The US 19th and 20th century experiences: Lessons for the Eurozone crisis[*]

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Abstract

The evolution of institutions in the US and other unions provides clear lessons. There are large gains from buffering currency unions with a union-wide deposit insurance, and partial debt mutualisation. The credibility of a union deposit insurance scheme requires transparent funding and supervision, with a reliable backstopping mechanism. Establishing the credibility of such a scheme benefits from partial debt mutualisation and the formation of a dedicated union-level tax collection needed to serve these liabilities. Limited debt mutualisation does not preclude the existence of a vibrant independent debt market for the union's states, restricted by each state's tax revenue.

The short history of the euro project has been remarkable. Earlier scepticism regarding the gains from forming the euro was deemed overblown during the 2000s. In the tenth anniversary of the ECB (2008), the euro's founding fathers brushed away the earlier critics, presuming that little can be gained by looking at historical lessons, as the euro project is unique and unprecedented.[1] However, the slowing down of the euro's periphery in 2010, at a time when Germany kept growing, awakened the market to the growing debt overhang of the Eurozone (EZ) periphery, and to the incompleteness of the euro project. The resultant crisis is testing the viability of the single currency.

The Eurozone's recent history makes it clear that the tradeoffs facing the euro resemble the ones experienced by other unions throughout history. Thus, those who ignore lessons from history are bound to painfully reenact and learn them. This is probably because the formation of a new currency area is not unidirectional, and weak unions are bound to fail.[2] Evolutionary pressure purges arrangements and institutions that do not survive the realised shocks. Timely learning from mistakes may be the key for the dynamic viability of institutions, and the chances are that the US, Canada and other unions morphed via a painful evolution into more robust institutions. While there is no reason for it to replicate institutions of other unions, the Eurozone ignored their experiences at its own peril. This paper overviews possible lessons from the 19th and 20th

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[1] Jonung and Drea (2010) exemplified the buoyant view regarding the Euro. "Never before have some of the world's largest economies surrendered their national currencies in favor of a common central bank. The euro is one of the most exciting experiments in monetary history." See also Weber's (2008) upbeat assessment of the first decade.

[2] See Aizenman (2012) and Bordo and Jonug (1999).

century experiences of the US with a banking union, centralised supervision, and the logic of federal debt.

1. **States versus centralised deposit insurance**

There are large gains from pooling risks from the states to the union level. These gains reflect both deeper diversification, and the greater credibility of backstopping the deposit insurance scheme at the union level. The Federal Deposit Insurance Cooperation (FDIC) in the US is the outcome of a costly learning process. Its birth in 1933-4 was the outcome of a political alliance generated during a deep crisis.

Crises present opportunities for the creation of bold new institutions, when in the name of preserving the benefits of an existing system new institutions are needed to prevent the system's collapse. The initial blueprint of deposit insurance schemes and other regulatory institutions should go through periodic evaluations and changes, to accommodate the lessons of history.

The FDIC's formation and its 80-year history provide insights into the challenges of macro insurance and supervision. During 1829-1933, various US states experimented with state level schemes of deposit insurance with mixed success, and ultimate profound failure.

> "By the mid-1920s, all of the state insurance programs were in difficulty, and by the early 1930 none remained in operation. Consequently, 150 proposals for deposit insurance or guaranty were introduced into Congress between 1886 and 1933. The basic principles of the federal deposit insurance system were developed in these bills and in the experience of the various states that adopted insurance programs. These principles included financing the federal deposit insurance fund through assessments; the use of rigorous bank examination and supervision to limit the exposure of the fund; and other elements, such as standards for failed-bank payoffs and liquidations, intended to minimize the economic disruptions caused by bank failures."[3]

Forming an institution like the FDIC is a major endeavour, as it needs the support of parties with diverging interests. Yet, no pain, no gain: deep crises provide opportunities for the formation of new coalitions which, with the proper leadership, may deliver more effective institutions. The

[3] See FDIC (1998) page 18. In 1829, New York became the first state to adopt a bank-obligation insurance program. "During the next three decades five other states followed New York's lead. Except for Michigan's insurance plan, which failed after a short period of operation, these plans accomplished their purposes. Nevertheless, the last of these insurance programs went out of existence in 1866 when the great majority of state-chartered banks became national banks. Insurance of bank obligations was not attempted again by the states until the early 1900s. Eight states established deposit guaranty funds from 1908 to 1917. In contrast to the earlier state insurance systems, those adopted from 1908 to 1917 were generally unsuccessful."

written history of the FDIC states: "The adoption of nationwide deposit insurance in 1933 was made possible by the times, by the perseverance of the chairman of the House Committee on Banking and Currency, and by the fact that the legislation attracted support from two groups which formerly had divergent aims and interests – those who were determined to end destruction of circulating medium due to bank failures and those who sought to preserve the existing banking structure." (FDIC 1998, page 20.)

The short history of the FDIC reveals the need to change periodically the insurance risk premia, and supervision, responding to history and to anticipated challenges.[4] Crucially, the ultimate credibility of the FDIC rests on its ability to change the risk assessment to replenish losses, to engage in effective supervision and liquidation, and by its unique status, being backstopped by the federal government:

> "The FDIC is funded by its member institutions through premiums and assessments paid on deposits. And, if ever needed, the FDIC can draw on a line of credit with the US Treasury. FDIC deposit insurance is backed by the full faith and credit of the United States government. This means that the resources of the United States government stand behind FDIC-insured depositors."

2. **State debt, debt mutualisation, and the stability of a currency union**

There are large gains from limited debt mutualisation supported by a transparent dedicated source of taxation. Credible limited debt mutualisation serves to create a widely demanded safe asset, proving a cheap source of funding the legacy debt overhang. Limited debt mutualisation does not preclude the existence of a vibrant independent debt market for the union's states, restricted by each state's tax revenue.

The dollar is a 'successful' union of 50 states. Yet, this is the outcome of painful learning and a turbulent history of more than 200 years. A major challenge for the emerging federal government was dealing with the debt overhang after the American Revolutionary War (1775–1783). A brilliant resolution of these challenges was put forward by Alexander Hamilton, the Secretary of the Treasury from 1789 to 1795. Key elements of Hamilton's scheme included converting outstanding federal and state debt obligations into long-term bonds and creating credible mechanisms to service and amortise this debt. A sinking fund was created, setting aside in 1795 explicit revenues to be devoted to the fund: part of import duties, excise taxes on alcohol and other levies, and the sale of public lands.[5]

Yet, Hamilton's scheme did not deal with destabilising threats associated with future states' borrowing. In the following decades, states created and expanded their transportation

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[4] The banking crisis of 1980s and 1990s had major implications on the functioning of the FDIC. Similarly, the 2008-9 crisis has propagated a new round of modifications.

[5] See Perkins (1994) and Bordo and Vegh (2002).

infrastructure, investing heavily in their canals and railroads, relying deeply on debt funding during the economic boom of the decades that followed Hamilton's scheme. This boom came to an abrupt bust in the depression that began in 1839. By 1842, eight states were in default. In response, states' constitutions in the 1840s created procedures requiring state governments to raise taxes before they borrowed, and made those taxes irrevocable until the debt had been repaid. Wallis (2005) attributes the success and the stability of the US dollar union to these institutional changes: "After the fiscal crisis of the early 1840s, states changed their constitutions to eliminate taxless finance in the future."

Are built-in fiscal restraints enough to ensure the stability of a union? Not necessarily. Von Hagen (1991) is skeptical about the effectiveness of fiscal restraints on states in the US: "Fiscal restraints significantly affect the probability of fiscal choices and performance, without however preventing extreme outcomes." An alternative perspective may combine the above views on the stability of a union. When the fiscal centre receives significant taxes from the states, and provides meaningful discretionary transfers to the states, the union's centre has plenty of bargaining clout. If a state misbehaves, the centre may cut the transfers to a degree that would prevent such behaviour.[6]

We close with reflections on the future of the Eurozone. History suggests large gains from buffering currency unions with a union wide deposit insurance, and partial debt mutualisation. The credibility of a possible euro deposit insurance scheme requires a transparent funding and supervision mode, with a reliable backstopping mechanism. Establishing the credibility of such a scheme benefits from partial debt mutualisation and the formation of a dedicated Eurozone tax collection needed to serve these liabilities. Such a system may work in a lean federal system – deep enough to generate the necessary centralised funding, yet preserving considerable autonomy for the states. Building these capacities requires urgent investment in institutional modifications. A unique feature of the Eurozone is that, by virtue of its short history and its structure, the necessary modifications require contentious modifications at the EU level. While this process may be bumpy, the euro's future hinges on its success.

[6] The center's bargaining clout strengthens the fiscal restraints on states' over-borrowing. If this mechanism is powerful, the threat is enough to impose the necessary discipline. The states would refrain from running a large public debt-to-GDP ratio, and the threat of cutting transfers would be rarely used. In the US, this mechanism seems to be potent, as state governments receive a hefty share of their general revenue directly from the federal government – about 32% in 2009. Yet, if the credibility of the threat is questionable, it would be tested and used, as has been the case in Brazil (see Melo et al. 2010).

References and further reading

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