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Financial oversight, the third flawed pillar of the European Union: The missing piece in the Arestis-Sawyer critique of EMU macropolicy design*

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ABSTRACT

This paper presents a chronological survey of the 20 academic papers that Malcolm authored or co-authored between 1997 and 2017 on the flawed design - and hence flawed implementation - of the European Monetary Union (EMU)'s macroeconomic policy pillars. We augment his analyses by pointing out a third – complementary – design flaw: the EMU's two-tiered structure of financial regulation and oversight. While this financial pillar aimed at reconciling Europe's historically bank-based financial systems with large European banks' entry into global financial competition, it created a combustible mix when combined with the EMU's macroeconomic-policy pillars. The Global Financial Crisis lit the fire: member-nations, forced to rescue their domestically-chartered too-big-to-fail megabanks, had to adopt austerity policies that both slowed the pace of post-crisis economic growth and eroded support for pro-Union political leaders. Only marginal changes have been made in these policy pillars post-crisis. Consequently, Europe faces a financial bifurcation point: either to continue 'whatever it takes' support for its megabanks, or to rethink both its financial architecture and its macroeconomic and financial policy pillars.

Keywords: European Monetary Union, macroeconomic and financial policy pillars, financial crisis, megabanks, Malcolm Sawyer

JEL Codes: E11, E12, E58, G01, G38, N14

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1. Introduction

Malcolm Sawyer has established himself as a global figure in heterodox political economy for several reasons. His writings on macroeconomic theory have synthesized the insights of Keynes and Marx and their interpreters, and have enhanced contemporary understanding of Kalecki's work and legacy (see, for example, Sawyer 1985). Through the years, he has created publishing and research outlets for younger scholars, including this journal; indeed, he capped his long career at Leeds by leading the 2011-16 FESSUD research project, which encompassed researchers at 14 universities in 12 countries.[1]

Malcolm has also secured a place as one of the foremost analysts of Europe's transformation into a monetary union. This paper undertakes a chronological review of the 21 academic papers, written over 20 years, that Malcolm has authored or co-authored on the European Union (EU) and European Monetary Union (EMU, or Eurozone). Even as the Euro was launched, Sawyer, his long-time collaborator Philip Arestis, and other co-authors, argued that the EMU's two defining macroeconomic-policy pillars were fundamentally flawed: it featured an independent central bank focused solely on inflation targeting to the exclusion of employment or growth targets; and it placed tight constraints on member-nation fiscal policy, and lacked any plan for Euro-area fiscal policy. They carried through this critique after the Great Financial Crisis (GFC), as the EMU entered a sustained period of stagnation.[2]

In this paper, we supplement Malcolm's work on the applied macroeconomics of Europe by focusing on the links between these two macroeconomic pillars and the financial policies adopted by the European Union and its member-nations. We show that in combination with the EMU's approach to monetary and fiscal policy, these policies created a combustible mix. As the first decade of Eurozone operations unfolded, the interaction of EU and member-nation financial policies lit the fuse that burned down this brittle – and hence fragile – construct. On one hand, the EU was financially open to external capital flows – and in accordance with its law of one market, intra-EU capital movements were unconstrained. On the other hand, EU member-nations, confronting the prospect of open competition for their domestic banking markets, facilitated the creation of national banking champions that could compete on the global stage. This was the deadly formula that combined to bring financial crisis to all of Europe.

Exposing this third unstable pillar in EU design, and linking it to the two exposed in Sawyer's work, brings the links between Minsky's financial instability hypothesis and European policy dilemmas into clearer focus. Sawyer (1999) wrote appreciatively of Minsky's contention that avoiding a financial market meltdown requires the coordinated use of central-bank and fiscal policy, and pointed out that the EMU's limits on macroeconomic

[1] See www.fessud.eu.

[2] The term 'Global Financial Crisis' (GFC) refers herein to the worldwide economic crisis that began with the 2007-08 subprime crisis and led into the Eurozone crisis from 2009 onward.

policy represented an invitation to financial disaster. We show that this third unstable pillar made the European financial crisis a matter of not if, but when.

In what follows, section 2 reviews the 12 academic papers that Sawyer authored or co-authored on the EMU before the GFC. Sections 3 and 4 complement Malcolm's analysis with a description of the European Union's flawed two-tiered financial pillar: permitting open cross-border financial flows inside Europe and across its external borders at the EU level, while its member-nations retained control of banking regulation and structure. We show how this approach led many European nations to encourage the growth of 'national champion' banks that could compete in global financial markets. Section 5 summarizes Malcolm's papers on the EU and EMU after the GFC. These papers show that the EMU's failure to rethink its macroeconomic policy pillars are responsible for its stagnant post-GFC growth. Section 6 shows how the EU's two-tiered financial pillar led EMU nations into a double-loop of financial crisis whose second loop takes the form of economic policy failures by member-nations with current-account deficits. Section 7 argues that European nations in the post-GFC period may have to choose between stabilizing their locally-focused banks and redoubling their reliance on megabanks tied into global financial cycles.[3] Section 8 briefly summarizes and concludes.

2. The monetary and fiscal policy design flaws of the European Monetary Union

Malcolm Sawyer's first academic paper on the EU was co-authored in 1997 with Philip Arestis, as were many of his subsequent papers. Arestis and Sawyer (1997a) – or A-S (1997a) – critically analyses the proposal for an 'independent European system of central banks' (IESCB). The IESCB proposal represented a plan for the European Monetary Union (EMU, or Eurozone), which would be led by a European Central Bank, which member states could join by meeting macroeconomic convergence criteria involving price inflation (no more than 1.5 percent per annum), government finance (with government deficit of no more than 3 per cent of GDP, and the government debt/GDP ratio capped at 60 percent), and interest- and exchange-rate levels maintained close to European averages.[4] The authors argue that this proposal will have 'severe implications' for unemployment, which certainly is not the intent of its authors. This divergence in views is rooted in different ways of understanding how macroeconomies work. Arestis and Sawyer take a Keynesian/Kaleckian approach, which sees output and employment dependent on the adequacy of aggregate demand. The IESCB proposal takes an orthodox approach which incorporates in the 'classical dichotomy,' wherein output and employment (the real economy) depends solely on supply-side factors, not aggregate demand; and since inflation is a monetary phenomenon, the only task of the central bank is to keep prices stable through its control of the rate of interest - the aim being to achieve a non-accelerating inflation rate of unemployment (NAIRU).

These authors' exploration of the theoretical basis of the convergence criteria reveals that the EMU proposal is consistent with 'new consensus macroeconomics' (which Keynes would have termed the 'Classical' worldview).[5] In lieu of this proposal, which sets up the European

[3] The term 'megabank' used herein refers to large financial firms operating comprehensive, integrated financial service platforms on a global scale.
[4] In a complementary analysis, Arestis, McCauley, and Sawyer (1999) describe the historical evolution of European economic union and monetary integration in great depth.
[5] A-S (2008) investigate the behavioral implications of the formal 'new consensus' models used by the ECB and Bank of England, and demonstrate their dependence on the assumption that the macroeconomy is following a pre-given equilibrium long-run growth path.

Central Bank (ECB) and member-nations' central banks as 'custodians of international capital' (p. 359), the authors propose that the European Monetary Union operates a regional version of Keynes' Bancor proposal (Keynes, 1980a (1942), 1980b (1943)).

In a further analysis, A-S (1997b) argue that central bank price-inflation targets lead to sub-optimal employment and output, and that the central bank cannot control the price level by manipulating the rate of interest. In turn, A-S (1997c) identifies the elements that can lead to underemployed resources: a shortfall of aggregate demand and/or inflationary pressure due to productivity and balance of trade constraints.

With the launching of the Euro in 1999, Malcolm's writings on Europe turned to the problematic implications of self-imposed EMU constraints on the use of macro-policy instruments. A 1999 paper (A-S 1999) reviewed the EMU from the perspective of Hyman Minsky's writings on financial instability. Minsky's policy dicta can be summarized in the terms 'big bank' and 'big government': responding to the endogenously-generated debt-fuelled downturns in economies with developed financial structures requires a central bank willing and able to stop panics and/or runs with lender-of-last-resort interventions ('big bank'), followed by countercyclical fiscal policies that re-establish aggregate demand ('big government'). Adopting Minsky's analysis, A-S argue that 'The Protocols under which the ECB is established enables, but does not require, the ECB to act as a lender of last resort.' (*ibid.,* page 2); the mandate for this independent body extends only to price stability, not employment. Further, the budget of the European Union (EU) itself is small (limited to 1.5 percent of member-nations' GDP) and tightly constrained.

The authors then develop a Minskyian theme: because the financial and economic structures of member nations differ, occurrences of instability are likely to be asymmetric across Europe; and because the ECB's mandate focuses on Europe (and European inflation) as a whole, member-states' plunges into instability are more likely to be branded as instances of 'irresponsibility' than as occasions warranting lender-of-last-resort intervention. The authors also highlight the problem of capital mobility. They note that whereas 90 percent of portfolios have consisted of domestic assets prior to 1999, the combination of 'single market' freedom to move and the uniform currency ensures that 'the amount of funds moving within the euro area will make a quantum leap' (*ibid.,* p. 6). The authors warn against the formation and bursting of asset bubbles, recalling recent East Asian experience.

Two Levy Institute working papers in March 2001 reiterate these points of criticism in light of the Euro's decline against other leading currencies during its first 15 months of existence. While other analysts cited labour-market inflexibility in Europe as the cause of this runoff, A-S (2001) and Arestis, Biefang-Frisancho Mariscal, Brown, and Sawyer (2001) pointed instead for the importance of diverging trends within the Eurozone in its member-states' core macroeconomic indicators (GDP, inflation, and unemployment, in particular). In light of this evidence, Arestis, McCauley, and Sawyer (2001) refine their 1999 argument about the EMU's missing policy instruments. They highlight 'the separation between monetary policy conducted by the ECB and the constrained fiscal policy operated by national governments (Arestis, McCauley, and Sawyer, 2001, p. 120). Once the euphoric Euro-launch period is over, long-term investors will worry about whether the EMU can survive a future crisis given its current policy architecture:

> 'What is needed is an expanded institutional setting, allowing the co-ordination of fiscal and monetary policy and large-scale regional transfers, guided by an alternative to the stability and growth pact (Arestis *et al*., *ibid*., p. 7).

While the Euro subsequently recovered some ground, its member-states' economies fizzled – Germany went into recession in 2003, followed by a slowdown in Italy in 2005. Two A-S papers in 2003 pointed out that these problems could be traced back to the Classical foundations of the EMU's Stability and Growth Pact (A-S, 2003a), and to the confused and badly-communicated conduct of EMU monetary policy (A-S, 2003b).

In sum, Malcolm's work on the EMU shows how its limits on macroeconomic policy, given the clash between member-nations' heterogeneity and the EMU's one-size-fits-all mandate, invites economic instability. Financial considerations were implicit in this analysis, but didn't take center-stage. We bring these elements into the analytical light in the following sections.

3. Cross-border capital flows as a disciplining device in EU design

Malcolm Sawyer and co-author Philip Arestis establish that the combination in the EMU of a Europe-wide central bank committed to inflation targeting with severe constraints on member-nations' fiscal policies can only work under rarified conditions: for example, that all external shocks symmetrically affect all member nations; that price and interest-rate movements affect all member nations equally; and that the economic growth engine in every member nation depends only on supply-side forces operationalized by anticipatory price shifts. That is, the EMU's flawed macroeconomic policy design rests on an unachievable idealization of market-based allocation.

The flawed third pillar in EU/EMU design is its unleashing of free capital movements throughout Europe (and between Europe and the rest of the world), together with a purposeful inattention to EU/EMU-wide financial oversight. A two-tiered system was put in place: member-states would remain in control of financial institutions: they would continue to issue financial charters, decide on the form and powers of these financial organizations, and carry out prudential regulation; the movement of capital and provision of financial services would be covered by the principle of the 'European single market': a good or service provided anywhere in the 27 nations of the European Union could be provided everywhere in that 'single market.'

This solution represents a compromise between two historical dynamics in Europe. An older dynamic involved the relationship between national economic development and banking structures across Europe. As scholars including Gerschenkron (1962) and Cameron (1972) have documented, European nations' economic development from the 1800s onward typically involved strong central-state guidance and close cooperation with financiers, whether foreign or domestic. The foundational texts of European economists Hilferding (1919) and Schumpeter (1934), while grounded in different theoretical entry points, both emphasized the central role of financial intermediaries in guiding economic development. A groundbreaking 1981 study conducted for the Joint Economic Committee of the US Congress pointed up the contrast between the roles played in national industrial growth by the US and UK financial sectors, on one side, and West German, French, and Swedish financial institutions, on the other. John Zysman, one of that study's co-authors, formalized these observations in an acclaimed 1984 book: he argued that the credit-based financial systems in France, West Germany, and Japan encouraged a longer-term approach consistent with technology development, in contrast to the short-term-oriented market-based financial systems of the US and UK. This contrast was embedded in the distinction made in the 'varieties of capitalism' literature between 'liberal market economies' and 'coordinated market economies' (Hall and Soskice, 2001, page 8).

While the notion of differing capitalist formations leads to important insights, the notion that Europe's national financial sectors are at the service of government-guided industrial development has to be reconsidered. The same pressures toward financial liberalization that had broken the regulated US banking system in the mid-late 1970s were at work in the UK and in continental Europe. The UK had its markets' 'big bang' in 1986, resulting in what Philip Augur (2001) termed the 'death of gentlemanly capitalism.' That was only the most dramatic case in a broad western European shift. Consider the case of France: the Chirac government privatized 13 large financial groups in 1986; by 2002, the public-sector accounted for only 5 percent of all French employment in banking (Abdelal, 2006). A French futures market was opened, and securities and foreign exchange markets were liberalized (Cerny 1989). France turned in just over a decade into a 'financial market economy' (Morin, 2000, p. 36), open to foreign capital, with 'a transformation in strategic orientation of the most profound type: a surrender to short-term goals, to accountability for meeting targets, and "submitting to the imperative of profitability".' (Loulmet and Morin, 1999, p. 14). The French model was no longer bank-based; large, globally active French companies turned increasingly to equity markets to raise money in the 1990s (Levy, 1999). French experience was repeated in other European countries.

These moves to liberalize and to open financial markets to global flows of capital in the name of sectoral efficiency and profitability constituted a newer European dynamic, which rested on a critique of state-led economic growth. States had to be disciplined to permit Europe to compete in open global markets. The disciplining of member states was, in any case, precisely the point of the EMU convergence criteria. And the idea that market forces, not national policy tools, was implicit in the elimination of national currencies and their replacement by a common currency emitted by an EMU central bank that did not have prudential responsibility for European banks and that lacked a lender-of-last-resort mandate.

This third financial pillar in EU/EMU design did respect the older dynamic of European banking: the diverse national financial eco-systems would continue to be structured and regulated at the nation-state level. However, these structures had to coexist with the newer dynamic: free financial flows in the hands of fund managers and arbitrageurs would punish member-nations whose policy choices were inconsistent with EMU convergence criteria.

The Delors Commission report (1989) sets out the principle of using free cross-border capital flows to discipline member-nation policy makers in so many words. After affirming that "Greater convergence of economic performance is needed" as is "more intensive and effective policy coordination" (p. 11), it argues for "a large degree of freedom for market behavior" (p. 17), so that market forces can discipline states: "Financial markets, consumers and investors would … penalize deviations from commonly agreed budgetary guidelines or wage settlements, and thus exert pressure for sounder policies." But since access to markets can "even facilitate the financing of economic imbalances," and thus "The constraints imposed by market forces might either be too slow and weak or too sudden and disruptive", member nations would "have to accept that sharing a common market and a single currency area imposed policy constraints" (p. 20). Installing an independent central bank and establishing "the full liberalization of capital movements and financial market integration" (*ibid*., p. 16) before exchange rates are fixed would make it feasible to coordinate monetary policy across all banks and the entirety of the Euro area. So as in Mundell (1963), making capital completely mobile would lead to welfare-improving equilibria.

As the Delors report shows, the design of the Eurozone was based on the dual premise that capital is scarce and globally mobile, and will be attracted to ports of call where it has fewest constraints on its movements (Dymski, 2019). The framework put in place conformed to the policy views of the Classical mainstream view. As Chari and Kehoe (2006) put it:

> "the practice of macroeconomics by economists have changed significantly—for the better. Macroeconomics is now firmly grounded in the principles of economic theory" [specifically] … a "commitment regime … [wherein] all policies for today, tomorrow, the day after and so on, are set today and cannot be changed" (p. 6). …
>
> "We think of commitment as a situation in which at the beginning of time society prescribes a rule for the conduct of monetary policy in all periods. The monetary authority then simply implements the rule. … The message … is that discretionary policy making has only costs and no benefits. … [One possibility] is to delegate policy to an independent authority" (p. 7)

Not surprisingly, these authors have glowing words for the Eurozone: "Perhaps the most vivid example of both the movement toward independence and the movement toward a rule-based method of policy making is to be found in the charter of the European Central Bank …[whose] 'primary objective' is … to "maintain price stability." This focus on stability and credibility was reinforced by Issing (2001) and his insistence that a uniform monetary policy across the zone ("one size fits all") would encourage convergence; it was seemingly guaranteed by the fact that the ECB was designed as a virtual duplicate of the Deutsche Bundesbank (Lohmann, 1994).

So the European Commission's plan for the ECB forgot Minsky (1986), and forgot that even for the globally-hegemonic United States during the "golden age of capitalism," periodic financial-market malfunctions that caused so little damage – as "credit crunches" – precisely because of timely central-bank interventions (Wojnilower, 1980). The notion that the ECB would lack LLR powers was greeted with incredulity by economists with central-banking experience. As early as 1992, Folkerts-Landau and Garber (1992) warned that the "narrow" approach being taken would make it necessary "to slow or even prevent the ongoing development of Community-wide liquid, securitized financial markets" (p. 1). Goodhart (1999) pointed out the impossibility of dispensing with the LLR function. Blinder (1999) critiqued the ECB plan's New Classical emphasis on credibility by asking central bankers about it, and summarizing their answers: "Respondents think central banks get their credibility the old-fashioned way: They earn it by building a track record, … not by limiting their discretion via commitment technologies or by entering into incentive-compatible contracts" (pp. 21-22).

Nonetheless, the Euro was launched in January 1999.[6] The ECB responded to critiques of its architecture by establishing several initiatives – such as the Financial Services Action Plan (1999) and the Committee of Wise Men (2001) – that would more closely harmonize European financial markets (Hartmann, Maddaloni, and Manganelli, 2003). These did not mollify analysts worried that ECB jurisdiction would be inadequate in a crisis, such as Dominguez (2006) and Schinasi and Teixeira (2006). The latter two IMF economists recommended the "centralization, or rather the federalization, of financial stability functions", observing that "given the decentralized banking supervision and financial market surveillance, it may prove difficult to work out responsibilities on an ad-hoc basis in the

[6] The European Commission leadership calculated that an imperfect union would generate ressures toward constructing a more thoroughly consistent common regime (Spolaore, 2013).

midst of a crisis" (pp. 21-22).

Clearly, this flawed pillar, like the EU's two macropolicy pillars, rested on an idealized view of capital flows and financial markets. Just as the EMU's macroeconomic structure could only work under rarified general-equilibrium laboratory conditions, its open regulatory financial architecture would work seamlessly only if speculation-free financial-market efficiency obtained both inside and outside the single market. But whether or not deregulated financial markets would yield more allocative efficiency, they would accomplish the goals of the EU architecture of reining in the macrobehavior of EMU member states.

4. The impact of the single market and financial globalization on EMU banking structure and competition

However effective it was in disciplining convergence, the new EU/EMU architecture had problematic implications for banking policy. The twin ideas of opening Europe to overseas capital flows to discipline European economies, and of permitting unchecked capital flows within the single European market, posed two dilemmas for member-nations. The first dilemma arose because nation-states would remain responsible for the safety and soundness of their domestically-chartered financial intermediaries.

On one hand, each national market could be freely entered by other nations' financial-services firms and the products they sold. On the other, domestic central banks – because they would no longer issue domestic currencies - would lose their LLR capacities. These powers were instead vested in a European Central Bank whose formal mandate extended only to inflation targeting. This central-bank design doubled down on the idea that EMU banks and the member-nations that chartered them should avoid excessive risk-taking; further, it made clear that the Eurozone could not withstand a deep financial crisis without setting aside its own rules – as should become evidence in the Eurozone crisis

The second dilemma arose because of Europe's historically-rooted heterogeneous financial structures, whose diversity was threatened by the single market. France's big banks had until the 1980s been government-owned tools for achieving national purposes; large German banks typically had cross-shareholding and long-term relationships with large domestic corporations. Some countries favoured arms-length markets for credit and financial-service provision (for example, Great Britain), whereas others favoured 'relationship-based' banking (with Germany as a paradigm case). In some parts of Europe – such as Spain, Italy, and Germany – regional and city-based financial institutions provided core financial services; elsewhere – the Netherlands, Luxembourg, and Switzerland – regional differences were unimportant, and instead international linkages were fundamental.

While these strong home-country advantages had led to dependable income flows for incumbent banks servicing their home markets (Dermine, 1996), EMU banking structure was already under pressure due to foreign entry; in particular, US investment banks were penetrating European markets, dismantling the "webs of national influence built up over decades" (*The Economist,* June 23, 2001). The arrival of the single market broke the dam: EMU nations, in particular, encouraged their banks to secure their market position through mergers as the Euro era began. *Time International* (March 22, 1999) observed: "Banks within domestic markets are beefing up in preparation for the next stage: a slew of crossborder banking tie-ups between the remaining players."

Numerous mergers aimed at establishing 'national champion' banks that could stand up to heightened intra-European competition, while also competing globally, followed. For example, in June 1999, Banque Nationale de Paris (BNP), primarily a commercial bank, succeeded in buying Paribas, an investment bank. In March 1999, Italy's two largest banking groups made merger bids--UniCredito Italiano for Banca Commerciale Italiana (BCI), and Sanpaolo IMI for Banca di Roma. In June 1999, Italy's fourth-largest bank, Banca Intesa, merged with the fifth-largest, Banca Commerciale Italiana (BCI). The second-largest Spanish bank, Banco Bilbao Vizcaya, had been created by the merger of two Basque banks in 1988; in January 1999 Banco Santander, the largest Spanish bank, consolidated its lead over the second-largest Spanish bank, Banco Bilbao Vizcaya (created by the 1988 merger of two Basque banks) by merging with BCH, then third-largest. Generally, these mergers permitted branch closings, cost cutting, and increases in market capitalization.

Apart from defensive considerations, scaling up to compete globally was another motivation for large European banks. Not all designated 'national champion' banks sought to become megabanks (see footnote 2), but some did. The two Spanish megabanks mentioned above used acquisitions to take a leading role in Latin American banking markets. Italian banks moved aggressively into emerging European markets. The largest German bank, Deutsche Bank tried but failed to merge with the second largest, Dresdner Bank, in mid-1999, as part of its quest to achieve global scale in investment banking and underwrite megacorporations' "bulge bracket" issues.[7] Dresdner, after several unsuccessful merger attempts, was finally bought by Allianz, the world's second-largest insurer, in April 2001; this combination represented an effort to create what the *Wall Street Journal* (April 2, 2001) termed a "banking, insurance, and asset-management colossus" – a German Citigroup. ABN Amro, based in the small-market Netherlands, took on substantial leverage so as to expand its consumer banking operations in Asia and Latin America.

This push to create globally-competitive European megabanks came in a period of rapid global innovation in financial practices. US megabanks had taken advantage of the collapse of the thrift-based US mortgage market in the 1980s to take a global lead in securitization, an advantage that was fed by the systematic US capital-account inflows (a consequence of its current-account deficit from 1982 onward). The 1999 repeal of the US Glass-Steagall Act (that had required the institutional separation of commercial and investment banking), along with the increasing availability of liquidity and risk-tolerant investment funds, permitted US megabanks to construct shadow-banking systems and to make and securitize high-risk loans – most notably, subprime mortgage loans. Market-based credit increasingly replaced bank-based credit.

Large European banks also had to turn increasing to market-based instruments to maintain their larger European customers. Without expanding their deposit networks beyond their domestic borders, they could tap the explosively-growing markets for borrowed funds to buy assets and find loan customers in other countries. These shifts coincided with the post-Euro intensification of trade and financing relations within a consolidating Euro area: now, cross border imbalances were no longer reduced through currency re- and/or devaluations, but instead through compensating capital flows from trade surplus to trade deficit countries.

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[7] Deutsche Bank had already bought US blue-chip Bankers Trust in mid-1998, leading other European megabanks to try (unsuccessfully) to acquire blue-chip U.S. investment banks. Among the European banks seeking to compete at global scale were Credit Suisse First Boston and Lloyds. Ironically, most large European mergers in this period were underwritten by US investment banks.

These competitive and market-opening dynamics, in the early years of the Euro, suggested that many apparent benefits flowed from the EU's embrace of open financial markets. Financial integration in Europe increased, as measured by higher levels of interbank lending and securitization, by narrowed interest-rate differentials, and by the larger deficits being run by the poorer nations:

> "Prior to European monetary union, investors would typically have required larger country risk premia to fund such deficits, and the risk of a speculative attack on a debtor's currency would have increased. However, these countries are now largely insulated from such pressures. In effect, claims on other euro-area members are increasingly viewed as good substitutes for claims on domestic parties" (Lane, 2006, p. 55).

While these intra-European capital flows, from surplus to deficit areas, conformed with the expectations of efficient-capital-market theory (Lucas, 1990), these were not the only flows of cross-border capital in which European megabanks were involved. US megabanks and shadow banks were combining innovations in borrowed-money markets with innovations in securitized debt and in derivatives markets to vastly expand their asset bases and revenue flows. Given that globally unbalanced financial flows favoured the US, European megabanks competing globally had to absorb exchange risk and buy the new asset classes at a distance if they wanted to keep up. The 'go-go' atmosphere of the pre-crisis years took hold, transforming formerly staid European banks beyond recognition. As *Fortune's* Guyon (2000) put it:

> "The bank may still be called Deutsche, but the center of gravity has clearly moved from the old-line German commercial bankers in Frankfurt to a polyglot team of investment bankers headquartered in London .. transform[ing] it into a money machine that has finally brought Deutsche within spitting distance of investment banking's perennial leaders, Goldman Sachs and Morgan Stanley."

The elements for a severe crisis were falling into place worldwide. In the US, megabanks were at the heart of US subprime lending: the creation, bundling, and selling of loans whose viability depended on sustaining unsustainable price increases in the housing market was refined into a high art by the time housing prices fell (Dymski, 2019). The UK had its own plunge into subprime lending and megabank over-expansion. Many European megabanks, eager to compete head-to-head across the landscape of esoteric finance, were pulled along by US and UK megabanks' momentum into speculative position-taking, improbable mergers, and risky cross-border lending, especially for residential and commercial real estate. Tooze (2018, Chapter 3) describes this as the system of 'Transatlantic Finance.'

Since domestic rules on bankruptcy and default blocked the expansion of subprime lending in many EU member-states, European megabanks compensated for this disadvantage by taking positions in securitized loans originated in the US subprime markets. Often, as Lewis (2010, Chapters 2-3) points out, they were gamed by insider Wall Streeters who were a step ahead in riding the bubble even as it collapsed. And then the subprime crisis hit: the US and UK housing bubbles slowed and fell, then Northern Rock's failure led to the collapse of the asset-backed commercial paper market; then came US and UK megabanks' insolvencies. Initially, the subprime crisis hit European banking selectively: Fortis and Commerzbank and Germany's *Landesbanken* failed due in large part to subprime securities holdings. Through mid-2009, the situation stabilized: these failed-bank situations were resolved via fiscal (taxpayer) injections and asset fire sales, and social-welfare provisions seemed to be holding.

But by late 2009, austerity macro provisions were imposed throughout most the EMU, and with the change of government in Greece, the scope of the bad debt problem of Greek banks was revealed. Then came a deep macroeconomic recession in the GIPSI nations, and stagnation in most of the rest of Europe.

5. The GFC leads the Stability and Growth Pact into a macroeconomic policy cul-de-sac

This brings us to the second – post-GFC – round of Malcolm Sawyer's work with Philip Arestis on the EMU. Published between 2011 and 2017, these six papers, one co-authored with Giuseppe Fontana, focus on how policy design errors about which these authors had warned ten years earlier now limited EMU responses to what they termed the 'Great Recession' (A-S 2011a, 2011b). [8]

Several of these post-GFC papers show how the EMU's inflexible rules worsened the macroeconomic downturn that followed the financial turmoil of 2008, especially for nations in the EMU's southern and western (GIPSI) periphery.[9] The implementation phase of the EMU converted its convergence criteria into Stability and Growth Pact (SGP) targets (A-S, 2012). The economic slowdown – the Great Recession – then exposed Europe's structural problems (A-S, 2011a): increased budget deficits, falling GDP levels, and rising debt hit all EMU countries hard, but 'peripheral' countries were hit harder. These countries had been losing competitiveness to Northern EMU nations since the launching of the Euro. The modest relative advances achieved by labour market reforms were swept due to the scale of macroeconomic losses (Sawyer, 2015).

The conventional path to diverging unit-labor costs among close trading partners would be currency devaluation for those slipping behind; but this path was closed off – so doing was the very heart of the EMU's policy design. These differentials widened current-account imbalances among EMU nations. And whereas before the crisis period, private-sector capital flows had readily covered peripheral nations' deficits, these flows dried up during the GFC. A-S (2011) then show how this led directly to crises of non-compliance with SGP criteria for EMU economies with intra-EMU current-account deficits:

> "The current account deficits of the south European countries required those countries to borrow heavily from other countries, and in the main from north European banks as well as British and American ones. Because south European countries had much lower interest rates than previously, they rapidly built up their debt. The debts were mainly, though not exclusively, private sector rather than public sector. However, when the Great Recession hit, borrowing was increasingly done by the government." (p. 8)

The consequences for macroeconomic policy management are stark: repaying these loans depended on bringing borrower (peripheral) nations' macroeconomic parameters back to a glide path consistent with (every nation's) SGP targets; but the only way onto that path while remaining a member of the EMU was through unprecedently draconian budget cuts.

The second point made in these post-GFC papers is that only fundamental reforms in the design architecture of the EMU can block future macroeconomic crises. A-S (2011b) set out

[8] Malcolm Sawyer also published a book (Sawyer 2018) on the prospects of the Euro which synthesizes themes presented in the papers reviewed herein.
[9] The term GIPSI refers to Greece, Italy, Portugal, Spain, and Ireland.

the sequence of flawed and interlocking EMU policies leading to the current impasse.[10] They begin with the convergence criteria, which led directly to the SGP criteria and "impose a general deflationary bias" (p. 25), strictly limiting fiscal transfers from richer to poorer regions within Europe. They next list the ECB, which is independent and tasked only with meeting European inflation targets. It lacks a LLR mandate, and its 'one size fits all' policy – in the context of national governments that cannot issue their own domestic currency – means that central-bank policies take no explicit account of local variations in employment, growth, and investment. They finish by pointing out that the convergence criteria do not take current-account imbalances within the EMU into account, and thus imbalances can only be handled by bailouts or by deficit countries' wage and price reductions. Since the former are prohibited, the latter represent the only feasible path consistent with maintaining EMU membership. In sum, the crisis is due not to "the wrong application of the relevant economic policies of some member states" (p. 31) but from design flaws in the EMU.

Arestis, Fontana, and Sawyer (2013) further refine this argument. They point out that the small scale of the European Union budget itself limits meaningful fiscal transfers, and that EU/EMU policy architecture, in closely conforming with 'new consensus macroeconomics', undercuts the 'European social model', which rests on "the universalistic character of welfare provision and a high degree of coordination between economic actors" (p. 30). In effect, the flexible labour markets required to achieve competitiveness necessarily undercut social protection. A-S (2013) go further, and wonder whether a comprehensive political union – the creation of a United States of Europe – will be necessary to permit the fiscal stimulus – and thus intra-EMU fiscal transfers – needed in the face of adverse macro shocks (such as the GFC). The European Stability Mechanism does not provide an effective substitute for political union. Further, the tepid response to post-crisis plans for a European Monetary Union demonstrates that some member-nations' demands for complete separation between bank oversight and monetary policy can be effectively countered only through adoption of a full-scale European political union.

6. The double loop of Europe's banking crisis and Europe's financial bifurcation point

Malcolm Sawyer's post-crisis essays emphasize the fragility built into the EMU's economic architecture by its two flawed macroeconomic policy pillars, and the asymmetric losses that would result from any downturn. The cyclical downturn associated with the GFC is seen as a case in point. This extended analysis does not examine the implications of the perverse financial dynamics that triggered the GFC: the possibility that structural changes in global finance may now be driving business cycle dynamics.

Yet what launched the EMU and most of the world into macroeconomic downturn was an immense financial crisis – one which involved the collapse of market-based cross-border capital flows within Europe and between Europe and the US, with European megabanks centrally involved and many others (such as Spain's cajas and Germany's landenbanken) deeply – even mortally – scarred.

From the perspective of macroeconomic policy per se, why does the financial trigger of the subsequent downturn and period of stagnation matter? The answer is that linking these two together can explain why Europe's post-GFC period led directly into the Eurozone crisis. For what Arestis and Sawyer leave out of their indictment of EMU macroeconomic policy is that

[10] Sawyer (2013) discusses the EMU's reliance on the supposed supply-side benefits that will flow from 'structural reforms' in labour and product markets.

the European sovereign debt crisis arose because the GFC's impact involved a double loop through the balance sheets of large private banks – the very ones whose size and scale had been championed in the launching of the European single market.

Loop one of the crisis involved the cash-flow impact of the crisis itself – the spike in the cost of borrowed funds after the 2007 collapse of European interbank markets collapsed, the failure of subprime paper bought by European banks, and so on. Many European banks' cross border loans inside Europe also went bad. Some large banks' asset sizes dwarfed their home nation-states' GDPs; nurtured as national champions in global financial competition, they'd become "too big to save."[11] So they were not allowed to fail.

Then, as noted above, the Greek debt crisis was revealed as George Papandreou's government came to power in October 2009. Pressures rose on the ECB due to its hesitant crisis response (Tooze, 2018), while European banks' opacity fed market participants' fear and uncertainty. Not only was Greek government debt larger than was previously known, but loan defaults throughout the GIPSI member-nations rose asymmetrically, compared to Northern Europe. French and German banks that had developed loan-customer relations with borrowers in GIPSI nations, including many large banks, now found much of their loan portfolios in default. GIPSI nations' current-account deficits had to be financed.

This led to loop two: large banks took on this debt. Already weakened from loop one, they were in no position to write down more bad debt. However, in the GFC's dire straits, these sovereigns became what Minsky would have called 'Ponzi' units: far from repaying accumulated debts, they required further borrowing even to meet debt-servicing obligations. So the EMU's large private banks holding this debt creditor nations' large banks were forced to finance deficit nations' further borrowing. This was done grudgingly, and under the oversight of the 'troika' – the European Commission, the ECB, and the IMF (Varoufakis, 2017, Chapter 2). As Varoufakis put it, this was not a debt crisis – it was both a banking crisis (2017, Chapter 2) and a crisis of the failure of Europe's missing surplus recycling mechanism (Varoufakis, 2013).

At the end of the day, the banking situation was not solved – the banks recapitalized; but those who aimed at megabanking status have, for the most part, had their wings clipped. Deutschebank has shrunk in size and ambition. RBS is a shadow of its former self; ABN Amro has survived as a shadow of its former self; Fortis was taken over by BNP Paribas; and so on. Europe's capital markets union and banking union are off to rocky starts due to the unwillingness of nation states to cede ground to one another on the possibility that crises could result in cross-country subsidies.

7. A financial bifurcation point in European banking?

We do not pursue the details of the GFC and its aftermath here. It is sufficient to note that the collapse of leveraged subprime securitization from 2007 onward has compromised global liquidity and forced the use of nation-states' fiscal capacity aces to prevent collapse. The banks were rescued, but credit remains unavailable for small/medium businesses. To some extent, the shadow banking market has filled in the gaps. US investment megabanks' global

[11] Nine of the 20 countries with the highest bank-liability-to-GDP ratios in the world, in 2008, were EU countries; and among the others in the top bracket were the UK, Switzerland, and Denmark (Demirgüç-Kunt and Huizinga, 2013, Table 2, p. 878).

dominance is threatened more by emerging IT platforms (Platt, Noonan and Bullock, 2019) than by European megabank rivals, who have withdrawn from US markets (Noonan, 2020).

The key point made in section 6 is that the dysfunctional EU financial pillar was responsible for the asymmetric depths that the EMU's macroeconomic pillars forced, in particular, on the peripheral countries of the Eurozone. Whether this interaction among the pillars of the flawed EMU/EU policy architecture becomes an infinite loop depends in part on how European policy makers manage the banking structures whose reform they thought would make them future-proof (section 4), but which the EMU's policy pillars have now revealed as a point of exquisite vulnerability.

EMU member-nations were caught in a particularly vicious whipsaw in the GFC, and now are threatened anew amidst the coronavirus pandemic. EMU rules still do not provide for either fiscal transfers or central-bank liquidity provision in the case of either financial or macroeconomic meltdowns (Hall, Arnold and Fleming, 2020). Plans for consolidated financial supervision, via a European Banking Union managed by the ECB, have not been approved (Fleming and Johnson, 2019). Faced with a coronavirus sudden-stop, nation-states are turning to ECB and national-bank lending stop-gaps and to Treasury fixes; but in the absence of further EU/EMU reforms such short-term fixes will compromises market confidence and lead to destabilising negative sovereign-debt loops. The stock of unpayable bank and government obligations can multiply faster than resources can be freed even with extreme austerity policies.

Attacks by suspicious global investors on bankrupt governments and insolvent banks will cease only in one of two circumstances. One would involve shrinking the megabanks and reining them in (along with their penumbra of shadow-banks). Eliminating the need to make good (for global investors' sake) on the obligations of domestically-chartered megabanks whose liabilities approximate the scale of national GDP could recenter attention on how banks can best serve domestic loan customers. The other circumstance would involve ensuring that a willing and able central bank provide lender-of-last-resort interventions as necessary for too-big-to-fail European megabanks. This would not be the ECB as it currently exists; and it would have to be a Europe in which the megabanks in question would indeed be European in scope, providing payments, savings, and investment facilities that serve the EU in its entirety.

This is then the financial bifurcation point. In one direction, a diverse eco-system of European banks, differing among countries and regions, all operating at scales and in activities that do not pose risks larger than their national governments can handle. In the other direction, a small set of homogeneous large European banks, offering similar products and services throughout Europe, operating adventurously in global markets – in head-to-head competition with large Wall Street banks; systemic and even catastrophic failure would be a possibility, one that is viewed as more than offset by the gains accruing to international financial centre status.

In the latter scenario, the European Central Bank would have to accept its role as a backstop against meltdown, since meltdown would bring the entire European financial system with it. The first part of this latter option – the existence of megabanks whose scale dwarfs national income flows – has already happened. What has not yet happened is continent-wide expansion by a small set of European (or non-European) megabanks; it may yet come. Regardless of whether the European Central Bank agrees to backstop the banking system, though, this sequence of events is likely to end in catastrophe.

European banks themselves, caught between Wall Street and the City of London, have lobbied since the GFC, as they always do, for maximum regulatory flexibility and no size or bonus restraints, while searching for new business models. But against the view that their further enabling will permit them to better serve Europe and to compete with overseas competitors is the reality in that only extraordinary measures and luck permitted Europe's megabanks to survive the 2008 crisis. The capacity of European governments to support – and if necessary underwrite - new megabank recombinations and rescues under the current patchwork quilt of national bank/national-sovereign circumstances should not be exaggerated – especially in the current moment.

8. Summary and Conclusions

While many analyses of the Eurozone's flaws have been undertaken, Malcolm Sawyer's work stands out for the depth and breadth of its critique of its macroeconomic policy design, and of the implications of that design. His work, frequently undertaken in collaboration with Philip Arestis, initially diagnosed design flaws in the EMU, then turned to its failure to generate prosperity in Europe, and finally showed how the EU's limitations in confronting financial crisis still require a fundamental rethinking of its policy architecture.

This paper has extended this foundational work by pointing out that the equally flawed financial policy pillar of the EU/EMU has both triggered and deepened Europe's 21st-century crises. Just as the European macroeconomic policy architecture could only work under the unachievable assumptions of the New Consensus Macroeconomic model – a point so vigorously made by Malcolm Sawyer over the years – so too the changes made to European banking so as to achieve the efficiencies available in globally-connected, market-based financial markets would only enhance Europeans' economic and social welfare under conditions that real-world financial systems cannot reach.

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