Trust and cohesion in Europe: Lessons from the Delian League

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Abstract

The multiple crises observed in the European Union over the past decade have undermined trust and the foundations for cohesion in Europe. In the absence of a common government, confederations without strong common independent institutions are fragile and prone to collapse. Some of the observed weaknesses in Europe today have parallels to the Delian League, a confederation of states formed in Europe in the fifth century BCE. Though initially successful, the Delian League collapsed within a century of its formation, following its transformation from a confederation of equal member states to an empire governed by Athens. Deviations from best policy practice by European institutions and the adoption of policies that appear to favor stronger Member States over weaker Member States similarly risk undermining Europe today.

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I. Introduction

Cohesion among states requires trust and good will. It requires economic policies that reflect mutual respect and the pursuit of the common good. It requires respect for the high-level ideals of equality and justice for all, ideals that are enshrined in the European Treaties but are under stress in Europe today.

Before discussing how to finance cohesion, it is worthwhile to explore whether the political preconditions for robustly working toward cohesion are met in the European Union (EU). The multiple crises observed in the EU over the past decade have been a severe test. Arguably, the EU has not managed this test well. The euro crisis that started nine years ago has been the most profound demonstration of failure. The migration crisis, and more recently Brexit, have served as additional confirmation of dysfunction. Questions regarding democratic legitimacy and the very foundations of the European Project have become commonplace, highlighting the importance of reestablishing trust and rebuilding the foundations for cohesion in Europe.

The underlying problem with Europe’s multiple crises is politics.¹ When a crisis hits, good crisis management is essential. Good crisis management is about minimizing the total economic losses of the crisis, and about ensuring a fair distribution of the losses between diverse stakeholders. This requires prompt action as delays invariably raise the overall costs of any crisis. Good crisis management also requires decisions that can be politically costly for the authorities involved. In the context of the EU, and especially the euro area, this has proven problematic. Without a common government tasked to protect the common good in an equitable manner, policy may be dominated by narrow national interests. The political leadership of an individual Member State is ultimately responsible for and accountable to the citizens of its own state only. During a crisis, the bias toward protecting national interests may overwhelm other considerations, precluding a fair distribution of losses. Crisis management may end up protecting stronger Member States that can leverage narrow national interests at the cost of the common good. Crisis losses may consequently be transferred to weaker Member States and their citizens, feeding tensions that may ultimately lead to the unwinding of the European Project. Such are the perils of the current loose confederation structure of the EU.

II. Lessons from the Delian League

As already stressed, cohesion among states requires trust and good will. A federation can achieve trust and good will through a common government, accountable to all the people of all the states. In the absence of a common government, the establishment and maintenance of trust and good

¹ This problem, and its worrisome implications for Europe, have been identified long ago, see for example Helmut Schmidt (2011a and 2011b).
will requires strong common independent institutions that can protect the common good. A confederation without strong common institutions will remain fragile.

There is a historical precedent to the ongoing troubles of the euro area that is worth recalling: the Delian League. Named after Delos, a small island in the Aegean Sea, the Delian League was a confederation of Hellenic city states, formed in the fifth century BCE. At the time, this was the center of Europe. Interestingly, some parallels can be drawn between the aims of the Delian League back then and the ongoing efforts toward a political and economic union of the EU today. The Delian League was a confederation of sovereign states sharing a common heritage and common interests. In terms of the global economy, the individual member states were small. Coming together was recognized as important to pursue common interests and to defend the confederation against potential threats from the rest of the world. In the aftermath of two costly wars and the successful defense of Europe from Persia, the alliance was seen as important for maintaining peace. With peace came prosperity and a common currency that became dominant in trade and finance in the confederation. For a while, the Delian League appeared to be a successful economic and monetary union. The iconic silver tetradrachm coin was as much a symbol of the success of the confederation two and a half thousand years ago as the euro strives to be a symbol of success in Europe today. The same depiction of the owl of Athena, which was stamped on the tetradrachm coins, appears on one-euro coins in circulation today.

The success of the confederation, however, proved fleeting. The Delian League was formed in 478 BCE as an alliance that respected equality among its member states. However, over time, the largest member state, Athens, developed undue influence on the common institutions, including the institutions controlling financial matters in the confederation. In 454 BCE, the Delian League’s Treasury was moved from Delos to Athens, an event that marked the consolidation of the alliance’s power by its largest member state. The alliance evolved from a confederation of equal member states into an empire governed by Athens.

The exploitation of the economic and monetary union by Athens brought riches to its citizens, at the expense of citizens of other member states of the alliance. Among others, it helped finance the golden age of Athens, including the building of the Athenian Acropolis and the Parthenon we still admire in Europe today. The construction of the Parthenon started in 447 BCE, just a few years after the transfer of the League’s Treasury to Athens. But the prosperity in Athens was not shared with its allies and could not be sustained. Hegemonic control by Athens gave rise to resentment in the other member states, which led to tensions and rebellion. The exploitation of other members of the confederation by Athens eventually resulted in the disintegration of the alliance. Exploited allies turned into enemies of Athens, ultimately bringing about the destruction

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2 As highlighted by Thomas Sargent in his 2011 Nobel prize lecture, the evolution of the United States of America from a fragile confederacy to a strong federal union in the 18th century is another historical precedent with important lessons for the EU today.
of the Athenian democracy with the end of the Peloponnesian wars. In 404 BCE, less than a century after its formation, the League was dissolved.

Some parallels to the development of the EU and the euro area are apparent. However, some questions have yet to be settled. Is it just one or is it a small number of Member States – perhaps two – that play in today’s Europe the role that Athens played in the Delian League? Is a reversal of the process of disintegration that has hampered Europe over the past decade still feasible? Can trust be reestablished toward rebuilding the foundations for cohesion?

It is important to note that the malfunction observed in Europe over the past decade was not preordained. Confederations are weak by design because they lack a common government that protects the common good. Yet, this was certainly understood by the proponents of the European Union. The EU was meant to promote shared prosperity. In the original design of the EU, as enshrined in the Treaties, independent European institutions were envisioned to support high-level principles at the core of the EU. These include promoting equality and solidarity as well as protecting the common good.

This vision placed a high burden on European institutions. Unfortunately, the challenge proved too difficult to handle in the face of the practical political realities and conflicting interests among the Union’s Member States.

III. Monetary policy in a diverse monetary union

Consider the case of the European Central Bank (ECB), arguably the most powerful institution in the euro area and the most powerful central bank ever created. Regarding the question of how to finance cohesion, examining the role of the ECB in financing the euro area economies is certainly pertinent. Before the crisis, the ECB was considered a successful institution. However, when focusing on its monetary policy since the eruption of the euro crisis less than a decade ago, the ECB’s success has been put to the test time and again. Has the ECB done all it could within its mandate to minimize the economic losses of the crisis for the euro area as a whole? Has the ECB acted in a manner that has been supportive of the euro area economies, and that could be objectively termed equitable across euro area Member States?

Regarding the overall stance of monetary policy, the ECB aims at achieving and maintaining inflation rates of ‘close to 2 per cent’ over the medium term. Before the crisis, policy was pursued in a manner that was consistent with a symmetric 1.9 per cent inflation goal and this goal was achieved. In contrast, over the past several years, the ECB has pursued a policy characterized by the International Monetary Fund (IMF) as ‘lowflation,’ which describes a central bank that systematically aims at achieving lower inflation compared to the central bank’s stated inflation goal. Indeed, over the past several years, the ECB has consistently kept core
inflation to only 1 per cent, which is well below its stated objective. There is no question that the ECB has provided considerable monetary policy accommodation since the crisis; nonetheless, over the past several years, the accommodation provided has been systematically less than what would have been necessary to keep inflation close to 2 per cent. And recently, despite forecasts suggesting that the inflation rate is expected to remain too low, the ECB has communicated that it intends to end the provision of additional accommodation.

Maintaining overly tight monetary conditions is not without cost. For the euro area as a whole, overly tight monetary conditions have resulted in lower income and higher unemployment than what would have been achievable and consistent with the ECB’s mandate. Best practice monetary policy for the euro area as a whole would have avoided lowflation. The question therefore is: What could possibly explain the observed deviation of the ECB’s policy from best practice measures?

Counterfactual questions such as this are never straightforward to address. Yet, some of the possible explanations put forward to answer the question posed above are troubling. One sensitive issue in any monetary union is the fact that monetary policy measures that are considered ideal for one member state may be far from ideal for another member state. Accordingly, policies corresponding to best practice for the euro area as a whole would be excessively easy for some Member States and excessively tight for other ones. Policies deviating from best practice for the euro area as a whole, on the other hand, may guide monetary conditions closer to what is ideal for a Member State whose political authorities manage to exert undue influence on the common policies.

Another, not unrelated issue, is that when interest rates are constrained by the zero lower bound (ZLB), additional monetary easing is achieved by expanding a central bank’s balance sheet, for example through purchases of government debt—also known as quantitative easing (QE). Since 2008, the Federal Reserve and the Bank of Japan (BOJ) have expanded their balance sheets by a factor of five. The ECB would have needed to engineer a similar expansion to provide adequate accommodation for the euro area. However, QE has proven controversial in some Member States, especially in those where QE is not needed and where ideal monetary conditions would call for tightening rather than easing monetary policy. What is more, the ECB has even faced multiple legal challenges for QE, which may have influenced ECB decisions towards avoiding QE and consequently implementing considerably tighter policies for the euro area as a whole relative to best practice.

Monetary policy mistakes are not uncommon in the history of central banking. In some respects, ECB plans to exit QE prematurely resemble other unfortunate episodes of premature policy tightening, such as that initiated by the Federal Reserve in the mid-1930s and by the BOJ in the 2000s. What is more troubling, however, is the possibility that the observed deviation from best
practice has been the result of undue influence by the political authorities of those Member States that benefit the most from this deviation at the expense of other Member States and the euro area as a whole.

IV. Fiscal stress and fiscal transfers

Another deviation from best policy practice has arguably proven even more damaging than the inadequate expansion of the ECB’s balance sheet. This relates to the following observation: Since the beginning of the euro area crisis, euro area governments have experienced greater fiscal stress than governments of advanced economies outside the euro area with comparable or weaker fiscal fundamentals (see De Grauwe 2011 and Krugman 2014). One may wonder what the source of the fragility experienced by euro area governments may be and whether it is related to ECB decisions and actions.

To answer these questions, it is worthwhile to take stock of where we are today by comparing the cost of financing for two of the largest euro area governments over the past few months – that is of Italy and Germany. At the ten-year maturity, yields on German debt have recently been less than one-half per cent. For Italy, they have recently exceeded three per cent. At the two-year maturity, Italian yields have exceeded 100 basis points, while German yields have been negative, around −60 basis points.

What is the cause of these large differences? It is sometimes suggested that such differences purely reflect fiscal policies that make the debt of some countries ‘safe’ and that of other countries ‘unsafe,’ exposing the latter to greater risk of a rollover crisis that could result in default. Hence, a possible explanation may be that the Italian government has been overspending and accumulating large primary deficits, while the German government has been thrifty, registering large primary surpluses. However, this explanation is not correct. In fact, the Italian government has been running substantial primary fiscal surpluses both before and after the crisis. As a matter of fact, Italy has registered, on average, a larger primary surplus than Germany since the creation of the euro.

In light of these facts, the explanation may rather be that running large fiscal surpluses is not sufficient to keep a country’s debt ‘safe.’ It is also essential that the country’s central bank implements policies in a reasonable manner to avoid unnecessary crises. The difference between German and Italian yields can be accounted for by discretionary ECB decisions that have unnecessarily compromised the safe asset status of government debt in the euro area (see Orphanides 2017 and 2018). More specifically, discretionary decisions relating to the ECB’s collateral framework. Current ECB policy is to deny the eligibility of a Member State’s debt as collateral for ECB open market operations unless it meets a minimum credit rating threshold.
This makes a Member State with relatively lower credit ratings vulnerable to a rollover crisis regardless of whether it has been running large primary fiscal surpluses or not.

The ECB effectively supports what is known in the theoretical literature as adverse self-fulfilling equilibria. This practice is unique among advanced economies and inconsistent with best practice in the implementation of monetary policy.

Deviating from best practice in collateral policy is, yet again, not without cost. While being harmful to the euro area in general, and particularly so to some Member States, such as Italy, the ECB’s collateral policy has been beneficial to some other states, above all to Germany. This is due to the immense distributional effects that have been induced by the ECB in euro area government bond markets since the euro crisis. Inducing rollover risk and thereby making the debt of some Member States ‘unsafe’ poses an implicit tax on these states as their Treasuries are forced to pay higher interest rates to service existing debt. Moreover, this practice generates a safe haven subsidy to the Member States that are perceived as ‘stronger’ as their Treasuries are being subsidized when they issue debt at artificially low interest rates.

In effect, the ECB’s collateral policy has induced transfers from ‘weaker’ Member States to ‘stronger’ Member States in the euro area. Is this helpful for reestablishing trust and rebuilding the foundations for cohesion in Europe?

V. Conclusion

Cohesion among states requires trust and good will. Currently, this is in very short supply in Europe. The underlying problem is politics – an inherent weakness in confederations. In the absence of a common government, confederations without strong common independent institutions are fragile and prone to collapse.

European Treaties foresaw the need for strong common independent institutions to promote shared prosperity. However, European institutions have been challenged and have not always managed to effectively counterbalance narrow national interests. Yet, they have to assert their independence and operate as envisaged in the European Treaties. Shared prosperity must be promoted over narrow national interests, if trust is to be reestablished among the people of Europe. This way, one can hope that the foundations for cohesion in Europe will be successfully rebuilt. The economic and monetary union in Europe today should not have the same end as the Delian League 25 centuries ago.

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