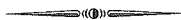




THE FUTURE OF THE EURO



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The Forgotten Problem of Embeddedness

HISTORY LESSONS FOR THE EURO

Kathleen R. McNamara

Introduction

When euro coins and bills were introduced at midnight on New Year's Eve in 2002, enthusiastic crowds lined up at cash machines on the Boulevard Saint-Germain, the Kurfürstendamm, and the Gran Via to be the first in their neighborhood to hold the new single European currency in their hands. The feeling of excitement across the Eurozone was heightened by the sense that Europe had embarked on a path of historic importance. The naysayers were few and far between, but they included some vocal American economists who viewed the euro as economically ill advised.¹ Within a decade, however, "euro euphoria" had turned to "euro phobia" in many quarters, and the single currency was blamed for exacerbating the hardships of a cataclysmic global financial crisis, a bursting European credit bubble, and sovereign debt crises spreading across EU member states. The European Parliament elections of May 2014 demonstrated the deep political cleavages around the European project and seemed to usher in a new era of political contestation around the euro, and the European Union more generally. The skeptics' gloomy predictions seemed to be coming true, and much of the conventional wisdom explaining the calamitous path of the Eurozone focused on the differing economic fundamentals of the Eurozone member states. Europe, it was

argued, is not an “optimum currency area,” making it impossible to sustain a single currency.

This is the wrong diagnosis, however, for Europe’s current illness. Instead, the argument in this chapter is that the Eurozone’s biggest challenges lie not in its economic suboptimality, but instead in a particular political problem. The design of the Eurozone is notably different from every other successful single currency in history in that it is “disembedded” from the broader social and political institutions needed to provide a solid and durable foundation for monetary union. The euro lacks, quite simply, the political institutions needed for adjustment when the currency is removed from national control. Markets need political authority to stabilize them, and it is this lack of governance that will sink the euro, not its shortcomings as an optimum currency area. In other words, it is the politics—not the economics—that will need to be fixed.

The future of the euro therefore will depend heavily on the reclamation of important lessons from history and a much more political and social reading of the fundamental logics of markets. The history lessons of previous monetary unions have a lot to say about the Eurozone’s current predicament. They suggest that rather than trying to mimic the classical markets of Adam Smith, Friedrich von Hayek, and Milton Friedman, European leaders and their publics will need to channel the historical sociology of anthropologist Karl Polanyi if they want to fix the euro’s problems. Markets function only when they are embedded within larger formal and informal institutions of political authority. Rather than reach for some optimal set of wished-for attributes, we should understand the minimal conditions that will sustain governance. The future of the euro will depend on a recognition by political leaders, policymakers, and the publics they govern of the importance of designing an embedded currency area to stabilize the euro.

What Underpins the Future of the Euro?

The euro is a historical innovation of startling proportions, as it is the only example in the modern era of a group of states consolidating their currencies into a new, supranational money. Despite its innovations, the euro can be analyzed with two more general theories of what makes a currency area hang together. One, optimum currency area (OCA) theory, dominates how most prominent economic commentators understand the euro today. I argue, however, that this approach is incomplete, as it is missing an account of the various political institutions and conditions that allow for a single

currency to be successful. Instead, I propose a theory of what I call embedded currency areas (ECA), which better captures the necessary foundations for managing the slings and arrows of macroeconomic fortune in a single currency zone.

The Market Makes the Currency: Optimum Currency Area Theory

To recognize the problems of the euro, most analysts start with deductive economic theories regarding the conditions under which the move to a single currency is likely to be desirable, that is, the benefits will outweigh the costs, and will be sustainable. The conventional approach centers on the theory of optimum currency areas (OCA), also often referred to as optimal currency area theory.² Pioneered by Robert Mundell, the approach begins with the straightforward fact that when you join your currency with others, either as a single currency or as irrevocably fixed exchange rates, your exchange rate can only collectively fluctuate against the rest of the world and can no longer be used for national purposes within that currency zone.³ In effect, you will lose autonomy in your economic decision-making without exchange rate flexibility. OCA theory then moves to assess the relative costs of adjustment in the new monetary union versus life with an independent currency.

In OCA theory, certain factors have been identified as critical for a monetary union with a single currency to be a net benefit to its members, despite this loss of policy autonomy.⁴ In Mundell's original framing of the question, he assumed that the key issue for analysis centered on assessing whether, for any given geographic area, an asymmetric economic shock would better be addressed by individual external exchange rate adjustments, or whether internal adjustments would be adequate to stabilize the economy. For example, what are the policy demands created when Ireland is booming but Germany is anemic, as was the case in 2002? What about the differential effects of the global economic crisis on the Eurozone, as Spain's unemployment soars while Germany's falls? Can a single, common monetary policy address the varied needs of the European states, without the option of using individual exchange rates to adjust? The notion of asymmetry is important here: the monetary union is most challenged when an unexpected shock impacts some parts of the region differently than it does others. If the shock, be it positive or negative, was not asymmetric, then a common external exchange rate adjustment would fix most problems, and individual adjustment through the exchange rate could be forfeited. The ideal monetary union is therefore one

where internal adjustments are effective and less costly than an individual region's independent, nominal exchange rate adjustment would be in the face of asymmetric shocks.

Certain factors make it more likely that the internal adjustments will be achievable, from this theoretical perspective. Nominal price and wage flexibility in the currency area is considered to be a key factor in those adjustments.⁵ With such flexibility, the assumption is that unemployment or inflation in the face of asymmetric economic shocks might be lessened even without the ability to adjust the economy through the exchange rate. Labor and capital mobility are presumed to be a key way to achieve such adjustment.⁶ If both factors of production can move freely throughout the monetary union, then adjustments can more easily happen internally. For example, if one area, say southern Italy, is more severely impacted by an economic shock, and its workers can easily move to another part of the Eurozone that is flourishing, such as the Netherlands, there will be less need for an external exchange rate adjustment, and membership in the euro will be less costly for Italy. Essentially, in this view, the greater the ability of all internal factor markets to adjust through price and wage flexibility to market forces without barriers, the better the single currency will function.

Other economic factors were highlighted in subsequent OCA work as important in determining the success of monetary unions and single currencies. Ronald McKinnon argued that openness to the international economy was a good indicator of whether a single currency made sense for any geographic area.⁷ The more open an economy is to world prices, through trade and investment flows, the less "money illusion" there is for the domestic economy (i.e., workers would not be "fooled" for very long by nominal changes in price). This pressure on domestic prices to adjust to competitive levels internationally would mean that the economic merit of exchange rate flexibility would be reduced, as a devaluation in the currency would not likely achieve sustainable growth and employment gains, but would be swamped by the higher costs of tradable goods and increased cost of living. Other elements might also dilute the impact of giving up your currency and make a monetary union more attractive. Peter Kenen posited that the more diverse an economy is in production and consumption, the better it would weather economic shocks.⁸ If only certain parts of the economy were struck by downturns at any point in time, the loss of the exchange rate as a tool of adjustment would be less important, according to Kenen, leading him (and others) to argue that groups of countries whose economies were highly diversified are likely to make the most robust partners for a single currency.

Yet this OCA framework, while logical, does not fully capture the entirety of how markets work and risks missing key factors that help determine the likelihood of future success and stability in a currency area. These lacunae produce a striking empirical falsification for OCA theory: no currency union in history, whether successful or not, has actually met all of the requirements of optimum currency area theory. In fact, the key determinant of currency robustness is the existence of political borders, not a currency region drawn because of high factor mobility, openness to the international economy, or sector diversity. State boundaries delineated a vast array of national currencies that hang together despite their imperfect economic structures. The main reason for this can be found in an entirely different view of how markets work, one that looks to political authority, power, and institutions. While this view is anathema to a classical economic view of currency and money, it has both deductive and inductive power in explaining the likely future of the euro, as we will see next.

Politics Makes the Currency: Embedded Currency Area Theory

Currency is always and everywhere a political thing.⁹ Contrasting with the rational and abstracted cost-benefit analysis outlined above, my alternative approach seeks to embed market dynamics within a broader set of social and political interactions. It also is an argument against the notion of an optimal rubric for currencies as a guide to the reality of the euro. The idea of the fundamental “embeddedness” of markets comes from the seminal work of Karl Polanyi. In *The Great Transformation*, Polanyi argued that the rise of capitalism upended the traditional relationship between markets, power, and society.¹⁰ Familial or communal ties became subordinate to the market and its seemingly impersonal forces of exchange. But, Polanyi argued, this was not a natural or inevitable process, and it was one that would spawn a powerful backlash of citizens suffering from the social dislocations of liberal market capitalism. This societal counterattack would lead to what Polanyi termed a “double movement,” as economic liberalism, on one hand, prompts political demands for social protection by political authorities, on the other. In other words, markets were fundamentally political in nature and would soon become subject to political control.

If we take Polanyi’s insight and apply it to the realm of money, currency unions are likely to succeed only as part of a broader series of institutional structures that attempt to stabilize economic interactions within a context

of political agreement and a legitimate process for setting economic goals and targets.¹¹ These institutional setups are inculcated with political and social logics as well as with our more familiar rationalist, economic logics. Economic actors are social beings as well as profit-maximizing creatures, and their perceptions, goals, and desires are shaded by motivations for status, emotional reactions, and larger worldviews and cultural dynamics. These economic actors are likewise “embedded” within larger social institutions that create cultural frames for their actions and onto which those actions reverberate and feed back.¹²

Given this approach, rather than rational, stripped-down market reactions to various economic scenarios in the manner of OCA theory, the determinants of a stable, sustainable monetary union with a single currency should be analyzed in terms of the entire package of elements that are required for monetary unions to succeed. These elements constitute a minimum, rather than an optimal, foundation for monetary union. To analyze the future of the euro, we need to turn from the purely economic understandings of the costs and benefits to an appreciation of the pathways of adjustment in a composite polity. In this embedded currency area (or ECA) approach, key elements bundled together to allow for adjustment include (1) a legitimated generator of market confidence and liquidity, (2) mechanisms for fiscal redistribution and economic adjustment, (3) regulation of financial risk and uncertainty, and (4) political solidarity. Each of these four key elements is further explained below.

First, understanding how money works from an embedded perspective suggests that the market does not itself generate authoritative rules and confidence in compliance with those rules. Instead, there must be some sort of legitimate, centralized political authority that is viewed as both willing and able to provide the public good of stability within the monetary system, allowing for the social construction of market confidence critical to that stability. Central banks developed over the last century as the organizational form in which this sort of authority is vested.¹³ The central bank is the tip of the iceberg, the visible expression of the concentration of legitimate political authority in a political system that—ideally—stabilizes expectations about the future of the currency. One key element in the provision of such stabilization of expectations is the acknowledgment, either implicit or explicit, that the central bank will act as a true lender of last resort when needed to stabilize the currency and the broader monetary union. Providing liquidity to markets when money dries up overcomes market failure and demonstrates why markets should be understood as

functioning smoothly only when embedded within larger social and political structures.

In addition to the authoritative lender of last resort, a second element important to the stability of monetary unions is a matching fiscal union or economic government.¹⁴ As with the OCA literature, it is instructive to consider what a political entity is giving up when it merges its currency, that is, its exchange rate flexibility. The inability of political authorities to rely on exchange rate depreciation or devaluation to stimulate growth through exports, as for example the Japanese government did in 2013 to revive its moribund economy, can be an unacceptable cost of monetary union. Likewise, if growth is too fast, yet the exchange rate cannot appreciate or be revalued, there is a significant risk of inflation, as in Ireland before the financial crisis of 2008. Rather than look solely to markets for adjustment, the ECA approach suggests the merging together of the fiscal side of economic policy governance. With a broader pool of revenue potential that is spread across the entirety of the currency union, the all but inevitable times when one part of the union is in recession while another part is booming can be smoothed out by transfers from the high-growth regions to the suffering areas through the operation of a system of fiscal federalism. Higher tax revenues from the robust areas will fund automatic social welfare payouts in the faltering regions without the need for highly visible bailout funds transferring from one part of the union to the other. Redistribution in a federal fiscal union can also occur through more explicit targeted ways as well, through programs such as high-speed rail infrastructure investments, tax credits for specific manufacturing plants, or high-tech retraining programs tailored to particular regions.

Another reason that fiscal unions are critical for a monetary union to be successful lies in the need for centralized debt instruments in the single currency. The operation of financial markets in a monetary union with decentralized fiscal policies can create giant pressures on the subordinate political units if there is no monetary union-wide debt instrument to mutualize debt and reduce perceived member state risk. Bond market investors see that monetary union members cannot use the exchange rate to correct the course of the economy, and begin to see their bonds as riskier, putting upward pressure on the national rates needed to borrow. As borrowing becomes more expensive, a vicious circle can be created as higher interest rate charges increase annual deficits and overall public debt levels, further putting stress on the economic performance of the individual currency union member. With a centralized public debt instrument, members can spread the costs of giving up their exchange rates over the entirety of the union and potentially weather temporary downturns

more successfully. The flight to safety out of the troubled member state can thereby be mitigated, thus avoiding a liquidity crisis. This would not only help the individual political unit, but also strengthen the unified currency overall.

Fiscal union or economic government is also desirable because of the benefits of balancing monetary and fiscal policy in the macroeconomic “policy mix.” Monetary policy (the regulation of the money supply through interest rate changes and open market operations on the part of the central bank) tends to work better if it is done in tandem with fiscal policy (comprising the centralized tax and spending policies of a political unit). A union-wide fiscal policy may be key particularly in a situation where a polity is giving up the ability to tailor monetary policy directly to their political economic circumstances, resulting in what Vivien Schmidt calls a “one size fits none” monetary policy in Chapter 5 of this volume (neither restrictive enough to keep fast-growing economies from overheating, nor lax enough to stimulate growth where it is most needed). Fiscal policy can be targeted much more closely toward specific societal actors and geographic regions, potentially substituting for the shortcomings of a single monetary policy.

The third element needed in the ECA model is authoritative rules regarding banking activities within the union. The combination of monetary and fiscal union needs to be complemented with authoritative rules to reduce the systemic risk in the financial sector. A banking union, composed of a common regulatory framework and a set of security guarantees for bank depositors, as well as resolution funds for financially troubled banks, stabilizes markets by embedding them within larger political structures. If not, the tightly woven monetary and fiscal union means that lax banking regulations and failing banks in one area of the currency union will likely spill over into the broader economy. Risky investment vehicles and undercapitalized banks mean trouble for the entire union because of the working of financial markets and the pressures they will exert on the fiscal, monetary, and currency spheres of activity, as we have seen after the crash of 2008, triggered by the bankruptcy of Lehman Brothers. Markets have been proven to be lacking in the efficient and orderly correction of bad banking activities, making the ability of the broader political and institutional setting to generate regulatory regimes critical for successful monetary union.

These three elements, an authoritative lender of last resort, fiscal union, and banking union, cannot be achieved absent an overarching and robust political union.¹⁵ This fourth part of the bundle that supports currency areas is critical, as all of the above must be situated within a context of broader political solidarity and mechanisms of democratic legitimacy. Political union

Table 2.1 Determinants of Successful Monetary Union

Optimum Currency Area Theory (OCA) (Mundell, McKinnon, Kenen)	Embedded Currency Area Theory (ECA) (McNamara)
Factor Mobility (K & L) (Mundell)	A “True” Lender of Last Resort function (LOLR) <i>(Chapters 3 and 4, Jones & Jabko)</i>
Wage and Price Flexibility (Mundell)	Fiscal Redistribution, Sovereign Debt Pooling (Fiscal Union) <i>(Chapter 4, Jabko)</i>
Openness to Global Markets (McKinnon)	Financial Market Regulation, Bailouts, Resolution Mechanisms, Deposit Guarantees (Banking Union) <i>(Chapter 3, Jones)</i>
A Diversified Economy (Kenen)	Legitimate and Democratic Institutions of Governance (Political Union) <i>(Chapter 5, Schmidt)</i>

is necessary to create governance rules over the various markets, but also to support the political authority needed to govern beyond mere rules, with the type of discretionary activities of stabilizing and redistributing necessary for successful monetary union. Political union must also be in concert with the prevailing modes of legitimacy of the moment. In the modern era, that means representative democracy. This fourth element pervades the other three and sets the parameters for how the economy develops, including the integrity of the single currency. It speaks to the heart of the model of embedded markets, which assumes that markets will not be able to function without these broader political bargains, social understandings, and democratically accountable public institutions. It can be thought of as the framework necessary to facilitate a sense of social solidarity, facilitating the institutional mechanisms needed to ensure that the losers of economic crisis are compensated in ways adequate to make them feel that they are not being left behind, while not alienating the economic winners. In this regard, a political union is the opposite of the ordoliberal union that currently structures the institutions of the euro.

In sum, my theoretical perspective sees markets as embedded in larger social, political, and cultural institutions, and therefore generates a very different set of criteria from those found in the optimal currency area literature, as illustrated in Table 2.1. This is no random laundry list of desirable institutions, but rather needs to be understood as deductively generated from an

entirely different way of understanding the nature of markets. As outlined in my theoretical discussion above, a model of the economy that sees markets as constructed with power and social logics side by side with economic motivations predicts that isolating money institutionally will not produce the necessary institutional and social stabilizers to sustain a single currency. Moving beyond theory, the historical record on currency unions also strongly bears out the validity of the ECA approach, to which we turn next.

Currency Unions in Practice

Historical cases of monetary integration provide important and instructive lessons for the future of the euro. The simplest historical lesson that we have is that currencies conform to national borders, not to optimum currency areas, and exceptions to this rule have all been relatively short-lived. A sustained monetary union is empirically associated with a high degree of embeddedness in authoritative political institutions, not factor mobility, wage and price flexibility, or diversified and open economies. Modern currencies largely arose as part of state formation processes alongside the rise of the nineteenth-century nation-state, although there have been some examples of currency unions outside the nation-state as well. The currencies that have lasted have all been part of the consolidation of a bundle of activities under a framework of strong political authority. Below, I provide a typology of monetary unions assessed in terms of two variables: the centralization of monetary authority and currency, and the degree of political integration. I use the typology to provide a stylized overview of the historical record on monetary unions, and then parse out some of the details of the variations across different cases of monetary unions in each category. The selected historical record allows for the construction of a comparative qualitative assessment that links the relative sustainability of the currency to the most embedded cases of monetary union (national currencies) to the partially embedded (the euro and the krone of the Austro-Hungarian Empire) and to the least embedded (the Latin Monetary Union and the Scandinavian Monetary Union). This attention to the *degree* of embeddedness and the relative durability of the currency union sets up our analysis about the future of the euro, both here and in the three chapters that follow.

Embedded Currencies: One Money, One Government

Since the nineteenth century, successful modern currencies have had a one-to-one relationship with modern nation-states, with currency unions

endogenous to larger projects of state formation and nation building. As previously autonomous geographic units were brought together, usually “through iron and blood,” in the words of Prussia’s Otto von Bismarck, a range of administrative activities were consolidated by the dominant political authorities.¹⁶ Power was established and institutionalized through policymaking capacity at the center of a bounded geographical territory and population, resulting in a sovereign state. For most theorists, components of modern states generally (but not always) include a unified fiscal system; a common, often imposed, national language; a unified legal system; and, critical for our purposes here, a single currency.¹⁷ Political elites sought to consolidate the levers of control over the economy to the center of a political entity, and currency has been seen as one of those levers. To revise a familiar phrase from Charles Tilly, war makes the state, and the state makes the currency.¹⁸

National money or currency can be a crucial component of state capacity in times of war, facilitating the collection of revenues, the payment of federal expenditures, and the organization of debt. War can also provide a political opportunity for currency consolidation, as savvy political actors have often taken advantage of crises to consolidate power, using a frame of the “logic of no alternative” to create political conditions to transfer both monetary and fiscal authority to the center.¹⁹ Not just currency, but fiscal policy is a crucial component in this story, as it is the ability to raise revenue and distribute it efficiently that can make the difference between winning a war and being subjugated to a competing power.²⁰ In addition to the security benefits, a single currency can also aid in the development of a single national market, simplifying transactions and lowering uncertainty across economic actors.²¹ Finally, currency is a symbol of political community, and in generating practices around the use of that money in a particular, bounded area, may contribute to nation building if it is positively perceived. However, it can also be a potent symbol for dissolution, as in the case of the Soviet Union and the Austro-Hungarian Empire, discussed further below.²²

The United States

The development of a single currency in the United States allows us to more closely trace the process of the embedding of currencies, how it happens, and why it matters for the sustainability of a monetary union. The American case represents an example of a fully embedded currency, as it possesses all of the four necessary elements for embedding: a lender of last resort, and overlapping fiscal, banking, and political unions. As the discussion below highlights, however, these political institutions were gradually built up through

historical crises, including both political and military conflicts, and through the pressures of an increasingly complex market system and a series of financial calamities. The demands for governance and the political willingness and coalitional support for the development of a more centralized and powerful political authority over markets as public institutions were pivotal in pushing forward the necessary degree of embeddedness to support the single currency.

The early United States did not have a single currency until the second half of the nineteenth century. The American single currency, the greenback, first replaced a multitude of state currencies and private notes in 1863, during the US Civil War.²³ President Abraham Lincoln's Republican Party muscled through legislation giving the federal government exclusive currency rights once the Southern legislators, opposing more centralization of power, seceded from the union. The currency was viewed as aiding in the war effort by allowing for the rationalization of revenue raising and wartime payments. But it was also a potent symbol of the power of the federal state in the face of the challenges of a disintegrating union, and the various political institutions that came out of the Civil War framed the vigorous development of the American state.²⁴ The embeddedness of the currency in a putative political union was therefore central to the project of a single currency.

However, the other component parts of embeddedness were not immediately constructed. The authoritative lender of last resort function was only tenuous, as the charter for the US First National Bank was allowed to expire twice, until a permanent US Federal Reserve was finally set up in 1913, after a series of severe financial crises created political will for the centralization of monetary power in a federal reserve board, but only one at the center of a federal system of regional banks.²⁵ The United States had elements of a fiscal union early on, as Alexander Hamilton, the young country's first Secretary of the Treasury, prioritized the ability to issue and raise debt at the federal level and build a robust financial system. Randall Henning and Martin Kessler argue that the uneasy back and forth over federal bailouts of the states finally resulted in the states passing balanced budget rules in the nineteenth century, but doing so as part of a bargain over a federal state able and willing to provide countercyclical fiscal relief to states in distress.²⁶ Banking union in the United States likewise was built over time, and took a series of financial crises in the Great Depression to come to fruition. It was not until the Banking Act of 1933 that the Federal Deposit Insurance Corporation (FDIC) guaranteed savings up to \$2,500, established the Glass-Steagall banking rules, and, in subsequent legislation, put in force federal oversight of the banking industry.

The US case demonstrates the hard-won but critical relationship between the four elements of embeddedness and the outcome of currency system stability.

Federal Germany

Additional historical cases further illustrate the relationship between the embeddedness of a currency in a broader system of governance and the durability of such a currency. In Europe, the German case highlights the interaction between currency consolidation, war making, and political union, and the ways in which currencies became embedded historically. Germany began the nineteenth century as a highly decentralized, fragmented polity made up of over three hundred independent kingdoms, electorates, duchies, imperial cities, ecclesiastical territories, and estates of imperial kings.²⁷ Slow and gradual consolidation over the following decades included the Prussians joining with Hesse-Darmstadt in a customs union. This customs union formed the foundation for what would become the German Zollverein in 1834, a loose free trade area with some elements of currency consolidation, including efforts to standardize coins and establish a national central bank.

True monetary union would only occur with the rise of Otto von Bismarck as Minister-President of Prussia in 1862. Bismarck was able to build on the foundations of the Zollverein as he set out to create a modern and united Germany from the various political entities.²⁸ A gold standard mark was created on July 9, 1873, and the Reichsbank, or German central bank, was established in 1876. The monetary consolidation formed a part of a much larger *Gründungszeit*, or “foundation time” of German state building. The elements of embeddedness identified in our discussion of an optimal embedded currency area were gradually built into the German currency union: political union under Bismarck in 1871, the Reichsbank as a lender of last resort five years later, and a growing fiscal capacity as the German state was gradually built. In keeping with the times, a banking union with tight financial regulations was not created until after the economic collapse preceding World War II, as was true for all of the historical cases. The German mark, however, was clearly nested in a series of political institutions, however imperfect.

Italy and Switzerland

Several other European cases are also instructive. The case of Italy’s adoption of a national currency over several years after the *Risorgimento* in the 1860s has been studied by James Foreman-Peck, who found that the unification of the previously sovereign states did not constitute an optimum currency area, with regional disparities beyond the well-known North-South divide.²⁹

Instead, it was the larger political framework that stabilized the Italian currency regime, although as we will see further below, Italy soon entered into a larger currency union with its neighbors. Likewise, the Swiss franc came into being—after a brief aborted attempt during the early 1800 Helvetic Republic—with Switzerland’s unification through a treaty among 25 sovereign polities in 1848. As the central government took over foreign and military policy, a single Swiss customs union and single market were created, and the exclusive right of coinage was given to the Swiss government. But coin shortages and a desire for standardization in currency matters with a larger group of countries also soon led the Swiss to join the Latin Monetary Union, discussed below.

Partial Embeddedness: One Currency, One Decentralized Polity

There is at least one example of a partially embedded monetary union: Austria-Hungary in the period before and after the turn of the last century. Albeit with important historical caveats, it shares some of the Eurozone’s characteristics and represents a midpoint between the embedded national currencies, such as the US dollar, and the disembedded Latin and Scandinavian Monetary Unions discussed below. A currency union between the Austrian Empire and the Kingdom of Hungary ran from 1867 to 1914 as part of the larger Austro-Hungarian Empire or monarchy. Political elites established a single currency system (the krone, or *korona*) with a common central bank, but did not centralize fiscal policy. Instead, they maintained decentralized fiscal capacity to the two states that made up the empire, as well as three autonomous regions, Polish Galicia (under Austria), Croatia (under Hungary), and Bosnia and Herzegovina (administered jointly).

The Austro-Hungarian Empire had an extensive network of political ties and institutions, even as it also had distinct sovereign powers located separately within Austria and Hungary. The Empire had a common monarch in Hapsburg Emperor Franz Joseph I, who served as the ultimate political authority. There was a common army, diplomatic service, and legal system, in addition to its common currency, and a common Austro-Hungarian Bank, located in Vienna. There was a customs union, as well as extensive trade and financial integration across the empire. Yet Austria and Hungary each had their own national political leaders, parliaments, governments, national budgets, and debts.

The Austro-Hungarian currency union was stable for much of the second part of the nineteenth century, with the common central bank controlling the money supply, accumulating reserves, pegging the krone to gold, and maintaining significant independence.³⁰ However, the decentralized fiscal capacity meant that over time, debts began to rise and markets began to speculate against the solvency of the two states. In addition, ethnic groups within the union began demanding more independence with the advent of World War I and began to loosen their ties with the currency union and rack up large debts.³¹ Czechoslovakia and the Kingdom of the Serbs, Croats, and Slovenes left the union, and the monetary union soon fell apart, followed at the end of World War I by the collapse of the larger Austro-Hungarian Empire, whose fate was sealed by the Allied Powers at Versailles in 1919.

Disembedded Money: One Currency, Multiple Polities

Finally, we do have a few cases of disembedded monetary unions, examples of single currencies that were adopted by several separate polities.³² As predicted by the ECA argument, however, they all struggled and ultimately fell apart as members did not pursue policies that privileged the maintenance of the currency union. The particular reasons for the collapse of the currency unions differed, but they all shared one characteristic: their “disembeddedness” from the panoply of political and social institutions needed to govern money—a central bank, fiscal and banking unions, and political union. The disembedded nature of the currency meant that the legitimate and robust leadership, institutional flexibility, and political cohesion needed to navigate the stresses and strains of monetary union were absent, placing the currencies in peril.

We have two examples of “one currency, multiple polities,” and they both demonstrate the difficulties that arise when the instruments of and political support for governance are lacking. They both arose during the pre-World War I era of historical experimentation in political forms, when the modern nation-state was being invented in the second half of the nineteenth century.³³ As national currencies became consolidated in the administrative centralization process occurring across Europe, there were also instances of efforts at creating monetary unions with currencies locked against one another, in effect acting as a single currency. These pre-World War I historical monetary unions were the Scandinavian Monetary Union and the Latin Monetary Union.

Begun in 1866, the Latin Union was composed of France, Italy, Belgium, Switzerland, and eventually Greece. Members agreed to accept each other's coins as legal tender and had a set of standard sizes and fineness for gold and silver coins within the union, among other things. The underlying motivations for the union were, on the economic side, to ease trade and investment through a common monetary standard, and on the political side, France's ambitions to extend its geopolitical power by increasing the centrality of the French franc, on which the Latin currency units were based.³⁴ As Barry Eichengreen has pointed out, however, the particular issues involved in the Latin Monetary Union involved problems with bimetallism, and the stability sought by forming the union was not easily achieved. As incentives for defection from the agreement rose over time, they ultimately torpedoed the Union altogether.³⁵ There was no central bank, no common monetary authority, and countries attempted to coordinate their policies without pooling authority or transferring sovereignty to the center, and the union soon devolved into a de facto gold standard-based regime by 1873. Simply put, the stresses and strains of keeping the monetary union together were too much absent the legitimate political authority, institutional and fiscal support, or centralized leadership needed to make the Latin Monetary Union work.

The Scandinavian Monetary Union is the other nineteenth-century example of an attempt at a currency union between multiple political authorities. Beginning in the 1870s, Sweden, Denmark, and subsequently Norway standardized their coinages and allowed for the circulation of national currencies across the Scandinavian borders as their central banks accepted each other's notes at par.³⁶ Once again, the lack of a common monetary authority or central bank made the management of the Scandinavian Union difficult, as individual states had control over their own monetary policies and there was little sense on the part of market participants that the currencies were truly unified, leading to pressures for movement in the values against each other. Efforts at resisting the market forces were stymied by the disembedded nature of the union, with its lack of centralized or coordinated fiscal capacity or common central bank. The Scandinavian Monetary union was not wholly without political foundations, however, as Sweden and Norway had joined together in a political union from 1814 to 1905. But indicating the importance of political union for building a common currency, the dissolution of that union coincided with the end of agreements to accept each other's financial notes at par. Over the next decade, the Scandinavian Monetary Union crumbled and finally ended completely in 1920. As with the Latin Monetary Union, the Scandinavian experiment in disembedding monetary matters

Table 2.2 Comparing Historical Cases of Monetary Union: The Role of Embeddedness

Most Embedded ←-----→ Least Embedded

One Currency, One Political Authority (Sustained)	One Currency, Partial Political Authority (Tenuous)	One Currency, Multiple Political Authorities (Collapsed)
National Currencies (e.g., US dollar/United States 1863–present)	Euro/European Monetary Union (1999–present) Krone/Austro-Hungarian Empire (1892–1918)	Krone/Scandinavian Monetary Union (1873–1914) Interchangeable Currencies/Latin Monetary Union (1865–1927)

from the broader framework of governance institutions and understandings ended in failure.

Our historical survey of all the types of monetary union is captured in Table 2.2.

Understanding the Euro Crisis Through History’s Lens

Understood in terms of both theoretical and historical need for economic policy and markets to be embedded in larger frameworks of social and political relationships and institutions, the problems—and thus the potential future paths—of the euro are clear. While the euro initially enjoyed almost a decade of economic good times, the financial crises that developed in late 2008 put severe stress on the Eurozone. What ended up being the worst global macroeconomic shock since the Great Depression also ended up being the perfect storm for testing theories of what really makes a monetary union function smoothly. Troubles had been brewing for a long time, as easy money from various quarters combined with deregulation in financial markets to create massive credit bubbles and asset price rises. European banks were not immune from the litany of financial market “innovations” and the “flip this house” investment culture in holiday villas on the Spanish Costa del Sol and Irish West Coast. The banking crisis that began in the United States in 2008 soon spread to the EU, as European banks’ balance sheets took a nosedive and the

entire financial machinery in Europe creaked to a halt. Europe was not alone, of course, in its misery, as the United States suffered from similar woes.

But there was a big difference between the ultimate effects of the financial crisis in the US case versus the Eurozone, and the difference really stems from the insufficient embeddedness of the euro in contrast to the dollar. Banking crises in modern times most often result in a state takeover of ailing banks in order to stabilize panicking financial markets and restore overall market confidence. But the result is that a private debt crisis then becomes a sovereign debt crisis.³⁷ In the case of the United States, the Bush administration, after letting Lehman Brothers fail, stepped in to aggressively stabilize the American banking sector. The 2008 Troubled Assets Relief Program (TARP) was patched together despite conservative congressional complaints and eventually helped stabilize the US financial system. In early 2009, newly elected President Barack Obama enacted a huge stimulus bill, the American Recovery and Reinvestment Act, which distributed money around the country. Additionally, a bailout of the auto industry secured the largest source of manufacturing jobs and put the sector back on track, while every family on the lower end of the income spectrum got a tax refund for several years afterward. The US Federal Reserve has presided over this exercise with the most aggressive injection of money into the US economy, developing and legitimizing new instruments of bond buying in quantitative easing (QE) when interest rates alone no longer provided the punch needed to revive the American economy. While the European Central Bank (ECB), as we will discuss, has also moved beyond its expected mandate, it only started to embrace Fed-style QE well after the acute phase of the crisis was over, in late 2014, in order to fight a persistent deflationary spiral in the Eurozone.

It is not the lack of an optimum currency area that has hamstrung the EU's efforts to match the rebounding of the US economy.³⁸ Instead, it is the lack of an embedded currency area that has produced divergent outcomes, with devastatingly slow growth and high unemployment in much of southern Europe versus growth and recovery in the US. The problem is that the European Union has only been able to act through one channel, the ECB, to try to ease the broader societal impacts of the Eurozone's financial crisis, the one existing element of an embedded currency on which the EU could build. Yet even the ECB has been working under substantial institutional constraints, with little internal taste on the part of the sober central bankers in Frankfurt for monetizing the debts of its members, overturning the "no bailout" clause in its charter, or moving too far from their historic commitment to price stability above all other goals.³⁹

Complicating matters, because it lacks a fiscal union, the EU does not have any power or policy capacity to provide the fiscal stimulus and the special TARP funding found in the US case, which has arguably been a critical reason for the continuing bad performance of many of the European economies relative to the United States. The particular circumstances of the countries with the worst balance sheets—either private debt driven by banking and real estate bubbles, as in Spain or Ireland, or in the case of Greece and Italy, uniquely bad (among the Eurozone countries) political institutions—drove waves of bond market pressures on various countries in turn. As suggested in the literature on currency unions, an asymmetric shock tested the fundamentals of the single currency, and demonstrated the deep shortcomings of the euro. But it is the lack of institutional response at the EU level that sets the euro apart from the other non-optimum currency areas that make up many of the world's dominant national currencies, including, of course, the United States.

On one hand, this should not be surprising, as the EU does not meet the standards of the most successful political form that a currency union can take, that of the modern nation-state. Instead, the EU is a novel hybrid, with some component parts of a federal state, but where key powers, administrative capacities, and political authority firmly remain with the discrete units, the member states. For our purposes, unpacking the component parts vis-à-vis our deductive model helps us evaluate the strengths and weaknesses of the Eurozone. The four component parts identified above as crucial to the overall embeddedness of a currency, that is, a true and authoritative lender of last resort, a financial and banking union, a fiscal and economic union, and a political union, are only weakly represented in the case of the European Union.

The first element, an authoritative lender of last resort, is the area where arguably Europe's monetary union has proven the most sustainable.⁴⁰ Founded as a hyper-independent central bank and given a narrow mandate to fight inflation and protect the value of the euro, the European Central Bank has been playing a dramatically more political role than that initially assigned to it by its creators at Maastricht in the early 1990s. Most notably, at the end of 2011, the ECB, under the new leadership of Italian Mario Draghi, issued hundreds of billions of euros in emergency loans to European banks. The policy to some extent mirrored the US Treasury and Federal Reserve's decision in 2008 to bail out American banks in the Troubled Assets Relief Program (TARP). The ECB's new long-term refinancing operations (LTROs) constituted a significant departure from the notion that the ECB would not act to backstop entities in financial distress.

In addition, two new institutional developments also moved the Eurozone closer to having a true lender of last resort capacity. The European Financial Stability Facility (EFSF) was established in May 2010 as a limited liability company, in order to issue state-guaranteed loans for up to 440 billion euro as a first response to the financial distress in Greece. A permanent program, the European Stability Mechanism (ESM), was established in 2012 to provide the funds needed to stabilize financial markets. The ECB's LTRO interventions initially were relatively successful, as the interest rate charged on auctioned bonds in the most pressed member states fell starting in early 2012, allowing for some breathing room. Spain's 10-year bond yields were at 5.5 percent instead of over 7 percent, as they had been in the fall of 2011, and Italy's five-year bonds were selling at yields close to 5 percent, rather than close to 8 percent, as they had earlier. But at various points these interest rates have spiked up again, and the ECB's actions have not been universally applauded.

These new policies and programs have been matched by a much more forceful set of statements from the ECB's executives. In the summer of 2012, muscular remarks by ECB head Mario Draghi pledging his institution's commitment to do "whatever it takes" to save the euro got plenty of attention across Europe and the United States, but it was only one of such statements coming from the ECB as the Eurozone crisis dragged on. Both in terms of its institutional capacity and in terms of its role in the political debate, the ECB has been playing a critical and unexpected role as an unofficial lender of last resort. Yet it is debatable whether it is really fulfilling one of the criteria for stable monetary unions generated by the embedded approach. The ECB's new program of LTROs, begun in 2011, sought to inject money into the faltering European economies, but continuing economic collapse drove the ECB to launch a more aggressive effort, Outright Monetary Transactions (OMT), in September 2012. While OMT allows the ECB to buy up bonds from sovereign member states as well as in secondary markets, a surprising move given the ECB's cautious history, it is both conditional and untested.

The second element, found in all successful cases of currency consolidation, is fiscal and economic union, and this remains the most out of reach in the EU case.⁴¹ Fiscal union comprises the capacity to extract revenue through taxes, to redistribute money through public spending, and to raise additional funds through public debt instruments. The EU currently has none of these explicit functions, although it does redistribute funds through a variety of structural fund programs and other mechanisms. A laundry list of proposals for explicit "Eurobonds" and other ways to mutualize debt in the Eurozone have proved politically inflammatory in some influential circles. Instead of an

embedded approach, the EU's leadership and the heads of state and government have aggressively pursued efforts to impose austerity programs of deficit and debt reduction on societies already reeling from the fallout of the financial crisis. The effects look much more like the conditional lending programs and structural adjustment loans of the International Monetary Fund (IMF) than an embedded governance system that could hold together a monetary union. While Ireland has, as of this writing, made it out of its bailout program and met the required conditions of fiscal stringency, Portugal, Spain, Italy, and especially Greece are still mired in recession or stagnation. Nicolas Jabko discusses the missing fiscal union and economic government in greater detail in Chapter 4 of this volume.

The third area of embeddedness needed to sustain a currency, a European banking and financial union, has been slowly working its way through the EU political mill, but effective bargaining on the issue remains elusive. The European Commission, with support from the ECB, has been successful in getting agreement on a single supervisory mechanism (SSM) for the Eurozone's banks, to be spearheaded by the ECB, with a single rulebook for all banks. A European Banking Authority, created in 2011, now spans both the Eurozone and non-euro states as part of the European System of Financial Supervision. However, the regulatory and institutional developments have yet to include elements crucial to the historical cases such as the US, like common deposit insurance, and a single bank resolution program (and common fiscal backstop) in the face of future banking crises. French and especially German political authorities have proven resistant, however, and have stressed at various times a preference for enhanced cooperation rather than ceding power to Brussels and Frankfurt. A prime example is the difficulties surrounding the creation of a single resolution mechanism, which would create a pool of funds to staunch future banking crises. As explained more fully in Erik Jones's Chapter 3 in this volume, the construction of common institutions to safeguard European financial markets is critical for the euro's survival.

Finally, the broader political union that has framed all cases of lasting currency consolidation is likewise missing in the EU case. While the EU has become remarkably institutionalized over the past 50 years, with a constitutional-like legal framework and a series of politics and practices that penetrate deeply into the everyday life of all Europeans, it does not have all of the state-like governance structures of the other examples of currency creation. When, in the midst of the US financial crisis, US Treasury Secretary Henry Paulson stood up with Fed Chairman Ben Bernanke in front of the

US Congress to report on the situation, the world paid attention, and the US polity knew where power lay to make decisions. While the ECB president (first Jean Claude Trichet and then Mario Draghi) has become relatively well known in financial circles, that leader and Jean-Claude Juncker, the head of the Eurogroup at the worst of the crisis, do not have the political profile or confidence of their US counterparts. Indeed, Juncker's successor to head the Eurogroup, Jeroen Dijsselbloem, was an immigration expert with no experience in managing the intricacies of financial crises, which he demonstrated during the Cyprus banking blowup in the spring of 2013. Instead, as Vivien Schmidt argues in Chapter 5 of this volume, the EU "governs by the rules, and rules by the numbers." It has singularly not created the social solidarity and the legitimate political institutions to adequately embed the euro in a larger political framework. With the euro crisis dragging on and on, austerity giving the EU an increasingly bad name, and the political mechanisms for stabilizing the European economy still elusive, creating the political union needed for an embedded currency area will be an uphill battle.

Conclusions

The lessons from history for the future of the euro are clear. Karl Polanyi's insight was that markets, disembedded from broader societal relationships and lacking the political institutions to achieve goals other than market efficiency, would ultimately fail. The same holds true for currencies disembedded from governance structures and the political institutions and social solidarity to underpin that governance. Rather than focusing narrowly, as economists tend to do, on whether the euro is an optimum currency area, we need to understand the importance of creating an embedded currency area, if the euro is to have a future. In this approach, rather than focusing on a wished-for world of economic perfection, we argue for a pragmatic reading of how the political economy works in practice. The construction of the four key elements of currency embeddedness—a central bank to serve as a true lender of last resort, a fiscal and economic union, a financial and banking union, and a political union to govern it all—will be crucial to whether the euro ultimately endures or not. The following three chapters of this volume further flesh out and delineate the dynamics at work in Europe across each of those individual elements. To some degree, they suggest that a halting process is at work to nest the euro in new governance structures. But strong forces continue pushing for austerity and structural reform, emphasizing purely market answers to the euro's ills.

Across the historical cases, there also is a common theme of the wretchedly difficult political battles fought over proposals to move more authority to a new center of governance within a redrawn political community. From the ultimately successful embedding of the US dollar in the “second foundation moment” of nation building during the US Civil War, to the only partial embedding of the Austro-Hungarian krone in a central bank at the heart of a decentralized empire, to the disembedded Scandinavian and Latin Monetary Unions of nineteenth-century Europe, currency has always engendered deeply political dynamics. For all its unique features, there is no reason to believe that the European Union would be an exception. Despite the strong emphasis on the technical issues around the euro, or the rhetoric about the need for balanced budgets and austerity on the part of all euro member states, the fact is that the political underpinnings of monetary union cannot be shortchanged forever.

The European Union has already demonstrated that deeply embedded governance structures can exist beyond the nation-state. The network of EU regulations that support the Single Market, the multitude of decisions by the European Court of Justice that buffer the impact of markets on EU citizens, and the collaboration across the EU on internal security in a borderless Europe are only a few examples of how the EU has developed capacity and engaged its citizens in its supranational governance structure. The euro, arguably one of the most extreme examples of surrendering sovereign power to the EU level, is in jeopardy because national leaders, rather than embracing the necessity of designing the embedded institutions needed, seem to still be captured by economic orthodoxy and the private interests that support it.

The future of the euro has seemed very dark at many points in time since the outbreak of Europe’s sovereign debt crisis in late 2009. At the same time, astonishing and heroic amounts of money and political capital have been spent to bail out insolvent member states and their investors. But not enough has been done to reduce soaring unemployment and the disheartening lack of prospects for young generations of Europeans, particularly in the EU’s southern periphery.⁴² Markets alone, and prescriptions of austerity to make them run more efficiently, will not fix the euro, nor will they secure Europe’s future. The hard-won lessons of history, and the insights of Polanyi’s embeddedness, suggest that it will take more robust EU institutions and the willingness to match supranational currency innovations with equal amounts of imaginative political development to save the euro.