

Dieter, Heribert

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## The End of Grand Expectations: Monetary and Financial Integration After the Crisis in Europe

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# THE END OF GRAND EXPECTATIONS: MONETARY AND FINANCIAL INTEGRATION AFTER THE CRISIS IN EUROPE

*Heribert Dieter*

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ADB Working Paper Series on Regional Economic Integration

# The End of Grand Expectations: Monetary and Financial Integration After the Crisis in Europe

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Heribert Dieter\*  
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\*Senior Fellow, German Institute for International and Security Affairs, Berlin, and Visiting Professor for International Political Economy, Zeppelin University, Lake Constance. [heribert.dieter@swp-berlin.org](mailto:heribert.dieter@swp-berlin.org)

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## **Abstract**

The financial crisis in Europe has resulted in a new assessment of monetary and financial integration both in Europe and in Asia. Before the current crisis, regional integration in monetary and fiscal affairs including mechanisms to stabilize exchange rates enjoyed a lot of academic and political support. The crisis served as a reminder of the risks associated with monetary and financial integration and has resulted in a much more cautious appraisal. But despite the crisis, monetary and financial integration continues to be attractive. In particular, the facilitation of intra-regional trade through stable exchange rates and the potential development of joint lines of defense against financial volatility, e.g. a regional liquidity facility, are potential benefits of monetary and financial integration.

However, the crisis in Europe has exposed a number of weaknesses in the approach taken in the eurozone. In Europe, there was an unresolved tension between the so-called no-bailout clause and the absence of an exit mechanism. In addition, participating economies that suffered from a high inflow of foreign capital, i.e. Ireland and Spain, were not able to (temporarily) restrict capital inflows, but had to bear the consequences. Thus, after the crisis in Europe the concept of monetary regionalism needed to be modified, but did not have to be discarded.

*Keywords:* European integration, monetary regionalism, financial integration, Treaty of Maastricht

*JEL Classification:* F 15, F 33, F 36

## 1. Introduction

Since 1973, the year that marks the end of the regime of Bretton Woods, there has been a lively debate about the potential and risks of regional cooperation in monetary affairs. Of course, this debate on monetary regionalism and the options for exchange rate stabilization are not surprising since both the gold standard from the mid-19<sup>th</sup> century to 1914 and the Bretton Woods system provided economic agents with relatively stable exchange rates. Moreover, both regimes provided economic agents with exchange rates that fluctuated only mildly, and thus facilitated international trade.

In Europe, the search for exchange rate stability resulted in the presentation of the first plan for a new regime even before the system of Bretton Woods had collapsed. In 1970, Luxembourg's Prime Minister Pierre Werner introduced a concept of fixed exchange rates within the European Community. About 30 years later, the euro was introduced, and in its first years of existence the new currency seemed to work as expected. However, since early 2010 the common currency began experiencing a turbulent phase. Despite various rescue measures and the establishment of a new, regional institution, such as the European Stability Mechanism (ESM), the euro's long-term survival was far from certain.

The continuing financial crises in some member countries of the eurozone have intensified the debate about reforms of the monetary union. It is obvious that the original architecture has to be revised. The two alternatives suggested by the proponents of deeper integration – either deeper integration of monetary and fiscal policy, or return to antagonistic, national policies – are far from being inevitable. By contrast, it is possible to make the monetary union more crisis-proof while at the same time giving European nations a high degree of liability for their own economic development. The frequently cited assertion that transferring – i.e., centralizing – hitherto national competencies to the European level would make fiscal policy and financial regulation easier to manage has substantial downsides. That approach ignores the downside of centralization. Far-reaching centralization may result in new problems and will weaken, not strengthen the economic dynamism of the European Union (EU).

In this article, several aspects of monetary and financial integration are examined. First, I will analyze the contradictions in the Treaty of Maastricht and the Treaty on the Functioning of the European Union (TFEU). While these accords continue to have several elements that reflect the diversity of European economies and societies, both have structural flaws that have been exposed by Greece in particular. Second, I will examine the options for Europe in the medium term. In essence, Europe has the choice between returning to a (modified) Maastricht and fast-forwarding to full fiscal and financial integration. Third, I will discuss the consequences of the current turmoil in Europe for the concept of monetary and financial integration in Asia.

## 2. The Contractions in the Treaty of Maastricht

For many observers, the Treaty of Maastricht was the high point of European integration. German Chancellor Helmut Kohl argued that Maastricht and the subsequent introduction of



the common currency, the euro, made European integration irreversible.<sup>1</sup> But in the euphoria that characterized the debate in the 1990s, two flaws of the treaty were not considered: First, the contradiction between the no-bailout clause and the absence of an exit option, and second the inability of member countries to defend their economies against overheating caused by inflows of capital.

## 2.1 No Bailout and Exit

The so-called no-bailout clause was initially contained in Article 104 (b) of the Treaty of Maastricht (1992).<sup>2</sup> Today, the no-bailout clause is contained in Article 125 of the TFEU. It clearly reaffirms the independence of member countries with regard to their fiscal policy. In essence, no member country shall be responsible for the liabilities of any other member country.<sup>3</sup> In other words, all economies have to be able to finance themselves. Neither temporary nor permanent transfers are part of the current regime that all member countries have accepted. In contrast to the currently popular interpretation that Article 125 permits transfers, a narrow interpretation would suggest that even the voluntary assumption of liabilities is prohibited. Governments have been violating these regulations in the current financial crisis in order to ensure the sustainability of the common currency.

While the rules of Article 125 appear to be clear and coherent, both the Treaty of Maastricht and the TFEU made no explicit provision for the event of a member country facing insolvency. The illusion of the architects of the European monetary project was that this event – the illiquidity, let alone insolvency of a sovereign European country – would never occur.<sup>4</sup> The strict budget discipline – part of the process of European monetary integration – should and would ensure that no country would ever face a situation frequently experienced by emerging economies many times, including in the last three decades: A combination of high levels of debt and rising interest rates results in a liquidity crisis, which can quickly deteriorate into a solvency crisis.

But in Europe, such scenarios were deliberately excluded when the European Monetary Union was constructed. A combination of hubris and ignorance resulted in the flawed design that has

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<sup>1</sup> Kohl has repeatedly made that argument, for instance in 2002: [http://ec.europa.eu/economy\\_finance/emu10/quotes\\_kohl\\_de.htm](http://ec.europa.eu/economy_finance/emu10/quotes_kohl_de.htm)

<sup>2</sup> See the text of the Treaty, available at: <http://eur-lex.europa.eu/de/treaties/dat/11992M/htm/11992M.html> (accessed on 4 September 2013).

<sup>3</sup> The text prohibits both aids from the European Union (EU) and from individual member states. Exceptions are permitted for specific projects: “The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project.” (see The Official Journal of the European Union (EU), available at <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?url=OJ:C:2008:115:0047:0199:en:PDF> (downloaded on 29 May 2012).

<sup>4</sup> Faulty assessments of this kind are of course not new. In the early 1980s, Walter Wriston, the Chairman of Citigroup, the world’s largest bank at the time, frequently argued that “states don’t go bankrupt”. A few months later, Citigroup and other banks had to digest the shockwaves originating from the default of Argentina, Brazil and Mexico.

been creating today's severe turbulence. The bankruptcy of a European country was considered impossible. Of course, this was both an improper reading of financial history and a faulty incentive structure.

Thus, the no-bailout clause suffered from weak credibility. Of course, citizens in those Northern European economies that joined the monetary union reluctantly believed that Article 104 (b) provided sufficient protection against an unwanted transfer obligation. But the shield against liabilities that originated in profligate spending patterns elsewhere was weak. Societies that borrowed heavily, and often abroad, had an incentive to do so. As a consequence of monetary union, interest rates in those economies that previously had to pay high interest rates suddenly enjoyed low single-digit rates. Since the Treaty of Maastricht has no explicit provision for bankruptcy or for an exit from monetary union, Greece in particular tested Article 125.

The financial calamities of Athens, exposed soon after the 2009 elections, caught the other European governments off guard. While many observers had suggested that the fiscal position of some member countries was unsustainable, few had expected outright financial fraud. Yet the crisis exposed that Greek statistics were not all that accurate. In 2009, Greece generated a fiscal deficit of 15.8% of GDP, the top rank in the entire Organisation for Economic Cooperation and Development (OECD). In the years before, government liabilities had been understated, while revenue was overestimated.

The response of European policy makers was predictable, but did not solve the problem. Initially, both a Greek default and a Greek exit from the eurozone were publicly declared unthinkable. In order to pacify her domestic constituency, German Chancellor Angela Merkel declared that there is no alternative to the path taken.<sup>5</sup> She declared the rescue operation to be without alternative.<sup>6</sup>

By claiming that a rescue operation for Greece was in fact a rescue operation for the common currency, European leaders and the IMF sent a problematic message to Greek society. Essentially, the other member countries of the eurozone would help – no matter what happens in Greece. The absence of a credible alternative to a successful rescue operation – either default or exit from the eurozone – has delayed structural adjustment in Greece and has strengthened those political forces in Greece that have declared the transformation of the Greek economy both unnecessary and undesirable.

The situation in Greece has highlighted the first flaw in the Treaty of Maastricht. If member countries insist on sovereignty in fiscal policy, the consequence is potential failure. The indispensable addition to Article 125 would be a mechanism for default, or perhaps even an exit

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<sup>5</sup> Of course, she was not very successful with her public relation work. German voters continue to reject the transfers to Greece. In a poll taken just days after the May 2012 elections in Greece, 78% of the interviewees rejected any additional help for Athens. That represented a significant rise with months: In February 2012, 62% of respondents were opposed to transferring fresh money (see <http://www.deutschland.net/tags/emnid>, downloaded on 29 May 2012).

<sup>6</sup> In German, she labeled the operation as „alternativlos“. The Society for the German Language declared that term as the faux-pas word of 2010.

clause. Without this amendment, both member countries and creditors have reason to believe that a rescue operation will eventually be orchestrated.

In order to create a credible plan B, an amendment to the Treaty of Maastricht could be an exit clause in the event of a sovereign default. A defaulting member country of the eurozone would have to leave the monetary union after, say, six months. This amendment would leave the responsibility for sustainable fiscal policy where it belongs: in the member countries of the eurozone. The potential loss of economic benefits of membership in the monetary union would offer a sufficient incentive to implement a sustainable fiscal policy. The amendment would also send a signal to financial markets. Monetary cooperation is not independent of the fiscal policies in the member countries. Risks differ. The undesirable developments prior to 2008 – when markets did not distinguish appropriately between individual countries and demanded relatively uniform interest rates – will not reoccur.

Critics of such an amendment can argue that membership in the eurozone would thus no longer be considered permanent by financial markets. By opening the window for either default or exit, financial markets would be able to differentiate between economies much more than they have in the first years of the eurozone's existence. After the introduction of the euro, spreads were very small – too small in fact. Financial markets were dormant for years. The inability of markets to differentiate between good risks and bad risks has in fact contributed to the emergence of the crisis by sending inappropriate signals to profligate spenders. In those first years, markets (correctly) implied that all member countries of the eurozone would eventually be rescued.

By amending either a detailed default scenario or even an explicit exit option, the Treaty of Maastricht would lose what had been so important for supporters of the European integration process. Effectively, membership in the eurozone would be equivalent to establishing a very rigid exchange rate regime. Depending on the credibility of a country's economic policy, markets would demand varying compensations for country risk. There would not be a return to those days in which all countries in the eurozone paid more or less identical interest on government debt.

Of course, some observers find the prospect of the provision of discipline by financial markets – in fact the standard recipe outside the European Union (EU) – a disturbing idea. But even hard-nosed defenders of the autonomy of a society's fiscal policy do not propose the complete absence of mechanisms that are supposed to ensure fiscal prudence. Their competing concept is the creation of incentives by law – either with a compact on fiscal policy or the creation of a centralized supervising body. Of course, the consequences of this approach are similar to a market-based incentive structure: At some point, additional borrowing will become either more costly or impossible.

The alternative – disciplining societies with peer pressure or through centralized institutions – is not convincing. Europeans would have to discuss the appropriateness of certain items in other countries' budgets. The key weakness of centralized fiscal policy is the lack of ownership of economic policies. Societies would cease to be responsible for their economic development,

and they would blame European integration for their economic problems. The centralization of responsibility would weaken – rather than strengthen – economic governance in the eurozone.

## 2.2 The Inability of Economies to Protect Themselves against Overheating

But fiscal policy is not the only area which requires an amendment to the Treaty of Maastricht. As the cases of Ireland and Spain have clearly shown, the temporary overheating of an economy is as problematic and dangerous as imprudent fiscal policy.<sup>7</sup> A monetary integration scheme ought to provide instruments to protect an economy from the undesirable side-effects of a boom. Failure to do so will result in avoidable financial calamities.

In the first decade of the 21<sup>st</sup> century, neither Ireland nor Spain appeared to be steering an overly risky economic course. Both economies grew quickly and had low levels of public debt. Essentially, the future appeared to be rosy.

**Table: Economic Development in Ireland and Spain (2003–2012)**

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<b>Ireland:</b> Real GDP (change in %)	4.2	4.5	5.3	5.3	5.2	-3.0	-7.0	-0.4	1.2	0.9
<b>Spain:</b> Real GDP (change in %)	3.1	3.3	3.6	4.1	3.5	0.9	-3.7	-0.1	0.7	-1.4
<b>Ireland:</b> Public debt (in % of GDP)	34.5	33.1	32.9	29.2	28.7	49.6	71.1	98.5	112.6	123.3
<b>Spain:</b> Public debt (in % of GDP)	53.3	50.7	46.2	42.3	47.7	62.9	67.1	74.1	77.2	90.5
<b>Ireland:</b> Current account balance (in % of GDP)	0.0	-0.6	-3.5	-3.5	-5.3	-5.6	-2.9	1.1	1.1	4.9
<b>Spain:</b> Current account balance (in % of GDP)	-3.5	-5.2	-7.4	-9.0	-10.0	-9.6	-5.2	-4.5	-3.7	-1.1
<b>Ireland:</b> House prices (% change, inflation adjusted)	14.2	11.2	8.1	14.5	8.5	-5.9	-18.3	-13.1	-13.2	-12.8
<b>Spain:</b> House prices (% change, inflation adjusted)	20.0	18.3	14.6	10.0	5.5	0.2	-7.6	-3.6	-6.1	-8.9

Source: OECD Economic Outlook 90 and 93 databases (Tables 1, 32, 51, 59).

The data in the table demonstrates the specific problems of booming economic economies within a monetary union. Both Ireland and Spain were showing above average economic growth before the financial crisis led to a significant reduction of economic activity in 2008. But

<sup>7</sup> For a detailed discussion of the Spanish crisis and its origins see Dieter 2012a.

before that, both economies appeared to be poster children of the European Union (EU). Ireland was hailed by some observers as a “Celtic Tiger”. Ironically, Spain was the new “El Dorado” for citizens from countries hit hard by financial crises. For example, many Argentineans left their country after it was hit by the 2002 financial meltdown. Between 2003 and 2010, the Spanish population grew from 42 million to 46 million people. Both labor and capital flowed to Spain (Dieter 2012).

However, both economies were not on a sound trajectory. Capital inflows financed the overheating of real estate prices. House prices in Ireland had been growing for a number of years: Between 1994 and 2002, prices had risen on average by over 13% annually. But in both countries, the introduction of the euro resulted in lower interest rate levels, which in turn fuelled the bubbles even further.

In hindsight, it is clear that neither country should have permitted the rise of real estate prices to the levels prevailing before the crash. However, neither government had any powerful instrument to reduce the asset price inflation at its disposal. Of course, in a monetary union there is no tailor-made level of interest rates. The interest rate level set by the European Central Bank tried to accommodate both the need of slowly growing economies such as France and Germany with those of the rapidly growing ones. For both Ireland and Spain, those interest rate levels were too low.

But apart from interest rates, monetary policy left these booming economies with no potent tools to fight the emergence of asset price inflation. Any regulatory tightening at the national level – for instance the raising of reserve requirements – could have been bypassed by borrowers keen on participating in the boom. Instead of borrowing from Irish or Spanish banks, they could have borrowed directly from French or German banks.

The high levels of capital inflows – the flipside of current account deficits – were thus the Achilles heel of these two seemingly well-run economies. What they needed would have been an instrument to reduce the inflow of capital. Without foreign capital, neither the bubble nor the subsequent hangover would have reached the same disturbing levels. As Reinhart and Rogoff have demonstrated, so-called capital inflow bonanzas are good markers for financial crises, in particular since the liberalization of capital flows in the 1970s (Reinhart and Rogoff 2009).

But the construction of the eurozone has not considered those potential risks. While it is evident that the economies participating in a monetary union differ substantially, there have not been any instruments in the toolkit of the eurozone. After the Irish and Spanish experience, this negligence is no longer appropriate. A revised Treaty of Maastricht should include an instrument to ward off unsustainable capital inflows.

Hitherto, any restrictions of capital flows within the European Union (EU) have been considered inappropriate. But without measures that curb inflows, a repetition of the boom and bust pattern that characterized the developments in both Ireland and Spain will be inevitable. Of course, from today’s point of view the restriction of capital flows does not appear to be an urgent matter. If anything, capital outflows seem to require the attention of

authorities. But the current crisis will sooner or later end, and subsequently a return to unwanted capital inflows is only a matter of time.

In autumn 2012, a Commission of the Brookings Institution published a report on the risks and benefits of cross-border capital flows. Some of the most prominent American economists (Barry Eichengreen, Kenneth Rogoff, Dani Rodrik, Mohamed El-Erian) have concluded that cross-border flows at times require government intervention. While global regulation may in theory be superior, the inability to regulate financial markets at the global level has resulted in the need for second-best solutions: "... governments may need to resort to a second best approach in which they seek actively managed capital flows" (Brookings 2012, p. V).

While in the past, for example in the Bretton Woods era, measures that administratively curbed capital flows were the preferred instruments. In today's economic environment, taxes on inflows appear to be a possible tool. A tax of between 1% and 5% – levied on all capital inflows with exceptions for current account transactions and foreign direct investment – would most probably suffice to reach the desired cooling of the domestic economy.

Advocates of deep monetary and financial integration will reject such measures because they contribute to the segmentation of financial markets within the European Union (EU). The aim of achieving a fully integrated financial market will be – while taxes on inflows are implemented – temporarily suspended. But there is no need to tax capital inflows permanently. Taxes on inflows ought to be used as temporary measures to ward off potential financial instability.

For integration projects, temporary taxes on capital inflows (for economies experiencing unwanted levels of capital inflows) as well as on capital outflows offer an improved toolkit. Surplus countries will most probably be reluctant to tax outflows, but this reluctance may be due to lack of reflection of the consequences of large outflows.

The eurozone, or any project of monetary and financial integration, would benefit from the two additional instruments that I have suggested. First, an exit clause, or at least an unambiguous bankruptcy procedure, would inject an element of discipline into the fiscal policy of member countries that markets sometimes fail to provide. An exit option would ensure that fiscal policy does not have to be centralized, because member countries would have an incentive to make sure they implement a prudent fiscal policy. In addition, Article 125 of the TFEU would finally be credible.

The second amendment would be the introduction of instruments that permit the temporary restriction of capital inflows. There can be too much of a good thing. For those rare moments, policy makers need an instrument that permits them to avoid unwanted overheating.

### **3. Options for Europe: Between Deep Integration and a Return to Maastricht**

Many observers have suggested the way forward for Europe is deeper integration, and only deeper integration. Whether full political union, a complete fiscal integration or a so-called banking union, integration is supposed to correct the mistakes of the Treaty of Maastricht and shall provide a sustainable economic development of the member countries of the EU.

However, most of the arguments in favor of ever deeper integration do not withstand scrutiny. More integration at this juncture of European integration may in fact weaken the integration process and may result in the potential departure of some more prudently managed economies from the eurozone. If the wrong incentives are provided, deeper integration may thus result in shallower integration in the future. Europe might well make one step forward, and two steps back.

Both political union and a fiscal union are aimed at implementing sustainable economic and fiscal policies in the member countries. The consequences of a political union are far reaching: The member countries of the EU would reduce their sovereignty significantly. Of course, even a transfer of sovereignty to the supranational entity would not answer the question whether this step would result in a permanent reduction of sovereignty or whether the member countries of the EU would temporarily transfer powers to Brussels. Given the possibility of member countries to exit the European Union (EU) – a provision that was introduced in the Treaty of Lisbon – the latter interpretation is more convincing. The EU is the child, not the parent of the member countries.

As a consequence, the ultimate location of authority continues to be the member country, and any member country will be entitled to boycott a decision on economic and fiscal policy that Brussels has taken. Rather than improving the prospects for cooperation in Europe, a political union at this historical juncture would deteriorate the prospects for the EU.

In essence, a fiscal union would result in a situation that is not structurally different from 2013's arrangement in Greece. Greek society is fighting a battle against the foreign authority – the Troika comprised of the European Central Bank, the International Monetary Fund (IMF) and the European Commission. Instead of finding solutions for the country's economic mess, citizens in Greece no longer own their economic policy. They have been deprived of this essential ingredient of successful development. Creating these kinds of flawed incentives for the entire EU would weaken, rather than strengthen, the integration process.

### **4. Monetary and Financial Integration in Asia: Exit Option and Restrictions on Capital Flows**

Policy makers in Asia can benefit from the European experience. The development of monetary and financial integration that avoids the mistakes made in Europe is possible. A key feature would be the consideration of improbable events and the preparation for (inevitable)

crises. It has been a mistake to assume crises away in the European context, and scholars and policy makers in Asia can build a system of cooperation which is not collapsing in the event of a financial calamity. Reducing contagion – a key characteristic of the Asian financial crisis of 1997/98 – must be a paramount objective.

Of course, this type of monetary and financial integration will be shallower than the European version, but probably more durable and less crisis-prone. In effect, Asian economies could create a new approach to integration, which would put financial integration first. As I have argued elsewhere (Dieter and Higgott 2003), the traumatic experience of Asian economies in 1997-98 could serve as a catalyst and raise political support for monetary and financial integration.

In the short- and medium-term, Asian societies will probably refrain from implementing a high-risk strategy for monetary and financial integration. But even at this early stage it will be important to consider some lessons from Europe. The key goal ought to be the deepening of financial markets in Asia without causing unmanageable vulnerabilities. As the crises of the last two decades have shown very clearly, too much confidence in the proper functioning of financial markets ought to be avoided.

Some of the lessons that Europe has been providing for monetary and financial integration in Asia are:

(1) A no-bailout clause is not credible without a clear mechanism that can be applied in the event of a default. Before starting to implement a monetary union, the participating states should define a mechanism for the bankruptcy of a member country. The form of the response can vary: A predefined sovereign debt restructuring mechanism is as appropriate as a compulsory exit from the integration project. The key dimension is that default should be made very unattractive, and thus avoided.

(2) Liquidity provision in a financial crisis should be readily available in an Asian integration project. However, it is important to consider the key characteristics of successful last resort lending: Lend freely, at penalty rates, against good collateral. Asian economies could consider a liquidity mechanism – beyond the existing Chiang Mai Initiative – that explicitly builds on Walter Bagehot's recipe: Liquidity against collateral. This approach differs sharply from the European method, which essentially copied the IMF's (failed) policies: liquidity against conditionality.

Considering the negative effects of the IMF's disastrous crisis management in 1997-98, liquidity provision against collateral appears to be particularly useful. Of course, the identification of collateral in a supranational environment is more difficult than in a national context. But it can be done successfully: in 1995, the United States (US) lent \$50 billion to the Mexican government, which in return pledged the future earnings of the state-owned oil company PEMEX. German Chancellor Helmut Schmidt provided liquidity assistance to the Italian government in the late 1970s and demanded a part of the Italian gold reserves in return.



Considering the diversity of Asian societies, ownership of economic policies is particularly important. In the foreseeable future, there will not be a uniform economic model that will be accepted in all Asian societies. Thus, the European approach – attempting to define a single economic policy for all member countries – will be even less convincing in Asia.

(3) States should be able to leave the integration project if they wish to do so. If states consider the benefits of membership to be lower than the costs, the door should remain open. A project of monetary and financial integration does not have to act as a custodian for societies and impose certain and everlasting monetary and exchange rate policies on them. Compulsory membership turns a project into an ideology, which in turn ceases to be attractive both to members and non-members.

(4) Individual countries should be permitted to protect themselves against unwanted capital inflows. The prevailing doctrine – only unrestricted capital flows ensure rising prosperity – has to be called into question after recent experiences. Temporary restrictions on capital inflows may enable individual economies to curb excesses in the markets and to shield an economy from their negative effects.

There are numerous examples in financial history that demonstrate the risks associated with large current account deficits. These are reliable indicators for the potential emergence of a debt crisis. This was the case in the Latin American crisis of the early 1980s as well as in the 1997-98 Asian crisis, in addition to the crises in the USA, Iceland, Ireland, Spain, and Greece.

Therefore, temporary restrictions on capital flows could help to protect economies against “irrational exuberance.” The exact shape of these instruments – whether taxes on cross-border capital flows or reserve requirements – is of secondary importance. Examples are the taxation of inflows applied in Brazil since 2009 and the reserve requirements Chile demanded in the 1990s.

(5) Crisis management has to put emphasis on national ownership. Supranational solutions should only be considered as a last resort. Stumbling banks should receive regional support only when all national efforts for stabilizing institutes have failed.

## 5. Conclusions

While the benefits of monetary and financial integration are not featuring prominently in the current debate, they nevertheless continue to be enormous. Countries participating in such a project enjoy a range of economic benefits. Both cross-border trade and foreign direct investment are greatly facilitated. But as the experience of the European Monetary Union has shown, the existing framework of the Treaty of Maastricht is not sufficient and has not prevented the emergence of an existential crisis in Europe.

The two main categories essential for an efficient market economy – risk and accountability – ought to be feature prominently in an integration project, whether in Asia or in Europe. Too much emphasis on rescuing the financial sector will weaken economies rather than strengthen

them. Bailing out banks that cannot compete creates moral hazards and will result in a feeble – not a strong – region. Countries are well advised to depart from systems in which taxpayers bear the risk while financial markets are protected against the consequences of their own activities.

In this article, I have suggested an alternative approach to monetary and financial integration. An exit option, the provision of liquidity against collateral and the permission of permanent restrictions of cross-border capital flows are key features of that model.

For the debate in Asia, the European experience continues to have important lessons. Most importantly, it appears advisable to construct monetary and financial integration in a more prudent manner and to include to the greatest extent possible seemingly unlikely events. Financial crises, including sovereign defaults, have characterized financial history for the last eight centuries (Reinhart and Rogoff 2009). The European folly was to assume that it could not happen here. Countries in Asia do not have to make the same mistake.

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