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Charting a Realistic Path for European Integration in Light of U.S. Economic History

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February 13, 2018

Lessons from U.S. History for Improving EMU Function

- U.S. historical examples informed pre-Maastricht EMU discussions, but new data and Euro experience motivate another look
- The issue is not whether EU is integrating more or less quickly than U.S. did, but what are processes, sequences, goals that matter
- In the current European context, question is usually how far to aspire given political constraints
- But part of the message from U.S. history is that the cost of ongoing non-integration is high, so need to also look at what aspirations are needed

Themes of U.S. Economic Integration over the Long Run

Institution Building Requires Repeated Attempts and Often Constitutional Revision

- The U.S. Constitution itself has been amended 27 times
  - Toxic flaws regarding slavery, suffrage, and equal protection of laws were eventually addressed
  - In one case—alcohol prohibition in place from 1919 to 1933—even constitutional changes were undone after just 14 years
  - The architecture of today's Federal Reserve required repeated and far-reaching reform in the first two decades after its founding
- This suggests that European leaders should expect setbacks to integration and be prepared to return to their proposals
- It also means that changes to the underlying treaty for today's European Union will be inevitable
  - Economic integration cannot be limited forever to satisfy those who are averse to change
  - Excessive originalism with regard to the U.S. Constitution still harms American government adaptation and even basic function

Fiscal Integration Takes a Very Long Time

- The U.S. federal government had the power from 1789 to issue its own debt
  - For the first more than 130 years of American history it did so sparingly and essentially only to finance the nation's wars
- Only by 1930s did outstanding U.S. federal government debt permanently exceed total state and local government debt
  - Shared national experiences of participation in World War I and the Great Depression created the political
  - Absent such existential crises, the asks for EU fiscal integration may go as slowly
- But opportunistic expansions of fiscal capacity due to genuine external threats would make sense for the European Union, too
  - Migration policy, common defense, green energy…

The Right Fiscal Sequencing Is to First Identify the Need and then to Find the Resources

- U.S. fiscal expansion generally followed the same political sequence:
  - Congress would identify a problem that required a nationally consistent solution and would then find the necessary funding for it
  - Usually, the federal government dedicated or earmarked particular revenue sources to solving specific preidentified problems
- To increase the scope of the common EU or euro area budget, policymakers should follow a similar sequencing:
  - That means to first identify the policy problems best solved at the European level – with adequate political support
  - An incremental process should be adopted to provide the funding required to accomplish European governmental tasks collectively, not to build fiscal capacity per se

Large Centralized Fiscal Capacity Synchronizes Regional Business Cycles

- Increasing synchronization of U.S. business cycles across a diverse and continental-sized economy occurred only after the dramatic increase in the federal government’s fiscal role in the 1930s
- Previously, divergent regional booms and busts was the costly norm even as markets integrated over decades
  - The growth in the permanent federal budget increasingly alleviated the effects of adverse asymmetric economic shocks, but not just or even primarily through directed interregional transfers
- Given the low likelihood of a similarly sized central budget capacity in the EU, U.S. history suggests that European policymakers now ought instead to create a specialized asymmetric shock absorption instrument for at least the euro area
  - The economic benefits would be substantial, particularly for the operational effectiveness of monetary stabilization
  - Convergence will not come as the endogenous result of monetary union alone

New Centralized Institutions Unite Opposition and Invite Regulatory Arbitrage

- New U.S. federal government institutions have created, from otherwise uncollaborative groups, a broad unified political opposition against the symbolic issue of “more centralization/more Washington.”
  - Such negative coalitions are often easier to maintain than those in favor of specific positive proposals
  - These prompt economic costs and underperformance by allowing arbitrage around incomplete capabilities, making the new half institution vulnerable to ongoing political attacks
  - Such half measures repeatedly sowed the seed of future political and economic crises in the United States; in the financial services sector, resulting regulatory arbitrage by U.S. banks and other actors was particularly costly
- European policymakers must therefore be ready to confront a surprisingly vigorous political opposition to even small new integration measures.
  - This prospect leads to the potential creation of half-built European institutions that may herald greater centralization but are also vulnerable
  - EMU itself, as originally designed in the Maastricht Treaty, is of course the most prominent example of a half-built house that ultimately suffered a regionally driven crisis. This led to scapegoating for being too centralized, when the problem was that it was insufficiently so.

Only Complete Fiscal Support for the Lender of Last Resort Removed Redenomination Risk

- During the early decades following the Federal Reserve System's founding in 1913, negative feedback (or doom) loops materialized between regional banking sectors, state governments, and the regional nonfinancial private sector.
  - This is almost exactly the same as in the Euro Crisis
- Only after the comprehensive reforms initiated by President Franklin Roosevelt did interregional differentials in interest rate and risk perceptions end.
  - The potentially unlimited fiscal support for the Federal Reserve Board and regional Federal Reserve banks
  - The establishment of the Federal Deposit Insurance Corporation (FDIC)
- U.S. history thus implies that only similarly credible actions to fiscally support the European level banking supervisors and deposit insurance will alleviate stubborn country-specific redenomination risks within the euro area.

Federal Responsibilities Often Expand Following State-Level Policy Failures

- Important additions to U.S. federal government responsibilities historically took place when partial state-level services provision collapsed financially.
    - Particularly during periods of economic stress, which generated concerns about insurance provision to individual Americans
    - General old-age pension provision through Social Security and unemployment benefits were introduced during the Great Depression, when similar programs existing in just a few states became unsustainable
    - Federal deposit insurance was similarly adopted in 1933, following the largest financial panic in a sequence of them, when a wave of failures spread among smaller state-level insurance schemes
- European policymakers have reacted in a similar manner to state-level failures in the euro area with the quick adoption of the centralized banking.
    - In this regard, they are well ahead of the pace of their historical counterparts in the United States

Few Core Government Functions Are Exclusively Either State or Federal Responsibilities

- In practice, the U.S. federal government has only a few exclusive responsibilities, such as defense or foreign trade.
- Many core social insurance and regulatory responsibilities are in practice carried out through state-federal government partnerships both institutionally and financially.
  - Unemployment insurance
- Judging by the U.S. experience, European leaders seeking to expand the governing responsibilities at the EU level should look to do so in ways complementary to, and in partnership with, existing member state institutions and responsibilities.
- Just like few states' rights are exclusive in the United States, the principle of subsidiarity will rarely dictate that a governing task is the sole responsibility of a single level of government in Europe – which runs both ways.

National Security Crises and Other External Pressures Are Important Integrationist Forces

- Like the EU, many of the core institutions of the American central government were formed in response to crises, but these primarily were security crises.
  - Economic crises, as noted, were usually insufficient to prompt greater integration on their own, despite their evident costs
- The fiscal dominance of the federal level arose over time from the need to finance national wars, defense, and the New Deal (with collapsing U.S. state government finances).
- Instances of opportunistic integration during crisis eras frequently required subsequent revisiting by lawmakers.
- U.S. history, however, clearly shows how this path towards more integration was not prone to longer-term challenges to its legitimacy. The vast majority of American federal government institutions created in crisis periods were maintained.
  - European policymakers should therefore not regard it as fundamentally illegitimate or untenable politically to push European integration forward by “not wasting a crisis.”

Formation of an American State

- Rise of radical parties and erosion of political center among local identities required something the center could offer
- Center gets blame for conspiracies that don't exist and for any failure to prevent breakdowns due to weakness anyway
- Monetary and even fiscal union are not enough to produce income convergence
- External threats are often a reason to build a state, and EU has plenty of those now