s financial architecture has significant political implications. The current neoliberal inspired architecture, which imposes a complete separation between the central bank and public finances, puts governments under continuous financial pressures. That will make it difficult to maintain the European social democratic welfare state. This gives a political reason for reforming the euro and creating an EPFA that supplements the economic case for reform.

Keywords: monetary union, government banker, euro.

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I Introduction: The euro’s flawed design and its political consequences

The euro zone is caught in an intractable economic crisis, a significant cause of which is the financial architecture governing the euro. This paper is about the role of that flawed financial architecture.

Fixing that architecture is a necessary step to escaping the crisis, but it should also be recognized that alone will not be enough. This is because the euro zone is also afflicted by profound demand shortage problems that are the result of three decades of
neoliberal economic policy. The paper does not address this larger longer-running problem and is restricted to the financial dimension of the crisis which is worsening the demand shortage problem.

The paper presents ideas developed at greater length in an earlier paper (Palley, 2011a [2011b]). At that time the euro zone crisis was viewed by the IMF and mainstream economists as a standard, albeit extreme, “public sector debt crisis”. My argument was there is a deeper cause of the crisis which is the flawed design of the euro as a monetary system that prevents the central bank from acting as government banker.

The euro zone crisis started as a private sector debt crisis but it jumped the line and became a public sector debt crisis because the euro’s architecture prohibits the ECB from helping governments finance their deficits and manage their debts. Consequently, the crisis has taken the form of a public debt crisis, but that is the “symptom” rather than the “cause”.

Elements of this argument have now seeped into the public debate but European policymakers are trapped in an “intellectual schizophrenia”. On one hand, they realize the European Central Bank (ECB) must intervene and purchase country government bonds to contain the crisis. On the other hand, their neoliberal training and philosophical views mean they continue pushing fiscal austerity as if the crisis were truly a public sector debt crisis, which only worsens the problem.

The fact that the crisis has taken on the appearance of a public debt crisis has created a dangerous economic and political situation. That is because neoliberal political elements are seeking to exploit this appearance to push an agenda of fiscal austerity that attacks and shrinks the social democratic state. If successful, their agenda will be
disastrous. First, fiscal austerity will deepen the crisis because budget deficits are needed at this time of demand shortage. Second, fiscal austerity will do nothing to strengthen government finances as it will undermine tax revenues by weakening income. Third, the neoliberal agenda will cripple the social democratic state, which is one of the great achievements of the 20th century and which is essential for shared prosperity in the 21st century.

Properly resolving the crisis requires fixing the underlying design flaw in the euro’s architecture. Failure to do that means the euro’s flawed design will keep generating regressive political and economic pressures.

II Neoliberal economics and the euro

The euro was introduced in 1999, the high water mark of neoliberal economics. The neoliberal project aims to diminish the role of the state and enhance the power of the market, and this goal is reflected in neoliberal monetary theory that guided the euro’s design. The theory argues that the role of the central bank is to control inflation and the exchange rate, but there should be complete separation between the central bank and government finances.

By adopting this theory, the euro’s architects intentionally changed the balance between monetary and fiscal policy. Previous national monetary systems ensured “fiscal policy dominance” whereby central banks served governments. The new euro system instituted “monetary policy dominance” because governments were stripped of access to their own central bank that could help them finance budget deficits and manage interest rates on government debt.
The euro did this by creating a “detached” central bank. The concept of a “detached central bank” is different from an “independent central bank”. A detached central bank is prohibited from buying government debt. An independent central bank distances its decision making from government, but it is allowed to purchase government debt. Both the Federal Reserve and the Bank of England are significantly independent but they are not detached. The ECB is detached by design.

III Detached central banks and the problem of bond market instability

The prior national banking systems made European governments masters of the bond market. The euro’s architecture has made bond markets master of national governments. Under the old system of national money central banks played a key “government banker” role by helping manage the government debt and finance spending, including financial sector rescues. The euro’s neoliberal architecture cheats euro zone member countries of such assistance.

This can be seen by comparing euro zone country experience with that of the US and UK. The Federal Reserve and Bank of England have both lowered interest rates to near zero; helped finance private sector financial bailouts; and helped finance budget deficits at rock bottom interest rates. European countries have had none of this assistance. Spain entered the crisis in 2009 with a fiscal position little different from the US and UK, yet its bonds have been under persistent speculative attack that have driven Spanish yields much higher. This reflects the fact that the euro’s architecture means euro country governments no longer have a central bank to back them, which leaves national bond markets vulnerable to adverse speculation.
The problem of bond market attack is easy to understand if one thinks of a multiple equilibrium model of the bond market. A country can be subject to speculative attack that causes interest rates to jump. That can trigger a self-fulfilling change of equilibrium interest rates because higher interest rates raise the burden of debt, making it more likely the government will default, which justifies a higher equilibrium interest rate.

The flaw in the euro system is the ECB is not allowed to intervene in the bond market and help governments under speculative attack. Without a central bank, governments are reduced to the same bond market standing as provinces and large corporations – which is exactly what the euro’s neoliberal architects intended. Viewed from a public policy perspective, the euro solved the problem of exchange rate speculation that previously afflicted euro zone countries, but in its place the euro introduced the problem of bond market speculation.

IV Monetary union and the challenge of member country fiscal responsibility

The euro has delivered several economic benefits. First, it has contributed to transaction and pricing efficiencies by eliminating the need for exchange rate conversions. Second, it solved the problem of exchange rate speculation which was very serious for European economies which are small and open. However, the trouble with the euro is the ECB is legally unable to intervene and protect national government bonds and finance country budget deficits.

That prohibition is appropriate as the central bank in a currency union should not give special treatment and intervention subsidies to individual countries. If it did that could establish dangerous incentives as countries would have an incentive to engage in populist fiscal policy, knowing the central bank would come to their rescue. That in turn
could generate fiscal and monetary instability. Within a monetary union, the challenge is to design a system in which the central bank can help finance country budget deficits and defend government bonds, but without creating incentives for country fiscal irresponsibility.

V The solution: A European Public Finance Authority (EPFA)

Palley [2011a [2011b], 2011c, 2011d] argues the solution is a new public finance architecture involving the creation of an European Public Finance Authority (EPFA) which would issue European bonds, jointly and severally backed by all member countries. The critical feature that distinguishes this proposal is the ECB would have full rights to buy and sell EPFA bonds.

The EPFA would work as follows:

(1) EPFA would have the right to issue and sell new EPFA bonds at its discretion.
(2) The ECB would have the right to buy and sell EPFA bonds.
(3) All EPFA bond proceeds would be paid directly to national governments.
(4) Distribution of bond proceeds to countries would be on a per capita basis, as would payment by countries of EPFA debt service obligations. In effect EPFA would serve as a trust entity with regard to bond issues, paying out issue proceeds, receiving bond service payments from countries, and distributing those service payments to bond holders.
(5) EPFA would be governed by finance ministers of euro zone member countries.
(6) Voting rights within the EPFA would be allocated to each country on a per capita basis.

The creation of EPFA would have important monetary and fiscal policy implications. With regard to monetary policy, it would create a European bond without
any trace of national identity. That is critical as it means the ECB could legitimately trade EPFA bonds without favoring any country in the currency union. EPFA bonds would therefore constitute the basis for ECB open market operations, allowing the ECB to take on the role of government banker for Europe. This would fill the missing feature in the euro’s current institutional set-up.

With regard to fiscal policy, new EPFA bond issues would help finance annual budget deficits for member countries. The annual amount issued by EPFA could vary with the state of the overall Euro zone economy. All member countries would receive bond issue proceeds on a per capita basis. Countries that received payments in excess of their current financial needs could retire their existing sovereign debt, or they could build up a sovereign wealth fund by acquiring the national debt of other countries.

An EPFA - ECB system would therefore give the euro zone an institutional architecture similar to that enjoyed by the US and UK. The ECB would be responsible for monetary policy matters, including interest rates. It would also retain responsibility for exchange rates. The EPFA would be responsible for issuing euro zone bonds. However, all spending decisions would remain entirely in the hands of national governments as proceeds from bond sales would be paid to governments. EPFA would therefore not violate government sovereignty.

The critical feature is the ECB would be allowed to buy and resell euro zone bonds so that it would be able to conduct open market operations with EPFA bonds. This would be done in a system in which the ECB favored no country, while EPFA would not violate government sovereignty.

VI Transitional debt swap arrangements
Once fully in place EPFA would assist countries with normal budget deficit financing. However, there would be an initial transition period in which countries would swap existing national debt for new EPFA debt. This transition process would work as follows. EPFA would sell bonds and use the proceeds to buy existing country bonds on a per capita basis. Those country bonds would then be cancelled and EPFA member countries would be responsible for their per capita share of new EPFA debt. Countries with little existing national debt would be credited with new EPFA bonds to offset their excess EPFA liabilities. The new system could then kick in once the debt swap was completed.

VII Conclusions and lessons

To close, an analysis of the euro zone’s financial crisis yields several conclusions and lessons:

**Conclusion #1:** The euro zone is fundamentally hobbled by the neoliberal design of the euro that prevents the central bank from acting as government banker. That condition puts governments at the mercy of bond markets and makes them vulnerable to bond market attack that gives the appearance of public debt crisis.

**Conclusion #2:** The solution to the government banker problem is the creation of a European Public Finance Authority that issues bonds without any trace of national identity. The ECB can then buy and sell EPFA bonds (i.e. conduct open market operations) without favoring any individual country, which is a necessary institutional condition for a fair and successful currency union.

**Conclusion #3:** Fixing the euro’s financial architecture can restore financial stability but it will not fix the deeper problem of demand shortage. That will require reversing the
long-standing neoliberal economic policies that have governed euro zone economies since the early 1980s.

**Lesson #1:** To be successful, monetary unions must have arrangements that allow central banks to help finance country budget deficits and protect against bond market speculation.

**Lesson #2:** It is not necessary for monetary unions to have full “fiscal union” (whereby tax revenues are transferred between member countries), though that may improve performance. It is necessary to have some degree of “public financial union” whereby countries finance themselves collectively by issuing jointly guaranteed bonds.

**Lesson #3:** Neoliberal policymakers will interpret crises created by lack of a government banker to argue they are public debt crises that require fiscal austerity.

**Lesson #4:** Fiscal austerity policies worsen the problems caused by lack of a government banker, and they are worsening the Euro zone’s current problem of demand shortage.

**References**


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