Ontology and Theory for a Redesign of European Monetary Union

Sheila Dow
University of Stirling, UK and University of Victoria, Canada

Abstract

The Greek debt crisis opened up the policy discourse over Europe to the extent of an unprecedented extent of questioning of the original design of the Eurozone. Such a rethink requires an examination of how the European economy functions and the appropriate theoretical approach to analysing it. The purpose of this paper is to revisit the thinking behind the design of European Monetary Union and behind the Post Keynesian critique. While the mainstream response is couched in terms of addressing impediments to economic convergence through market forces, the Post Keynesian response focuses on the forces for divergence which the Eurozone framework currently exacerbates. In particular we argue that a focus on the forces for economic divergence and financial instability in Europe requires any monetary union to be supported by a system of fiscal support and a cohesive approach to bank regulation and support.

Keywords: European Monetary Union, ontology, divergence, Post Keynesian theory, regional finance

1. Introduction

The Greek debt crisis has had one valuable consequence. The situation posed such a strong threat to the functioning of the Eurozone (from Grexit or from Greece remaining in the Eurozone, depending on one's perspective) that longstanding questions about the viability of the original design of the Eurozone have been given a much more general airing in public discourse than in the past. The situation has been recognised as a crisis for Europe; it is now accepted that sovereign debt is not necessarily risk-free and there is uncertainty as to whether the structure of the Eurozone can handle the consequences. Was this a crisis which was bound to arise sooner or later because of problems with the structure of the Eurozone? The way in which questions about long-term viability of that structure are answered depends crucially on which theoretical perspective is employed (implicitly or explicitly) and thus how the problems with the Eurozone are understood. It is thus the purpose of this paper to step back from the current detailed discourse in order to explore the source of Europe's crisis in the design of the Eurozone, which has provided the basis for heterodox critiques in the past.[1]

Behind the different theoretical perspectives lies a view of theory itself, how far it is a technical matter separable from politics. The groping towards an interim resolution of the Greek debt crisis exposed the strong political elements in the functioning of the European Monetary Union (EMU), whereby it became more widely clear that policy ideas cannot be detached from power relations. The original theoretical basis for design of the Eurozone treated political matters as separable from 'technical' economic questions. But it had not addressed the increasingly pressing questions as to the rights and obligations of members of a currency union, and the mechanisms by which such a union deals with imbalances of political power among its members. As Brecher (1957: 241) noted in a different context, public policy is the outcome of a power struggle over competing interests. 'In this struggle, theory often emerges as the dominant group's instrument for identifying its welfare with that of the community'.

Other crises have never pushed the Eurozone so close to the edge; what have been regarded as solutions in the past have had some limited success, deflecting the fundamental critiques which have

[1] The critique is offered at a fairly general level (see further Chick and Dow, 2012). The complex particularities of financial arrangements in the Eurozone provide the basis for much more detailed critiques (see e.g. Bibow, 2015).

consistently been expressed by heterodox economists. But this is no time to be complacent that these critiques have been validated by events. Rather the current climate provides an opportunity to spell out the theoretical arguments again; heterodox economists have had good reasons to criticise the design of the Eurozone which are much more fundamental than such procedural questions as whether it was right to include Greece in the Eurozone in the first place. Just as it is common in mainstream discourse to identify the causes of the global financial crisis in particularities such as the development of opaque structured products rather than anything more fundamental, there is a danger that the Greek crisis is seen in a similar light.

There is a rich vein of critiques of the design of the Eurozone dating from its inception (see e.g. Parguez, 1999; Arestis and Sawyer, 2001). The purpose of this paper is to revisit the foundations of these critiques, focusing on the Post Keynesian approach, set against the foundations of the approach on which design of the Eurozone was based at Maastricht. We start with the importance of ontology: how the economic system is understood, in terms of forces for real divergence or convergence, financial instability or stability. We further explore the relations between the real and the financial by focusing on the operations of banks in Europe. These ontological positions provide the basis for the different theoretical systems which underpinned the design of EMU and the Post Keynesian critique. From this critique follows the proposal for a system of fiscal redistribution and for bank regulation suited to a heterogeneous banking sector. It is argued that the mainstream understandings of fiscal union and banking union are in fact very different.

How the European Economy is Understood and Analysed

EMU was designed on the basis of an understanding of the European economy as naturally equilibrating except for impediments to the working of market forces, particularly those arising from different government policies and institutions. EMU was to be a central element of the strategy to promote a single European market. A single currency was seen as contributing to the breaking down of barriers between member economies, allowing for the reaping of real economies of scale in production, as well as efficiency in financial matters (Cecchini, 1988). If goods and factors could flow freely between European economies, with reduced transaction costs (including exchange rate uncertainty), then Europe could compete on an equal footing with the US. National governments still had control of some economic levers, so efforts to harmonise policies were seen as a mechanism for reducing the scope for different market conditions in different member states. But institutions, conventions and practices continued to sustain some barriers between national economies. Indeed it was understood that European economies differed in terms of productivity and also financial structure, and these too needed to be harmonised in order for the single market to be fully realised.

The early mainstream debates over how to proceed towards monetary union reflected two different views on how to harmonise productivity and financial conditions (Coffey and Presley, 1971). The ‘monetarists’ argued that the introduction of the single currency would itself bring real convergence about, by enhancing factor mobility and competition within Europe. But the ‘economists’ argued that real convergence was required first in order for the single currency and the new centralised central banking system to substitute successfully for national currencies and national monetary policy. In the event the Maastricht Treaty required convergence as a condition for entry into EMU, but convergence with respect to financial indicators rather than real indicators, in the spirit of the ‘monetarist’ strategy. This was symptomatic of a more general emphasis on monetary factors as the focus of macroeconomic policy in EMU and inattention to real macroeconomic factors. It was assumed that, once real convergence had been achieved, it would be sustained by EMU. There would therefore no longer be a need for national policy on exchange rates to address any divergence in productivity performance, or for independent monetary policy.

It was accepted that real convergence might take time. Yet EMU would mean that the valuation of sovereign debt denominated in euros would not reflect any remaining differences in real economic conditions between member countries. It was therefore crucial for market acceptability that the implications of such differences be minimised by a common European monetary policy which was not subverted by national fiscal policies. Therefore the constraints on debt and fiscal deficits which were central to the Maastricht Treaty were designed to address the need to avoid either default on the bonds issued by an offending member or

else financial support from the rest of the Eurozone (see for example European Commission, 1990: 107). Thus, when in fact economic conditions have diverged within the Eurozone, the strict limits on fiscal deficits and debt have been enforced by imposing deflation on weaker economies, introducing an overall deflationary bias. In some cases, of course, stronger Eurozone members (Germany and France) were allowed to violate the conditions in 2003. A different attitude was therefore apparently taken to the risk of default on sovereign debt or need for financial support on the part of different types of member state. The expectation that capital markets would punish member states which violated the strictures on deficits and debt did not seem to apply equally to all member states, just as during the recent crisis.

This mainstream understanding of the economy which underpinned the design of EMU was based on an understanding that any economic divergence which might emerge in spite of a common monetary and fiscal policy must be the outcome of barriers to trade or to movements of factors. It was anticipated that the effect of asymmetric shocks on any member state would be addressed by factor movements. Harmonisation of and constraints on national government policies, the strengthening of European institutions, and above all the introduction of a single currency, would thus allow market forces to promote economic and financial convergence. Thus for example the Greek crisis is widely understood as the outcome of a lack of harmonisation by Greece with conventions and practices elsewhere in Europe. If only this harmonisation could be achieved, it is implied, the problem would be resolved and the Greek economy would converge with the rest of Europe.

This understanding of economies as naturally equilibrating, but subject to constraints on free market forces, supports the use of general equilibrium macroeconomic models. Indeed the volume representing preparatory research on EMU (European Commission, 1990) is a clear illustration that this was the methodological and theoretical approach on which EMU was based. Crucially, this approach *presumes* the outcome of convergence (subject to constraints).[2]

The dominant theory employed was optimal currency area theory in the particular form developed by Mundell (1961), i.e. emphasising labour and capital mobility (see also McKinnon, 1963). Other versions of optimal currency theory had offered different, potentially conflicting, versions. Some contributors specified real economic convergence as a precondition for monetary union (specifying conditions in terms of how far economies had a shared susceptibility to shocks and/or coincidence of economic cycles for example), while others specified capacity to address imbalances from asymmetric shocks by means of fiscal transfers, for example.[3] But it is telling that Mundell's view dominated, reflecting the general equilibrium theoretical perspective whereby factor mobility was seen as allowing market forces to address any real imbalances without any need for further government intervention.

In other words, while optimal currency area theory allowed for the possible emergence of short-term productivity differences, an optimal currency area was one where factors were sufficiently mobile to promote convergence. (Factors would move until their returns were again equalised.) Further the Classical dichotomy held – inflation was a monetary phenomenon and, as was evident from the European Commission collection of academic research in the run-up to EMU (European Commission, 1990), only minimal attention was paid to the banking sector, other than as a passive conduit of capital flows. Typical of mainstream macroeconomics before the crisis, the possibility of financial instability was not contemplated; even more than real economies, the financial sector could be assumed to equilibrate.

Optimal currency area theory had aimed to identify groups of national economies which satisfied the conditions (e.g. a high degree of factor mobility) for being able to deal with balance of payments problems without recourse to exchange rate adjustment. The exemplar was those national economies which apparently coped with regional imbalances without regional exchange rates or regional monetary policy. Within national economies, any payments imbalances before full adjustment occurs were seen to be resolved by the payments settlement system, through the banks' balances with the central bank. Similarly, within EMU, while some imbalances on the sum of the current and capital accounts of member states would emerge, they would be addressed in the short run by financial imbalances within the currency area (through

[2] Also the analysis is conducted at a highly aggregated level (with monetary policy represented by the target rate of inflation, for example).
[3] See further Ishiyama (1975) for a review and Eichengreen (1993) for an updated review in light of the Maastricht Treaty.

the payments system) until real adjustment occurred. For EMU, the Trans-European Automated Real-time Gross settlement Express Transfer (TARGET) system, currently operating in its second-generation form as TARGET2, was set up to provide a level playing field for effecting payments settlements across the Eurozone. The system was seen as a precondition for the effective conduct of ECB monetary policy as well as the further promotion of financial integration. It was expected that the imbalances within the system would be small and short-lived.

In fact the TARGET2 transfers have become very substantial since the onset of crisis, indicating persistent imbalances, particularly between Germany's credit position and the debit positions of peripheral member states, notably Greece and Ireland (Bibow, 2015: 71). There is a lively literature exploring the causal mechanisms behind these imbalances, notably as to whether or not they reflect balance-of-payments imbalances or simply a diversion of flows from the capital account to TARGET2 (see e.g. Sinn and Wollmershäuser, 2012 and Whelan, 2013).

Some commentators see the particular design of the TARGET system within the overall system of European monetary policy as simply distorting the way in which normal market forces naturally bring about adjustment to payments imbalances, impeding convergence. Others see the wider institutional framework of the Eurozone as being far too constrained to prevent divergence. According to this latter view, the TARGET2 imbalances in fact reflect the weakness of the institutional structures and policy tools in the Eurozone. The difficulties for governments in meeting deficit limits when faced with a national banking crisis have been compounded by the strictures on independent national central banks and the ECB with respect to directly financing governments. Even ECB financial support for banks has come up against the problem of the requirement for high-quality collateral just when public sector debt came to be seen as potentially risky (see e.g. Lavoie 2015b).

The Eurozone is accordingly understood from a heterodox perspective as a collection of economies, each of which was potentially unstable as an independent nation, but where the scope for collective instability has been reinforced by the institutional structures and practices of the Eurozone. A crucial factor has been the primacy given to money as the putative cause of inflation and capital markets as the key to promoting adjustment to payments imbalances. Fiscal policy has explicitly been constrained, treated as separable from (centralised) monetary policy, while unemployment has been seen as an issue only as a bi-product of the austerity policies required to enforce fiscal controls and achieve the inflation target rather than as a key policy concern.

The general equilibrium theoretical approach relies heavily on the mechanism of monetary flows. If a nation has a current account deficit and cannot attract sufficient capital to finance it, then the consequent outflow of funds will reduce local factor prices, restoring payments equilibrium (potentially on both accounts). The role of the banking system in effecting these flows is to intermediate, reducing loans when deposits decrease through a payments deficit and vice versa in the case of a surplus. This tight relationship may be mitigated by internal flows within a multinational bank, seen as transferring deposit-funded credit from one economy to another, but only when warranted by relatively high expected returns in the economy attracting such an inflow, in line with the general expected direction of capital flows.

But from a Post Keynesian perspective the process is quite different. The money supply is seen as being endogenously determined by the market for credit, albeit influenced by the central bank. In the absence of a negative relation between the return on capital and the interest rate, member countries experiencing a relative decline in productivity will experience not only a deterioration on the current account but may also experience a deterioration on the capital account as investment prospects weaken, which could be compounded by a reduced willingness of local banks to extend credit, and increased liquidity preference is satisfied by capital outflows. Such economies are forced therefore to adjust by introducing fiscal austerity; until (and if) this succeeds in improving the current account, the payments gap must be filled by borrowing. The ECB quantitative easing program has attempted to ease borrowing conditions. But the increased liquidity has not eased conditions in the real economy since banks have proved to be unwilling to accept the credit risk they perceive (thus increasing credit risk) and have preferred to exercise a high level of liquidity preference.

When he proposed an international central bank, issuing an international currency, Keynes envisaged a central payments settlement mechanism which would allow for temporary debit and credit balances. Cesarrato (2013) and Lavoie (2015a) discuss the extent to which the TARGET system accords with the Keynes plan. A critical difference is Keynes's insistence on measures to ensure that surplus countries not only bore some of the burden of adjustment but would actually have to take the initiative in adjustment. This would remove the normal deflationary bias of payments adjustment. Although the ECB deposit facility currently attracts a marginally negative rate, this is clearly not acting as an effective incentive for surplus countries to adjust. An effective penalty rate is required. In the meantime the purported connection of general equilibrium theory between money injections and aggregate demand have not materialised because of high liquidity preference and weak effective demand.

The other possible parallel is with a national payments system. Lavoie (2015a: 10) points out that current account imbalances between regions within any member country are not seen as a problem (in making the point that they should not be a problem between Eurozone members either). Regional economies are generally given national fiscal support, among other factors within a national political and institutional structure promoting convergence. Further temporary imbalances can be handled within national branch banks or the interbank market, supported by the liquidity provision of the national central bank designed to sustain the official rate. There is no currency value or (generally) valuation of regional government debt by which a crisis could be identified.

But the Post Keynesian approach to regional finance has suggested that regional economies do face hidden balance of payments problems (Dow, 1986). Accounts are not kept on a regional basis, particularly with respect to capital flows, but changing regional patterns of economic performance still have consequences. It is often assumed that any resulting imbalances are offset on the capital account such that crisis-level financial constraints do not arise. But if capital inflows are insufficient to finance current account outflows (e.g. businesses experiencing a decline in demand unable to borrow to finance production, far less investment), there is no option but to accept adjustment in the form of reduced regional employment and income and/or increased labour out-migration. Indeed, far from offsetting current account imbalances, the capital account may add to them; destabilising real adjustment may discourage capital inflows even further. Bank credit is endogenous, but the regional supply depends on banks' assessment of regional credit risk as well as the banks' general level of liquidity preference.

This approach draws on the Keynesian theories of effective demand and liquidity preference and combines these with Myrdal's theory of cumulative causation, emphasising the interdependence of the real and the financial. It has been applied to a theory of regional development by Chick and Dow (1988) and Rodriguez Fuentes (1998).[4] Further, Bibow (2010), Chick (2000), Dow (1993; 1998) and Dow and Rodriguez Fuentes (2003) have applied the Post Keynesian approach to the European Union. Rather than the typical mainstream presumption that flows between regional banks and within national banks serve to promote regional convergence, these examples of Post Keynesian analysis of the regional pattern of credit creation and liquidity preference indicate that these flows can be an additional force for divergence.

This regional theory of banking rests on the Keynesian/Minskyan theory, not only of economic instability, but also financial instability. Credit supply is determined by bank assessment of lenders' risk and expected returns, while credit demand is determined by borrowers' assessment of their own risk and expected returns. The more credit supply is concentrated in centralised institutions remote from borrowers' experience, the weaker the knowledge base (Porteous, 1995). The outcome is greater instability in credit supply, depending on ill-informed expectations. Given the experience of economic divergence and therefore financial vulnerability, investment planning (and thus demand for credit) in weaker regions is discouraged and high liquidity preference encouraged. Not only are financial systems in general vulnerable to instability, but the instability tends to be exaggerated in peripheral regions.[5] This process contributes to, as well as feeds on, the forces for real economic divergence.

[4] Applications of the theory include Dow (1992) with respect to Scotland, Chick, Dow and Rodriguez Fuentes (2013) with respect to Spanish regions, Dow, Montagnoli and Napolitano (2012) with respect to Italy, and Amado (1997) and Crocco et al. (2014) with respect to Brazil; see also other publications arising from the Lente project at the Federal University of Minas Gerais in Brazil

[5] As a result, national monetary policy has differential effects on regional economies (Rodriguez Fuentes, 2006).

From a Post Keynesian/institutionalist perspective, each regional economy is understood to be conditioned by its own history and institutions in a way which cannot readily be altered; this understanding applies with much greater force to national economies. Rather than constraints, these factors have more often than not lent stability and coherence to national economies. Thus for example, while national banks may find themselves constrained in terms of funding compared to large international banks, they have superior knowledge of the credit-worthiness of local borrowers and a tendency to finance investment by local firms. Myrdal (1972) concluded that, on balance, the cumulative forces for convergence would tend to outweigh those for divergence within national boundaries. This judgement is reinforced by the common fiscal framework within a national economy.

But in an international context Myrdal concluded that the balance of forces was tipped towards divergence. Applying his analysis to the opening up of competition between members of the EU with the development of the single market, some economies fared better than others. Factor flows induced by these differences and encouraged by the single market are more likely to be disequilibrating than equilibrating. It is the more skilled workers who leave relatively declining economies first, further reducing factor returns. Similarly, just as within national boundaries, capital flight from relatively declining economies, combined with relatively high liquidity preference there, increases the perception of high risk attached to any new credit, thus discouraging its supply.[6] The more factor mobility is encouraged, e.g. by the single European banking licence introduced in 1992, the more scope there is for the forces for divergence to operate. The increased concentration in the banking sector (following the initial flurry of competition) added to these forces by centralising bank credit decision-making, reducing the knowledge base on which loans could be extended in remoter parts of Europe.

The strong implication of this analysis is that, far from promoting real economic convergence among European economies, the efforts to open up the European market, particularly with a single currency, in fact added power to the forces for divergence, while removing mechanisms for counteracting these tendencies. Marelli and Signorelli (2015) provide evidence which supports this conclusion.

Policy Implications

The reason for exploring the basis of the different understandings of the European economy and their associated analytical approaches is that they lead to different understandings of the Eurozone's current problems and therefore different policy solutions to those problems. On the surface there appears to have been one problem with the Eurozone: Greece has been in danger of defaulting on its debt and/or of seeing the only option as being to leave the Eurozone. Either outcome would be highly damaging for the Eurozone, given the presumptions that the Maastricht criteria would eliminate the possibility of default and that the establishment of the single currency was irreversible. Greece's problems are however just a more extreme version of problems experienced elsewhere in the Eurozone's periphery. In particular the recent fiscal problems of several peripheral European economies arose from the need to shore up weak banks and the consequent need for financial support at the price of austerity policies. The solutions being aired to address these problems were fiscal union and banking union, with discussion also of the ECB acting as a lender of last resort.[7]

Each of these policy responses actually means something very different depending on theoretical approach and ontological foundation. Fiscal union from a mainstream perspective means a much more strict enforcement of the Maastricht rules on debt and deficits, as was required for example for Spain and Ireland. While Greece's fiscal problems similarly arose primarily from the need to support its banks, the mainstream interpretation of the causes of the Greek crisis, and therefore the basis for the solution, is that information had been concealed by previous Greek governments, that Greek institutions and practices had not

[6] A single European monetary policy can thus be expected to have differential effects across member states (Dow and Rodriguez Fuentes, 2003).

[7] There is also active discussion of a capital market union whose features would promote common institutions, practices and procedures throughout the Eurozone, encouraging further competition and furthering the process of securitisation which was an important driver of the crisis (Chick, 2008).

harmonised sufficiently with the rest of Europe, and that the standard mechanism for ensuring that Greece met the Maastricht restrictions on the fiscal deficit (austerity) was being resisted.

European banking union has been pursued both for consolidating the single currency and for 'rebooting' the euro area banking system (Bibow, 2015: 75-6). A particular motivation is to prevent recurrence of the fiscal cost of bank support, which makes it difficult for member governments to satisfy the Maastricht rules on deficits and debt. Bank failure would instead be dealt with at a European level, with 'bailing in' designed to protect the fiscal finances. Further, by thus detaching banks from national fiscal positions, the idea is that their uniform treatment would ensure a common cost of funding credit across Europe, thus ensuring uniform availability of credit to businesses in all member countries (European Commission 2014: 4). As with the fiscal union, banking union would involve a strict enforcement of common rules: prudential rules for European banks, a common supervisory framework and mechanisms for dealing with bank failures.[8] The primary prudential focus is to be on capital ratios, while resolution of bank failures is to impose the costs on shareholders and bondholders rather than on the state.

It is of critical importance that the thinking behind the conceptualisation of banking union reflects the mainstream view that bank failures can be regarded as separable incidents, a microeconomic problem rather than a systemic macroeconomic problem. Without what are regarded as distortions, such as state support for banks, it is assumed that market forces within a common market will ensure stability. Since market forces operate by competition whereby there are inevitably going to be losers from time to time, the issue addressed by banking union is how to minimise the fall-out (in fiscal cost and in contagion of expectations) of individual cases of bank failure. The aim therefore is to do away completely with the role of central banks as lenders of last resort to commercial banks. There is to be no 'fiscal backstop' (Bibow, 2015: 86-90). Rather the lender-of-last-resort proposal from the mainstream perspective refers to the possibility of the European Central Bank lending to Eurozone governments, something which was long resisted on the grounds that this would violate the Maastricht prohibition on central bank monetisation of deficits. Overall then the mainstream policy agenda follows from a theoretical framework which still understands market forces as equilibrating as long as they are not impeded by money creation resulting from excessive fiscal deficits or other market 'distortions'. If these deficits arise from bank support, then banks need to be exposed more to market forces (subject to centrally-established prudential requirements).

The Post Keynesian stance reflects the fact that regional balance of payments problems within economies rarely spark crises (even if they promote regional divergence) because of fiscal support at the national level, a national system of bank regulation and bank practices, and a lender-of-last-resort facility for all national and regional banks at the national central bank. Post Keynesian theory therefore indicates policy proposals which, like the mainstream approach, also involves fiscal union, banking union and a lender-of-last-resort facility. But in each case the meaning is very different from the mainstream proposals. The underlying Post Keynesian view is that there are powerful forces for divergence within Europe. The mechanisms promoting divergence have been given added force by EMU, since the Maastricht Treaty removed the normal policy tools for addressing the resulting productivity and payments imbalances. A single external value of the currency and a single official interest rate cannot accommodate differing economic conditions in different member states, where these differences are exacerbated by the increased openness of factor and goods markets promoted by the EU.

The Delors proposal (Committee for the Study of EMU, 1989) for a system of fiscal transfers between European nations was rejected. Yet this is how nation states address imbalances within their own boundaries. Even if regional policy has been eroded in many countries, reflecting the growing influence of market-oriented politics, the automatic fiscal stabilisers still serve to reduce regional disparities (Kaldor, 1970). For Post Keynesians, what is required is a sharing of revenues in order to counter the forces and effects of economic divergence, something which is normal within federal forms of economic and political union. This is a fiscal union in the spirit of cooperation (recognising that, as in a federal state, the direction of transfer changes as the fortunes of member states may change). This is very different from fiscal union as the attempted enforcement of fiscal rules which cannot succeed. Not only do governments not have control

[8] Little progress has been made on a common system of deposit insurance (see Bibow, 2015: 86, 90).

over their net deficits (Chick and Pettifor, with Tily, 2010), but even if they could be successful in controlling deficits, austerity policies would simply exacerbate forces for divergence.

Second, the banking sector is key, because credit creation and allocation are key drivers of the European economy, as well as potential sources of financial instability. While the mainstream policy for banking is to enhance the capacity for market forces to ensure efficient allocation of financial resources and financial stability, minimising state-led 'distortions', the Post Keynesian policy is to focus on the positive role for the state in partnership with the banking sector. It is argued that free competition in banking leads to concentration, diverting credit creation from productive activity towards speculation in centralised asset markets and from peripheral economies to large corporations located in the Centre. The state therefore has an important role in counteracting these tendencies. This role can extend from setting up state-run financial institutions tasked with extending credit to activities and regions ill-served by large international banks, to providing support for small local financial institutions. Thus for example Bibow (2014) proposes a Euro Treasury. Further, when central banks inject liquidity into the system to satisfy liquidity preference in the wake of the crisis, the conduit can be expenditure in, or credit to, sectors particularly disadvantaged by the crisis, as in the proposals for 'people's quantitative easing'. According to this view of the essential nature of the relationship between fiscal and monetary policy, central banks are lender of first resort to governments.

But the state equally has a fundamental role to play in ensuring the stability of the financial system. The latest financial crisis was spurred on by the deregulation of the financial sector since the 1970s (Chick, 2008). This process was a product of mainstream presumption of convergence as the normal state of the (unconstrained) world. While financial instability is the norm, the freeing up of the financial sector from the 1970s provided particular aggravation, whereby financial fragility was stoked up during the long period of the 'great moderation'. Far from bank vulnerability occurring on an isolated basis, the norm is for bank vulnerability to be systemic, rendering the 'bail-in' solution unsustainable (Avgouleas and Goodhart, 2014). While the mainstream response is to try to minimise the state's involvement in banking, focusing on the possibility of individual bank failure, the Post Keynesian response is to restore the traditional cooperative relationship between the state and banks. This relationship involved the banks enjoying lender-of-last-resort support from the state (and their consequent ability to attract short-term deposits with a high redeposit ratio) in return for submission to regulation and supervision to ensure the safety of those deposits (Dow, 2012). The important lender-of-last-resort function thus refers to the banks rather than government.

A European banking union from this perspective therefore involves a Europe-wide commitment to support retail banking in exchange for submission to regulation and supervision to ensure prudence. But there are dangers inherent in applying this policy at a European level. Historical relationships between state, banks and the public are important, and differ as between European economies (see e.g. Chick and Dow, 1997). Ultimately, the success of a monetary system derives from trust, which is a social phenomenon based on experience mediated through culture rather than calculative rationality. It would require careful and time-consuming development to arrive at a relationship between state, banks and public which would engender trust across Europe. In the meantime, the priority for European banking union is to facilitate the capacity of national authorities to act as lenders of last resort to their home banks. In turn this requires a recognition of the need for fiscal support, just one reflection of the inevitable interrelationships between monetary policy and fiscal policy which the Maastricht system tried to suppress.

Concluding Reflections

This discussion of the role of central banks illustrates well differences in viewpoint as to the nature of theory and policy advice. We have discussed the implications of ontological differences for theory and policy with respect to Europe. But there are implications too for how theory itself is regarded. In particular the mainstream closed-system approach encourages a view of theory and policy as being purely technical matters. The open-system Post Keynesian approach by contrast considers economic relations as bound up in social, political and ethical relations. Thus, for example, while trust for mainstream economists is a form of rational optimising behaviour, for Post Keynesians it involves history, sociology and politics in a complex way.

Certainly the mainstream analysis has paid considerable attention to institutional developments as an integral element of EMU. But these institutions have been understood as implementers of technical policies: controlling the European money supply according to an inflation target, controlling national fiscal policy, and more generally promoting institutional and policy uniformity across Europe. Yet the outcome has been far from what was anticipated. The economic divergence which has resulted has meant a very uneven distribution of costs and benefits, without any offsetting mechanisms other than those prompted by crisis situations. The response to crisis has clearly been political, surrounded by a range of stances as to what constitutes the rights and responsibilities involved in membership of a currency union. A monetary union without a fiscal union in the Post Keynesian sense has been proven to be unworkable, with disastrous consequences. A monetary union designed without reference to the detailed working of all aspects of the European banking sector has allowed the mainstream discourse to reject the idea of state support for banking, from which Post Keynesian theory would also predict disastrous consequences.

It has been argued here that the design and implementation of EMU was based on a theoretical structure which in effect assumed convergence as the default equilibrium position. Institutions and practices were required to limit impediments to real convergence, emphasising money and finance rather than real production. Given the crisis in Europe, the conclusion is inevitable that the cause must be that these institutions and practices were not fit for purpose and require reform to give more rein to market forces.

The heterodox critique is based on an understanding that economies are inevitably potentially unstable, such that institutions and practices are required to promote stability, recognising the inherent interdependence of the real and the financial in the economy and in government. It is on this basis that a more constructive (rather than preventative) approach is taken to the role of the state in Europe in terms of fiscal union and banking union, with the ECB acting as lender of first resort to governments and lender of last resort to banks.

To the extent that there is recognition that the design of the Eurozone is fundamentally flawed, there may be a political will to revisit Maastricht. If the mainstream theory's foundational belief in market convergence is seen to be challenged by events, then there is a political case for exploring an alternative theoretical framework based on alternative foundations. It is hard, given the experience in the European economy since the global financial crisis took hold in 2008, for any economist to deny that financial and economic instability can persist, and that monetary and fiscal rules may not be sufficient to address it. Mainstream thinking may have absorbed some of these real developments. Yet we have shown here that the fundamental mainstream understanding of economies as normally equilibrating unless impeded by market imperfections persists in the type of policy solutions being developed in the Eurozone. Until the shortcomings in that understanding are fully grasped, any attempt to revise the Maastricht principles will inevitably fall short.

References

Amado, A (1997) *Disparate Regional Development in Brazil*. Aldershot: Ashgate.

Arestis, P and Sawyer, M (2001) 'Will the Euro Bring Economic Crisis to Europe?', *Levy Institute Working Paper* no. 322.

Avgouleas, A and Goodhart, C A E (2014) 'A critical evaluation of bail-in as a bank recapitalization mechanism', *International Macroeconomics Discussion Paper Series* no. 10065, London, CEPR.

Bibow, J (2010) *Keynes on Monetary Policy, Finance and Uncertainty*. Cambridge: *Cambridge University Press.*

Bibow, J (2014) 'The Euro Treasury Plan', *Levy Institute Public Policy Brief* no. 135, August.

Bibow, (2015) 'The euro's savior? Assessing the ECB's crisis management performance and potential for crisis resolution', *IMK Study* 42, June.

Brecher, I (1957) *Monetary and Fiscal Thought and Policy in Canada*. Toronto: University of Toronto Press.

Cecchini, P (1988) *Report: The European Challenge: 1992 The Benefits of a Single Market*, Brussels: Commission of the European Communities SEC (88) 524 final. http://aei.pitt.edu/3813/1/3813.pdf

Cesaratto, S (2013) 'The Implications of TARGET2 in the European Balance of Payments Crisis and Beyond', *European Journal of Economics and Economic Policies: Intervention* 10(3): 359–82.

Chick, V (2000) 'The regions and small businesses in bankers' Europe', in J. Toporowski (ed.), *Political Economy and the New Capitalism: Essays in Memory of Sam Aaronovitch*. London: Routledge.

Chick, V (2008) 'Could the crisis at Northern Rock have been predicted?: An evolutionary approach', *Contributions to Political Economy* 27**:** 115-24.

Chick, V and Dow, S C (1988) 'A Post Keynesian perspective on banking and regional development', in P Arestis (ed), *Post Keynesian Monetary Economics*. Cheltenham: Edward Elgar.

Chick, V and Dow, S C (1997) 'Competition and Integration in European banking', in A Cohen, H Hagemann and J Smithin (eds), *Money, Financial Institutions and Macroeconomics*. Boston: Kluwer.

Chick, V and Dow, S C (2012) 'On Causes and Outcomes of the European Crisis: Ideas, Institutions and Reality', *Contributions to Political Economy*, 31 (1): 51-66.Chick, V, Dow, S C and Rodriguez Fuentes, C J (2013) 'Good Banks and Bad Banks, Centralised Banks and Local Banks and Economic Growth', *Ekonomiaz*, 84(3): 110-27.

Chick, V and Pettifor, A, with Tily, G (2010) *The Economic Consequences of Mr Osborne: Fiscal Consolidation: Lessons from a century of UK macroeconomic statistics.* London: Prime. https://static.squarespace.com/static/541ff5f5e4b02b7c37f31ed6/t/54abf084e4b0e845494bcd66/1420554372466/The+Economic+Consequences+of+Mr+Osbourne+-+Final.pdf, accessed 19 August 2015.

Coffey, P and Presley, J R (1971) *European Monetary Integration*. London: Macmillan.

Committee for the Study of EMU (1989) 'Report on Economic and Monetary Union in the European Community' (The Delors Report). Luxembourg: Office for Official Publications of the European Communities.

Crocco, M, Faria-Silva F, Paulo-Rezende L and Rodriguez-Fuentes, C J (2014) 'Banks and Regional Development: An Empirical Analysis on the Determinants of Credit Availability in Brazilian Regions', *Regional Studies* 48(5): 883-95.

Dow, S C (1986) 'The Capital Account and Regional Balance of Payments Problems', *Urban Studies*, 23(2): 173-84.

Dow, S C (1992) 'The Regional Financial Sector: A Scottish Case Study', *Regional Studies* 26(7): 619-31.

Dow, S C (1993) 'European Monetary Integration and the Distribution of Credit Availability', in S Corbridge, R Martin and N Thrift (eds), *Money, Power and Space*, Oxford: Basil Blackwell.

Dow, S C (1998) 'Financial Structure and the Economic Performance of Peripheral Economies: the Case of Europe', in S Hill and B Morgan (eds), *Inward Investment, Business Finance and Regional Development*. London: Macmillan, pp. 170-85.

Dow, S C (2012) 'What are Banks and Bank Regulation For? A Consideration of the Foundations for Reform', *European Journal of Economics and Economic Policies*: *Intervention*, 9 (1): 39-56.

Dow, S C, Montagnoli, A and Napolitano, O (2012), 'Interest Rates and Convergence Across Italian Regions', *Regional Studies,* 46 (7): 893-905.

Dow, S C and Rodriguez Fuentes, C (2003) 'EMU and the regional impact of monetary policy', *Regional Studies* 37 (9): 969-80.

Draghi, M (2014) 'A consistent strategy for a sustained recovery', Lecture, Paris, 25 March, https://www.ecb.europa.eu/press/key/date/2014/html/sp140325.en.html

Eichengreen B (1993) 'European Monetary Unification', *Journal of Economic Literature* 31(3): 1321-57.

European Commission (1990) 'One Market, One money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union', *European Economy*, 44 (October).

European Commission (2014) 'Banking union: restoring financial stability in the Eurozone', Memorandum, Brussels, 15 April.

Ishiyama, Y (1975) 'The Theory of Optimum Currency Areas: A Survey', *IMF Staff Papers* 22(2): 344-83.

Kaldor, N (1970) 'The case for regional policies', Scottish Journal of Political Economy 17(3): 337–48.

Lavoie, M (2015a) 'The Eurozone: Similarities to and Differences from Keynes's Plan', *International Journal of Political Economy* 44: 3–17,

Lavoie, M (2015b) 'The Eurozone Crisis: A Balance-of-Payments Problem or a Crisis Due to a Flawed Monetary Design? A Reply to Sergio Cesaratto', *International Journal of Political Economy* 44: 157–160.

Marelli, E and Signorelli, M (2015) 'The euro, long-run convergence and the impact of the crises', WEA European Crisis online conference, available at http://europeancrisis2015.weaconferences.net/papers/theeuro-long-run-convergence-and-the-impact-of-the-crises/ [accessed 15 October 2015].

McKinnon, R (1963) 'Optimum Currency Areas', *American Economic Review* 53(4): 717-25.

Mundell, R A (1961) 'A theory of optimal currency areas', *American Economic Review,* 51: 657-65.

Myrdal, G (1972) *Economic theory and Under-Developed Regions*. London: Duckworth.

Parguez, A (1999) 'The Expected Failure of the European Economic and Monetary Union: A False Money against the Real Economy', *Eastern Economic Journal* 25(91): 63–76.

Porteous, D J (1995) *The Geography of Finance*. Aldershot: Avebury.

Rodriguez Fuentes, C J (1998) 'Credit availability and regional development', *Papers in Regional Science* 77(1): 63-75.

Rodriguez Fuentes, C J (2006) *Regional Monetary Policy*. London: Routledge.

Sinn, H-W and Wollmershaeuser (2012) 'TARGET loans, current account balances and capital flows', *International Tax and Public Finance* 19(4): 468-508.

Whelan, K (2013) 'TARGET2 and Central Bank Balance Sheets', University College Dublin mimeo, March 17, available at http://www.karlwhelan.com/Papers/T2Paper-March2013.pdf [accessed 15 October 2015].

Author contact: s.c.dow@stir.ac.uk

SUGGESTED CITATION:
Dow, Sheila C. (2016) "Ontology and Theory for a Redesign of European Monetary Union" *World Economic Review*, 6, pp. 1-11.