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Costa Cabral, Nazare

2 November 2022

Online at <https://mpra.ub.uni-muenchen.de/115245/>
MPRA Paper No. 115245, posted 03 Nov 2022 14:17 UTC

**The European Monetary Integration Trap:
incomplete sovereignty and the State-mimicking method**

Nazaré da Costa Cabral

Centre for Research in European, Economic, Tax and Financial Law (CIDEEFF)
of the University of Lisbon.

Alameda da Universidade, 1649-014 Lisbon, Portugal

cideeff@fd.ulisboa.pt¹

Abstract

The author identifies the two main (external and internal) dimensions of incomplete sovereignty in the EMU and the respective caveats affecting the scope of the single monetary policy, here described as a ‘monetary policy integration trap’. The author details the main implications caused by this curtailed sovereignty both in its external and internal dimensions – e.g. on the one hand, the polarisation of external positions and, on the other hand, the effects of limited European fiscal/budgetary sovereignty and the atypical interaction between the latter and the single monetary policy. Finally, the way the E(M)U has in recent years addressed this integration trap is analysed, making use of a heterodox method here labelled as the ‘State-mimicking’ method.

Keywords

Sovereignities – Balance of Payments - Monetary policy – Integration trap – State-mimicking method

JEL classification: E5; E6; F12; F45

¹ ORCID ID: 0000-0002-7070-4236.

1. Introduction

The Economic and Monetary Union (EMU) is a territory with a single monetary policy, centralized in an (apparent) sovereign fashion at the European level, yet diminished by retained sovereignties in its member states: therefore, the EMU is a space of incomplete sovereignty. The objective of this article is twofold. On the one hand, it aims to analyse the two main (external and internal) dimensions of this incomplete sovereignty and the respective caveats affecting the scope of single monetary policy, an endogenous limitation posed by the boundaries of such incomplete sovereignty and here qualified as a ‘monetary policy integration trap’. This limitation becomes more disturbing in times of severe crisis, as were the 2010 sovereign debt and the COVID-19 crises and now the Russia-Ukraine war, and when the appeal for more centralization of powers at the E(M)U level² becomes *naturally* stronger. On the other hand, the article intends to shed some light on the way the EMU (as the EU as whole) has in recent years addressed this integration trap and will probably do in the near future, making use of a heterodox and unique method (considering other integration experiences around the world), which I label as the ‘State-mimicking’ method.

The sequence of the article will be as follows. In section 2, I start by analysing monetary integration in Europe before the creation of EMU. As we will see, the EMU was not sufficient to overcome the monetary integration trap. Then, in section 3, I analyse the two dimensions of the incomplete sovereignty trapping the exercise of the single monetary policy - on the one hand, I address the incompleteness externally, given remaining State

² I will use the acronym E(M)U when I am indistinctly considering the EMU and the European Union (EU) as a whole. For certain analytical purposes it is not interesting to make such a distinction, but whenever required, the distinction will be made.

members (national) Balance of Payments (BoP) and the polarisation of external positions and financial flows, highlighting some of the respective implications, e.g. the functioning of the EMU payment system; on the other hand, I analyse the sovereignty incompleteness internally, notably weakly centralized fiscal and budgetary policies, while also explaining the way in which this leads to an anomalous design of the EU budget and undermines proper interaction between monetary and fiscal policies at the EMU level. Then, in section 4, I present the ‘State-mimicking method’, how it seeks to address those sources of incomplete sovereignty, the respective shortcomings, following the same order - firstly, externally, I mention the macroeconomic imbalance procedure and its limitations in addressing remaining national BoP and then I analyse the seminal limitation to building a complete Capital Markets Unions due to the national biases of the remaining financial markets; secondly, and internally, I describe the atypical proposals made at the E(M)U level to overcome the inexistent fiscal union, identifying their peculiar features and insufficiencies.

2. From the European Monetary System to the EMU: the remaining misalignments of the euro

The EMU as a currency area can be described as an extreme version of a fixed exchange rate system³ where previous national currencies were fixed both between each other and with respect to a new currency (the euro), and this fixing occurred in an irrevocable manner (Cabral, 2021a). The euro as a store of value and unit of account implicitly corresponds on a weighted basis to the value of the pioneering European currencies

³ Following Frankel’s (1999) lesson, fixed exchange rates are constrained by the so-called ‘impossible trinity’: this principle states that a country should give up one of the following policy goals: capital mobility, fixed exchange rates, or autonomous monetary policy.

adopting the euro. In fact, the value of the Euro was, on the date of its legal inception (31 December 1998) equivalent on a one-to-one basis to its embryo and predecessor, the ECU. The ECU in turn was a basket-type currency in which however the Deutsche mark ended up being dominant. Indeed, as noted by Haldane (1991, p. 74), this latter currency became acknowledged, within the European Monetary System, EMS (set up in 1979), “as the *de facto* nominal anchor of the European Exchange Rate Mechanism (ERM), just as the dollar became the *de facto* nominal anchor under Bretton Woods - BW”. Furthermore – as also noted (Haldane, 1991, p. 74) – the ERM’s operation became marked by an asymmetry with the burden of adjustment, as under BW, carried disproportionately by the weak currency countries. Two main reasons are added to explain such German dominance in the system (*Idem* p. 74): *i*) on the one hand, the fact that the other participating currencies (notably, from high-inflation countries) voluntarily accepted to ‘import’ Germany’s credibility via an exchange rate peg with the Deutsche Mark – this would be the benefit of ‘tying one’s hands’ via exchange rate targeting in order to control/reduce inflation levels; *ii*) on the other hand, because under a fixed exchange rate regime, the countries building up their stock of reserves the fastest will be those with the most restrictive monetary stance; conversely, those countries following the most expansive monetary policy will be losing their reserves the fastest. In sum, “since a country’s stock or reserves is finite, the burden of adjustment is more often placed upon the expansionary /weak currency country (whose stock of reserves is being depleted) than upon the contractionary/strong currency (whose reserves are being added to). The weak currency will therefore be forced to tighten policy to hold the exchange rate fixed, with the strong currency country insulated from this policy adjustment” (Haldane, 1991, pp. 74-75).

Ultimately this asymmetric requirement for adjustment reflects, in turn, the very operational nature of fixed exchange rate regimes (especially when they rely on an implicit leading absorbent currency): the dominant currency country implicitly ‘centralizes’ monetary policy (e.g. the fixation of the short-term interest rate), whereas for the dominated currency countries the other currency stability tool basically remains – foreign exchange intervention. This same idea is stressed by Haldane (1991, p. 75) for whom in the adjustment mechanism Germany, as an inflation leader, would target nominal interest rates and the other ERM countries would mostly target foreign exchange reserves.

This is also, in turn, one of the ‘natural’ outcomes of the abovementioned ‘impossible trinity’. Assuming weak (or ineffective) capital controls, a fixed exchange rate system involves countries abdicating from their monetary policy independence: this can actually occur by implicitly delegating such policy to the dominant currency country. The problem arises when this implicitly centralized policy in the dominant country becomes incompatible with the other countries macro adjustment needs.

Recall, in this respect, the speculative attacks suffered by the British pound during the Summer of 1992, ultimately leading to the collapse of the EMS. Usually, these attacks are attributed to two main causes: firstly, due to doubts about the progress toward monetary union after the rejection of the Maastricht Treaty (including the creation of the EMU) in the June 1992 Danish referendum; secondly, to the weak commitment of the British authorities towards the fixed exchange rate, expressed for example by the reluctance shown by these authorities to allow, as a response to the speculative attack, short-term interest rates to rise in defence of the currency – this was hence a speculative self-fulfilling attack (Zurlinden, 1993, pp. 54-56). If these reasons are valid, also true was the nationally biased intervention from the German authorities as a response to such

increasing tensions during that Summer. In fact, the adjustments made by the Bundesbank (the first cuts in interest rates in nearly five years) were perceived as small by the markets (Zurlinden, 1993, p. 44). The refusal of the German authorities to go further in their monetary policy response – at a time where the country was still adjusting from the shock of reunification – was mostly due to the fear of further inflationary tensions. On 16 September – Black Wednesday – the Bank of England started intervening massively on the foreign exchange market in order to prevent the pound from falling below the lower margin of the Deutsche mark (*Idem*, p. 44) – note this was indeed a last resort intervention from a non-dominant currency country. Such intervention was not enough, however. By the end of the day the British authorities announced the temporary suspension of the pound from the ERM, which actually became a permanent withdrawal from the mechanism.

Against this background, it can be said that the EMU (formally launched in 1993 after the approval of the Maastricht Treaty), with its three main ingredients – capital mobility, fixed exchange rate, a single monetary policy (and a single currency) – was a radical solution for the ‘impossible trinity’. Simultaneously, it relied on two beliefs, one proved to be correct, while the other not so. The first belief was that the option for an irrevocable peg of the (previously existent) currencies both to each other on a bilateral basis and to the euro would finally prevent speculative attacks upon weaker currencies, thereby overcoming the usual gridlock attributed to fixed exchange rate regimes (as the EMU’s predecessor - the EMS - had also shown). This proved to be correct as subsequent speculative attacks were indeed impaired.

The second belief was that the creation of the EMU would eliminate all BoP problems within the area, because the introduction of a single currency would suppress exchange rate risks and, most of all, because a single monetary policy was expected to be a

‘common ground’ receiving the same seeds for macroeconomic management both internally and externally, including the seeds for competitiveness among EMU member states. Moreover, the EMU intended to overcome the asymmetry found in the previous EMS, where, as seen before, the effort of macro adjustment externally was mostly assigned to non-dominant currency economies, including through foreign exchange reserves management – like emerging economies when pegging their currencies to a leading/stable country usually do – in order to prevent a BoP crisis, ultimately capital outflows. But this belief has not proved to be so. For sure, differences in external positions between EMU countries are in the first place a reflection of differentiated economic structures and levels of competitiveness. However, the fact is that the euro, as a single currency, not only did not prevent macroeconomic imbalances to arise but also to a large extent it is deemed to have amplified them.

Indeed, the euro suffers from misalignments, both internal through the interest rate and external through its exchange rate (Stiglitz, 2016). The external misalignment is indeed attributed to the euro’s exchange rate, a value considered too low for some countries (in comparison to previous national currencies – e.g. the Deutsche Mark), fostering competitiveness, while it “was too high in several (other) countries, so that their imports systematically exceeded exports” (Stiglitz, 2016, p. 261). As a consequence, this gave rise, in those countries, to a trade imbalance financed mostly through rising external debt. The euro has indeed created a new kind of debt - apparently a domestic debt as issued in euros and yet this is in reality an external debt, simply because debtor countries have no individual control over the euro (see also Stiglitz, 2016, p. 265). De Grauwe (2011) in turn explained that when entering a monetary union, member countries cease to have control over the currency in which their debt is issued. In a severe crisis, weaker countries can be subject to default by financial markets; they are therefore “downgraded to the

status of emerging economies.” (De Grauwe, 2011). In short, the belief that the euro would eliminate BoP problems of its member countries was shown to be wrong. As a consequence, the distinction between dominant and non-dominant currencies in the system, while formally abandoned, remains present.

This external misalignment of the euro is an expression of the EMU’s incomplete sovereignty. The EMU is indeed a territory with a single monetary policy, centralized in an (apparent) sovereign fashion at the European level, yet diminished by the retained sovereignties within its member states: EMU member states are in fact the sovereign accounting entities for BoP purposes, they are the allocation centres for exports and imports, the centres of trade flows and payments, and of financial flows; ultimately they are the legal and accounting centres of financial assets and liabilities, and the public and private debt (credit) they owe (own) vis-à-vis other member countries is definitely external debt (credit).

In the next section, I will provide precise details of the two main dimensions, external and internal, of the E(M)U’s incomplete sovereignty, the caveats affecting the scope of the single monetary policy (and respective implications), what I describe as a ‘monetary policy integration trap’- *i)* Externally, the caveat is mainly due to the subsistence and polarization of external (BoP) positions, reflecting in turn the outstanding structural divergence between Member States (exhibiting a ‘core–periphery’ pattern); *ii)* Internally, the caveat is mostly related to the E(M)U’s curtailed fiscal sovereignty and the atypical interaction between this policy and the abovementioned monetary policy, explaining the troublesome risk-sharing effect resulting from such interaction.

3. The two dimensions of incomplete sovereignty and the monetary policy integration trap

3.1. A single monetary policy in a landscape of remaining national Balance of Payments: the euro misalignment and its short-term and structural expressions

3.1.1 The polarization of external positions and financial flows; the long lasting financial fragmentation in the European monetary union

In the first place, it should be noted that in typical currency unions (e.g. the United States of America, US), problems of BoP between its states (e.g. California vis-à-vis Mississippi) are not even considered: trade imbalances between these states can be recorded, respective financial flows are known, but this is not ‘the’ issue. The issue is the BoP of the US vis-à-vis the rest of the world. In the EMU, on the contrary, the single monetary policy operates in a landscape of remaining national BoP, recording trade relationships between EMU member countries and mutual financial flows.

The financial account is indeed the mirror of the current (trade) account. The single monetary union has avoided the polarization of neither external positions nor financial flows (Milesi-Ferreti and Tille, 2011). In particular, the fragmentation of capital markets in the EMU is a reflection of different ‘economic fundamentals’ such as the competitiveness capacity and it is a reflection of macroeconomic divergence across Europe. Lane (2006), while recognizing that the EMU had fostered financial integration in the area and had increased the so-called ‘euro bias’ in different segments of financial markets, also highlighted that this integration had not been the same for all EMU countries. As a sign of this bipolar financial integration, Lane (2006, p. 54) focused precisely on the increasingly larger current account deficits in the poorer countries of the EMU (Greece, Portugal and Spain) since the enactment of the monetary union.

It should be recalled, in particular, that the 2010 sovereign debt crisis was mostly a ‘sudden stop’ crisis in capital flows vis-à-vis the peripheral countries (Baldwin *et al.* 2015), very similar to BoP crises, which economists had considered the unthinkable for the euro area (Bénassy-Quéré and Wolff, 2020). During the early ‘good years’ of the euro, large capital flows from Euro area core countries to peripheral countries were viewed as real convergence dynamics, thus hindering the imbalances that were being created (Baldwin *et al.* 2015).

3.1.2 External polarization at the EMU and its structural expressions

In fact, such imbalances in external positions between EMU countries - that the sovereign-debt crisis thus exhibited – reflect in turn differentiated economic structures and levels of competitiveness. Although the European cohesion policy has attempted to resolve some of this divergence among EU countries, it has not been entirely successful. As noted by the European Commission, EC (2022), the economic convergence of regions over the period 2011-2019 was mainly driven by the catching-up of many of the less developed ones. But this picture is different across EU regions. So, while there has been significant catching-up in eastern Europe, “many less developed regions in Southern Europe have experienced sluggish or negative growth and their GDP per head is diverging away from the EU average” (*Idem*, pp. 24-25). One justification for this different pattern is related to so-called ‘development traps’ (EC, 2022, p. 35-36): growth is usually higher when initial GDP per head is lower. The low growth verified in middle category regions (in terms of GDP per head), as are some of those southern regions, may be due to this development trap – these regions are indeed characterised by the low cost of capital and labour and by being less innovative or productive than more developed regions (EC, 2022, p. 36).

In this regard, Kapeller *et al.* (2019) refer to the idea of ‘economic polarization’, while Gräbner *et al.* (2019) use the expression ‘structural polarization’ to analyse macroeconomic divergence in the E(M)U notably after the creation of the euro. In the former, the authors (Kapeller *et al.*, 2019) describe a process of multi-dimensional polarization of EU countries, linking the existing economic divergences with differences in the institutional and legal embedding (e.g. tax, labour market) and in technological capabilities. This polarization is due largely to the global and the European ‘race for the best location’. In the latter, the authors (Gräbner *et al.*, 2019) find evidence for a ‘core–periphery’ pattern among Eurozone countries; specifically, the emergence of export-driven growth in core countries and debt-driven growth in the Eurozone periphery can be traced back to differences in technological capabilities and firm performance.

The theoretical insights of this approach date back to the New Economic Geography theory, NEG, developed by Krugman (1991). According to this view, trade integration, pushed by economies of scale and other centripetal factors, leads to regional concentration of industrial activities whereby sector-specific shocks may turn into country-specific shocks (see also Puga and Venables 1996). Ascani *et al.* (2002) highlight that the main contribution of the NEG – a ‘core-periphery’ model - is precisely to evaluate the effects of economic integration on spatial development. In an environment of increasing returns and economies of scale, product differentiation and monopolistic competition, labour mobility and with intermediate transport costs, dispersion forces prevail in the case of negative externalities, driven by congestion or immobility of certain factors of production (e.g. land and certain types of labour), whereas agglomeration forces prevail in the case of positive externalities, such as price/wage externalities. In the case of Europe, where labour mobility is constrained, agglomeration effects vis-à-vis core regions are mostly explained by the so-called vertical linkages within a sector or industry (Ascani *et al.* 2002,

p. 10), thereby fostering a process of economic divergence between those core regions and peripheral ones.

Overcoming such economic divergence has proven to be hard in the E(M)U, not only given the nature of this ‘core-periphery’ economic pattern and the aforementioned development traps, but mostly because unlike that which happens in currency unions with complete sovereignty (the US) where those structural divergences between core/rich vs. peripheral/poor regions give rise to internal imbalances to be solved through internal macroeconomic management tools, in the EMU such imbalances paradoxically remain as external imbalances and therefore are much more troublesome to address.

3.1.3. Some implications of the incomplete sovereignty in the external dimension:

TARGET 2 and remaining asymmetries in external adjustment

The subsistence and polarization of external (BoP) positions in the EMU lead in turn to several implications. Let me highlight two of the most important: *i)* firstly, the specific design and role of the European payment system – the TARGET 2; *ii)* secondly, the remaining asymmetries in external adjustment.

As for the first implication – the role of the TARGET 2 – although the parallel that has been made between this system and similar payment systems in other currency unions, the most usual being the comparison with the US Inter-district Settlement Account (ISA), the fact is that important differences remain, and such differences become more visible in times of crisis. Firstly, it should be noted that the Eurosystem is characterized by a high degree of decentralization in favour of National Central Banks (NCBs): they are the recipient of both seigniorage revenues and dividends related to the implementation of the (single) monetary policy, e.g. the so-called ‘quantitative easing’ (Gros, 2016).

When considering in particular payment systems, it should be highlighted that they typically involve relationships between three layers – the National Central Bank, the intermediate central banks and commercial banks. The role of the central banks (on one hand, national/district banks, on the other hand the top level central bank) is crucial to understanding the nature, whether more centralized or decentralized, of the payment system itself. Bijlsma and Lukkezen (2012) compare the role of Federal Reserve Boards, FRBs, within the ISA with the role of NCBs in the EMU's payment system, TARGET 2. One common idea is that FRBs are owned by other banks (private equity), and this is a strong argument in favour of the decentralized nature of system management. However, Bijlsma and Lukkezen (2012) dispute such an alleged (high) decentralized nature of the ISA showing that the FRBs are effectively owned by the federal government.

In abnormal times of crisis, the differences between these two payments systems become more visible. In Sinn's (2012) opinion, TARGET 2 was a vehicle and an exhibitor of growing external imbalances within the euro area (two coexisting euros, a 'strong' vs. a 'weak' euro). Sinn (2012) qualified TARGET 2 as Target credit, through which peripheral countries 'forced' other Eurosystem countries – with Germany at the head – to provide this credit. The Bundesbank was therefore lending its money printing process to the EMU periphery (Sinn, 2012). Schelkle (2017, p. 295), although mentioning the insurance role played by TARGET 2 during the crisis, also acknowledges that that protection function did not neutralize the effects of capital flight. Such flight happened, in part, because, as appropriately noted by Buiter and Rahbari (2012), TARGET balances play the role of foreign exchange reserves: current account deficits can be financed by a capital import from TARGET and current account surpluses can continue because TARGET provides the capital export. Ultimately, this happens because TARGET 2 operates in a landscape with remaining national Balance of Payments thereby impairing

the full risk-sharing capacity of the payment system itself. The US payment system (ISA), on the contrary, operates in a single currency territory whose only external account is the account of the sovereign (the US) vis-à-vis the rest of the world. One important consequence is that the Fed is obliged by law to clear all cheques at par to maintain the integrity of the payments system (Schelkle, 2017, p. 284). In contrast, Rossi (2017, p. 38) highlights TARGET 2 ‘structural imbalances’ to explain how it lacks a final payment aspect between the NCBs so involved. This is so, because the ECB does not act as a settlement institution for the participating NCBs, contrary to the logic of money emission and the orderly working of any payment infrastructure (Rossi, 2017, p. 37).⁴

The second implication of this incomplete sovereignty in the external dimension relates to the asymmetry for external adjustment. Indeed, unlike that which was expected with the creation of EMU, this asymmetry (identified during the functioning of the EMS) was not overcome with the monetary union. The response to the sovereign-debt crisis – as a BoP crisis – marked that asymmetry. Given the impossibility to use nominal exchange rate depreciation as a short-term tool to address such external imbalance, the adjustment effort, mostly borne by highly indebted countries in the EMU, relied on so-called internal devaluation (through prices and wages). The very notion of ‘austerity’ as popularized by Blyth (2013, p. 2) - “a form of voluntary deflation in which the economy adjusts through the reduction of wages, prices, and public spending to restore competitiveness, which is (supposedly) best achieved by cutting the state’s budget, debts, and deficits” – pointed to

⁴ Within each country’s Real-Time Gross Settlement (RTGS), the national central bank is a necessary institution that issues the means of final payment that banks need to settle their debts during or at the end of any banking day. By contrast, between any two euro-area countries, to date, payments are not final for the countries concerned, as they leave the ‘receiving’ country with a claim on the set of TARGET2 participating countries (Rossi, 2017, p. 37).

that asymmetry in the adjustment effort. In the austerity momentum, surplus countries were not symmetrically engaged in the process of adjustment – e.g. they were spared having to inflate their internal demand in order to foster imports of goods and services from peripheral countries at the cost of reducing the respective external surplus.

As we will see, despite the attempt to overcome this asymmetry with the creation of the so-called Macroeconomic Imbalance Procedure, the response has not so far been sufficient.

3.2. The internal dimension of incomplete sovereignty: main implications

Within the internal dimension, one can also find caveats of the incomplete status of sovereignty at the E(M)U level, and the respective implications. As noted by Cabral (2021b, 2021c), E(M)U member states (MS) retain full sovereignty in the tax and borrowing domains: firstly, they are still the prevalent tax assignment beneficiaries of the most important taxes (including typical redistributive and macro stabilizing taxes, e.g. redistributive income taxes), also maintaining full tax powers, as they are the primary (constitutional) decision makers for tax creation and settling tax incidence and tax rates (with minor exceptions for customs taxes and for a certain degree of harmonization at the EU central level involving the general consumption tax); secondly, they have preserved full sovereignty in the borrowing/debt issuance domain, and are the location of the sovereign Treasury function. Hence, the allocation centre of the (so-called) sovereign debt for the E(M)U is neither the EU nor the EMU on their own (as accounting and legal centres for the allocation of liabilities).⁵ Sovereign debt is still the national Member States' debt.

⁵ However, COVID-19 crisis management has opened the “Pandora box” of centralization of competences in the borrowing field, as a way to finance the new Recovery and Resilience Facility (RRF) with the EC

3.2.1. The intermediate nature of the EU budget

One important caveat of the incomplete sovereignty in the tax and borrowing field is the anomalous design of the EU budget itself. In comparison to other central budgets (either of unitary or federal governments), the EU budget exhibits these three peculiar features:

i) Its historically small dimension

Unlike that which happens in most OECD countries (unitary or federal countries), the EU budget is not capable of ensuring a macroeconomic stabilization function since it is too small in comparison with national budgets (Begg, 2012). This characteristic of the EU budget, since its inception, has not seen much change from its initial (related to the EU's GDP) to its current dimension. Hence, as pointed out by De Grauwe (2014, p. 8), the EU's budget amounts to only 1% of EU GDP (now temporarily doubled with the RRF) while national budgets typically absorb 40% - 50% of GDP.

ii) The pattern of respective taxes and expenditures is not sensitive to cyclical fluctuations

Begg (2012) explains that in most mature economies, the federal or central government performs this crucial role, partly through the action of automatic stabilizers which arise through the interaction of public expenditure and taxation – tending to offset any fall in demand – and partly through discretionary changes in public expenditures or tax rates. The simple existence of a central budget allows for stabilization mechanisms to operate whenever adverse shocks occur. In the case of the EU budget, on the contrary, the type

being assigned (on behalf of the EU) with the power to issue debt (bonds and short term securities) on capital markets. The repayment of such debt is to be ensured through new EU Own Resources, which can ultimately be seen as a path for future EU tax sovereignty. As noted by Schelkle (2021), the RRF gave the Commission the power to tax for the first time.

of tax-based resources and expenditures are not designed to pursue interindividual redistributive functions and through that to pursue any kind of stabilizer goal.

iii) The intermediate nature of the EU budget

The relationship of the EU budget is not established directly with European citizens, as it is always a relationship mediated by the MS. On the revenue side, EU own resources are actually transfers from the MS to the European budget, according to a system of allocation based on a call rate. Therefore, EU own resources are not true tax revenues – and they are not even described as such - levied directly on individual tax payers (either persons or corporations), with the exception of the so-called ‘traditional own resources’ levied on an identifiable taxable operation. As noted in this regard by Cipriani (2014, p. 7), the concept of ‘own resources’ should have meant a shift of sovereignty from member states to the EU institutions, allowing the EU to exert direct power of taxation over EU citizens. Ultimately, a tax directly borne by EU citizens should not even be registered in national MS budgets. However, this was not the case: as witnessed, most MS still describe their own contribution as a transfer to the EU budget. In turn, on the expenditure side, EU expenditures are mostly earmarked grants paid by the EU budget to MS (transfers to their national budgets). Therefore, with small exceptions (e.g. EU personnel expenses) there are no direct expenses paid to European citizens by the EU budget, as typically found in other central budgets (e.g. unemployment benefits and other social benefits). In short, the EU budget – unlike state budgets – is not a ‘citizen budget’, and thereby lacks this democratic ingredient, which is ultimately a source of sovereign legitimacy.

3.2.2. The atypical interaction between fiscal and monetary policies and the limited risk-sharing effect in the debt market

Quantitative easing, QE, was materialized in the EMU through the Asset Purchase Programme launched in the aftermath of the sovereign-debt crisis (2013 onwards) and the Pandemic Emergency Asset Programme implemented in 2020 after the COVID-19 implosion. QE has shown new interactions between monetary and fiscal policies, given the mutually positive externalities verified – in the same way such expansionary monetary policy has created space for fiscal policy by reducing borrowing costs, fiscal policy has created space for monetary policy, providing a fiscal backstop and therefore internalizing the risks and costs of an ultra-low interest rate environment (Bartsch *et al.* 2020, p. 56). In particular, this backstop protected the central bank from having to run with thin or negative capital in the event it incurred large portfolio losses from its monetary operations; such insurance thus preserved the central bank's independence and credibility by enabling the significant risk-taking inherent to unconventional monetary operations (Bartsch *et al.* 2020, p. 55). However, if this was (is) true, it should also be highlighted that such risk-sharing tended (tends) to be constrained since such a fiscal backstop provided to NCBs has mostly been given by national fiscal authorities of each of the MS and not by a single Treasury of the Union, as one would expect to find in a centralized monetary policy (Cabral, 2021c). Debt purchased by the ECB is still the debt of MS (still the sovereigns in the borrowing domain) and not the debt of the central government, which is the E(M)U itself. Therefore, unlike that found in currency unions with complete fiscal sovereignty (both in tax and borrowing areas) the mutually positive externalities in the interaction between monetary and fiscal policies are not fully-fledged and the risk-sharing effect is necessarily more limited.

In particular, given the highly decentralized structure of the Eurosystem, just as NCBs can benefit from the implementation of QE with dividends, they can incur losses related to monetary operations. QE has meant a significant increase in the ECB's balance sheet,

but it has mostly meant an increase in NCB balance sheets. The occurrence of losses, the risk of which may have been amplified by QE itself, can affect the Eurosystem's profitability and ultimately the ECB's and NCBs' capital. This outcome can be problematic in the event of (abrupt) normalization of monetary policy - a 'natural' modification given the recent developments in inflation caused by the increase in energy and commodity prices in the course of post-lockdown recovery and now amplified by the war in Ukraine. To sum up, in the presence of this new inflation-driven shock, besides the likely increase in the spreads of peripheral country 10-year bonds vis-à-vis Germany's sovereign bonds (that is, again, a national bias in the debt market), one should add the increase of balance-sheet risks and costs suffered by the respective NCBs.

4. The State-mimicking method as a way to address the European monetary integration trap

In the absence of a State with complete sovereignty, the E(M)U has developed, especially after the sovereign-debt and COVID-19 crises, a policy-oriented approach or method that I describe as a 'State-mimicking' method. This is a heterodox, and yet pragmatic approach to overcoming the integration trap, that is, all the caveats found both in the external and internal dimensions in the implementation of the single monetary policy and caused by the status of E(M)U's incomplete sovereignty.

A notable feature of such an approach is that it relies on two attempts both on the external and internal fronts: *i*) on the external front, the attempt to bypass remaining national BoP and fragmented financial markets, using proxies of a non-differentiated territory (a 'metaverse'?), 'as if' it was real; *ii*) on the internal front, the attempt to mimic budgetary

instruments of the sovereign State, although not using conventional tools but instead innovative budgetary prototypes.

4.1. The State-mimicking method in the external dimension of incomplete sovereignty: two examples and their respective shortcomings

Bypassing remaining national BoP and financial fragmentation involves some sort of creativity, attempting to overcome the single monetary policy caveats, in particular, as seen above, the external misalignment of the euro and the related subsistence of polarization of external positions and capital flows within the currency union. My point is precisely that - such BoP positions remain ‘external’; they have not become ‘internal’ as would have happened were the EMU to be a true political union with complete sovereignty.

The first example of such a heterodox attempt relies on the so-called Macroeconomic Imbalance Procedure (MIP), a procedure created in the aftermath of the sovereign debt crisis,⁶ aiming to reinforce the functioning of the European internal market, fostering its optimality conditions, e.g. flexibility of prices and wages and mobility of factors (see Bénassy-Quéré, 2015). Differences in the functioning of the internal market can occur even in currency unions with complete sovereignty – e.g. regulatory regional differences (e.g. labour legislation), tax competition, barriers to factor mobility of several kinds. Macroeconomic imbalances of an internal nature (e.g. regional shocks differently affecting unemployment rates) can also take place. What does not happen within those (complete) currency unions is macroeconomic imbalances of an external nature, that is, different regional BoP positions. The MIP attempts to bypass these outstanding

⁶ Regulation (EU) No. 1174/2011 of the European Parliament and of the Council of 16 November 2011 on the reinforcement measures to correct excessive macroeconomic imbalances in the euro area.

differences by including, in the excessive imbalances procedure, adjustment measures both for countries with excessive external deficits and surpluses. Imposing corrective measures for both types of imbalances implies, to a certain extent, the idea of a mirror, as if offsetting measures to correct excessive deficits with measures to correct excessive surpluses would actually lead us to a territory without different external positions. However, this is not the EMU's real world, it is just a tentative yet imperfect proxy of having a 'single BoP' within the EMU. Moreover, in the case of the MIP, the adjustment effort is not symmetric: an external deficit above 4% regarding (the national) GDP is considered excessive, whereas in the case of surpluses they will be considered excessive if above 6% regarding GDP. In short, not only were remaining national BoP not overcome with the EMU, but also it was not capable of fully eliminating the implicit distinction between different currencies, the dominant and the non-dominant, where the adjustment effort is still mostly borne by the latter (despite a *de jure* single currency).

The second example – which is even more disturbing from this point of view – relies on the launching, also after the sovereign debt crisis, of the Capital Markets Union, the CMU (the first step formally given in 2015 with the establishment of the *CMU Action Plan*). The main purpose of the CMU was also to ensure a better functioning of the internal market and so to reinforce private risk sharing mechanisms through stock and bond markets. In particular, the CMU was conceived to overcome financial fragmentation within the EMU and, indirectly, to ensure a more uniform transmission mechanism of monetary policy. However, although inspired by the US model (as a typical example of full capital market integration), the European CMU entails a plausible oxymoron, since – due precisely to remaining national external positions and financial flows – it cannot aim to be a single *indistinct* (national) flow of capital as it is, by nature, in the US. At most, the CMU will be a creative proxy of the envisaged (US) model, however imperfect and

incapable of resolving the prior existential contradiction – e.g. national biases in capital markets - on which it relies.

4.2. Fiscal capacity and debt mutualization instruments as State-mimicking responses for the non-existent fiscal union: virtuality and limitations

Furthermore, in the internal dimension (fiscal/budgetary policy front), the proposals made after sovereign-debt and COVID-19 crises were (are) marked by an attempt to mimic a fiscal union, in the absence of it (Cabral, 2021c).

The first example was/is the proposal to create ‘fiscal capacity’ in the E(M)U. Given the lack of a central budget fulfilling a stabilizing role, this fiscal capacity, a sort of ‘micro-budget’, would work as an insurance device or a risk-sharing mechanism aiming to respond to asymmetric shocks (Cabral 2021c). The fiscal capacity could be materialized under two main approaches: on the one hand, the anti-cyclical approach (e.g. proposals for the European Unemployment Benefit Scheme⁷ and anti-cyclical funds⁸); on the other hand, the convergence-based approach (Cabral, 2021a) – the idea was to use EU (structural) funds, typically made for convergence purposes, to also carry out discretionary expenditure with some kind of stabilizing role, notably in areas with higher multiplier effects, e.g. investments in social housing and renewable energy. This latter approach was eventually accepted in certain programmes launched at that time, as was the case with the ‘Juncker Plan’ launched in 2015 and, more clearly, the ‘Budgetary Instrument for Convergence and Competitiveness’ proposal, in 2019, intending to use discretionary expenditure (e.g. specific investment) as a macro-stabilizer in the advent of adverse shocks.

⁷ See European Commission (2017).

⁸ For example, more recently, Beetsma and Kopits (2020).

The second example of these mimic-type instruments were the proposals for creating debt-pooling instruments (the so-called Eurobonds⁹, followed by the Coronabonds proposal¹⁰) and of new debt securitization instruments.¹¹ None of these instruments were intended to be confused with an actual Treasury, where debt issuance is made ‘in the name and on behalf’ of that sovereign central state thereby combining tax autonomy with full borrowing capacity. However, in terms of mimicking a Treasury, the peculiarity of such instruments should be acknowledged as they somehow intended to do more than Treasury bonds have actually been created to do (Cabral, 2021c). In fact, these new debt instruments to be created at the E(M)U level were assumed to have a specific purpose, which was to solve or prevent a debt crisis of member states, still considered ‘the’ fiscal sovereigns.

Lastly, it can be said that the proposed design for these instruments is heterodox as a way to circumvent the E(M)U’s incomplete sovereignty on the fiscal front, as well as in the sense that they do not correspond to conventional budgetary instruments (e.g. a budget, taxes, central borrowing instruments, a Treasury), but rather - as described - to innovative budgetary prototypes (e.g. ‘fiscal capacity’; debt pooling instruments; public debt securitization).

5. Conclusion

The ‘State-mimicking’ method, here described as a heterodox and unique method made to address the two dimensions of incomplete sovereignty both on the internal and external fronts, appears to so far be the possible (pragmatic) macroeconomic policy solution to

⁹ De Grauwe and Moesen (2009).

¹⁰ For details about pros and cons of Coronabonds, see Barbier-Gauchard *et al.* (2021).

¹¹ Brunnermeier *et al.* (2012).

bypass the monetary policy integration trap. This can be seen, in turn, as a recent expression of the heterodox nature of the EU institutional and governance architecture and of the atypical nature of the entity itself, permanently swinging between centrifugal and centripetal forces. The EU is the product of a singular combination of intergovernmental, domestic, (neo)functionalist and ‘expertocratic’ approaches (see Heipertz and Verdun, 2010). Interestingly, this ‘novel hybrid’ (McNamara, 2015) has been marked over the years by peculiar and pragmatic-driven institutional and legal features, able to forge new solutions for crises or disruptions, such as for example: *i*) the supranational delegation of powers not only in conventional EU institutions but in new atypical ones, that is, formal and informal EU institutions or bodies not within the conventional spectrum – e.g. the Eurogroup (see Lindseth, 2014); *ii*) an exotic legal system juxtaposing with EU law new sources of non-EU law, and eventually merging with the former – e.g. the legal provision of the European Stability Mechanism (see, in this regard, Bardutzky and Fahey, 2014). The State-mimicking method, while not solving the prior existential contradiction on which the E(M)U relies (it is not meant to do so) is indeed the ultimate expression of such a pragmatic and heterodox approach.

On the other hand, the RRF – the new financial package launched in the EU to tackle the economic effects of the COVID-19 pandemic – has assigned the EC with a new borrowing capacity as a way to finance EU expenditures to be eventually backed up by new tax own resources. In turn, more recently, the possible EC new competences to address the effects of the war in Ukraine – e.g. Energy, Defence – will most likely justify the issuance of new European bonds and other forms of European debt. These two recent developments seem to have transformed the EC into a new centre of sovereignty on the fiscal/budgetary front, with respect to borrowing and tax competences. As a consequence, a more complete match between monetary and fiscal European sovereignties can be

anticipated and so a new type of interaction between these two policies. Eventually, the debt purchased by the ECB under a future form of QE could now be ‘true’ European denominated-debt, allowing for the full mutual backstop between these two policies as usually seen in a state with complete sovereignty. However, these steps ahead must be cautiously interpreted: they are probably just another expression of heterodox *realpolitik*. Last May, Italy’s Prime Minister Mario Draghi urged the EU to embrace a “pragmatic federalism” that would include ditching national vetoes and treaty change.¹² In my view, this statement translates the political will to increment this realistic policy approach marked by institutional/legal disruption, of which the analysed ‘State-mimicking’ method is a good example. This approach, while imperfect, is indeed well-suited to sustain the E(M)U, a quasi-state afraid (unable) to become one.

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¹² Available at: <https://www.politico.eu/article/draghi-pragmatic-federalism-eu-treaty-change/>.

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