

1789 and all that

di Charlemagne

Trying to coerce a group of sovereign states to follow common rules is ultimately doomed. Leagues and confederacies are like feudal baronies: breaches lead to anarchy, tyranny and war. That was Alexander Hamilton's case for a strong American federal government. After the adoption of America's constitution, Hamilton became treasury secretary. The federal government assumed the war debts of the ex-colonies, issued new national bonds backed by direct taxes and minted its own currency. Hamilton's new financial system helped transform the young republic from a basket-case into an economic powerhouse.

Does Europe, in its chronic financial crisis, need such a "Hamiltonian moment"? The European elite is looking across the Atlantic for ideas. There is little danger, as Hamilton put it in the Federalist papers, of returning to "bloody wars in which one half of the confederacy has displayed its banners against the other half". But there is a surging resentment in creditor and debtor countries, and the risk of collapse. As a type of confederation, the euro zone struggles to take decisions, and to impose austerity and reforms on recalcitrant members like Greece.

Nicolas Sarkozy, the French president, has spoken vaguely of the need for European federalism. Angela Merkel, the German chancellor, envisages a step-by-step process to "political union" but offers little detail. Some in Germany talk of one day changing the constitution to allow more transfers of power to Brussels. Citing Hamilton, the German council of economic advisers last year proposed that euro-zone national debt exceeding 60% of GDP should be pooled and paid off over time. The European Commission thinks this one-off plan could presage joint Eurobonds.

Outsiders, notably the perfidious "Anglo-Saxons", are accused of plotting to destroy the euro. But the opposite is often truer: the criticism from America and Britain is that the euro zone lacks the integration needed to save the currency. In Davos recently David Cameron argued that successful currency unions had vital features in common: a lender of last resort for the state, economic integration and flexibility to deal with shocks, fiscal transfers and collective debt. "Currently it's not that the euro zone doesn't have all of these; it's that it doesn't have any of these." The most passionate Euro-idealist could not have put it better.

The euro zone is not about to make a great federalist leap. America in Hamilton's time was a young, post-revolutionary republic. Its founding fathers had the prestige to refashion the nation to confront military and economic threats. Hamilton's assumption of state debt was contentious: virtuous states did not think they should pay for lax ones. Allowing speculators to make fortunes from the junk debt they had bought, often from destitute revolutionary warriors, rankled. Sounds familiar? Yet for Hamilton, assuming the debt was a necessary price of liberty.

Europe, by contrast, is an older and more diverse place. America created political union followed by fiscal union. But Europe is doing things backwards, creating the euro partly in the hope of fostering political union. So fiscal integration is being pushed not to preserve freedom and a new nation, but to save a failing currency. In any case the embers of Europeanism are dying. French and Dutch voters killed the proposed EU constitution in 2005. Inter-governmentalism is the new fashion. Who among today's mediocrities could pretend to be a new Hamilton?

Still, the study of America's history—and that of Canada, Brazil and even Germany—offers lessons. A new booklet by Bruegel, a Brussels-based think-tank, looks at America's public finances. The reforms of 1789 were followed by a “no-bail-out” policy in 1840 that forced some states into default. The Federal Reserve was set up in 1913 to act as lender of last resort. The 1930s slump led to much-expanded federal spending under Roosevelt. American states are now constrained by balanced-budget rules, but the federal government borrows hugely to bolster demand.

In the euro zone, each country is responsible for its own finances, within specified limits on deficits and debt. The no-bail-out rule was meant to ensure that markets kept up the pressure. But the markets at first ignored the risks and then panicked, threatening to bankrupt even solvent states. Weak sovereigns weaken the banks, and vice versa. The European Central Bank is barred from lending to governments (though it is doing a lot to sustain euro-zone banks). Austerity stunts growth.

The wrong lesson?

The euro zone has, in effect, tried to create America's no-bail-out doctrine of 1840 with neither Hamilton's federal structure nor Roosevelt's counter-cyclical tools. Euro members are walking on a wobbly tightrope without a safety net. When the storm has blown they have found themselves tied together by the financial markets, meaning that if one were to fall, all would risk doing so.

A rescue fund has been improvised, though it is not big enough for the largest debtors, such as Italy. Tougher fiscal rules, with monitoring and penalties, including a new treaty requiring members to adopt balanced-budget rules, will strengthen the confederal set-up. But as Hamilton might have predicted, deeper intrusion into national policies may in time mean growing strife.

The euro zone will not become the United States of Europe any time soon. But it needs to consider elements of fiscal federalism to deal with its biggest weaknesses. A European-level bank deposit-guarantee scheme could avert bank runs. A one-off pooling of debt could arrest the run on sovereigns. Even without a big budget, a European unemployment-insurance scheme could be created to help deflect asymmetric shocks. Germany wants tough rules? Look at Brazil's measures of 2000, including the threat of jail for breaches of fiscal rules. The euro zone has much to learn from others.