HAMILTON’S PARADOX REVISITED

Lessons of the euro area for US history

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Introduction

- Europeans have received many lessons that are based on the United States being **an optimal currency area**
  - Labour mobility
  - Federal budget
  - Political unity

Transfer union

- At odds with historical political-economy research: **Hamilton's Paradox** (Rodden 2006)
- Turn the lesson-drawing around:
  given what we think we know now about the €A crisis, how exactly did the $A take these lessons historically, if at all?

Three tentative lessons from the €A crisis

1. **Political integration** must precede currency unification (eg McNamara 2003)
2. **Fiscal union** is required to escape diabolic loops between banks and sovereigns (eg De Grauwe 2011)
3. **Excessive fiscal risk-taking** of member states must be prevented to preserve union (eg Sachverständigenrat 2012)

➢ Has the $A come to adopt these lessons? When and how?

SHOULD POLITICAL UNION PRECEDE MONETARY UNION?

Lesson 1 from the €A for the $A

1. Sequencing of political and monetary union

- **1791 Hamilton's Plan**:
  first federal bailout of states;
  common bond and the First Bank of the US
- First and Second Bank licenses expire (1811 and 1836), second federal bailout of states (1816) but no more direct state bailouts after defaults in the 1840s
- **1863 National Banking Act**:
  crypto-monetary and financial union (no central bank) when political union had broken up
- **1913-35 Federal Reserve and New Deal reforms:**
  incomplete financial-fiscal-monetary union
  bailout via FDIC rather than federal budget (S&L crisis of the 1980s-90s)

Lesson 1

- Sequencing of political and monetary integration was different between the \$A and the €A
- But this did not lead to more solidarity among states: the \$A has a firm no-bailout policy
- The \$A sequencing came with much more financial instability

U.S. was the most crisis-prone country in the Western hemisphere (Broz 1997: 5)

The Economist: out of the **13 worst financial crises in world history** since 1720, more than half happened or started in the United States:

- 1792: First Bank of the U.S. panic
- 1837: Cotton crisis
- 1857: Railroad crisis
- 1907: Knickerbocker crash
- 1929: Wall Street crash
- 2001: Dotcom crash
- 2008: Subprime crisis

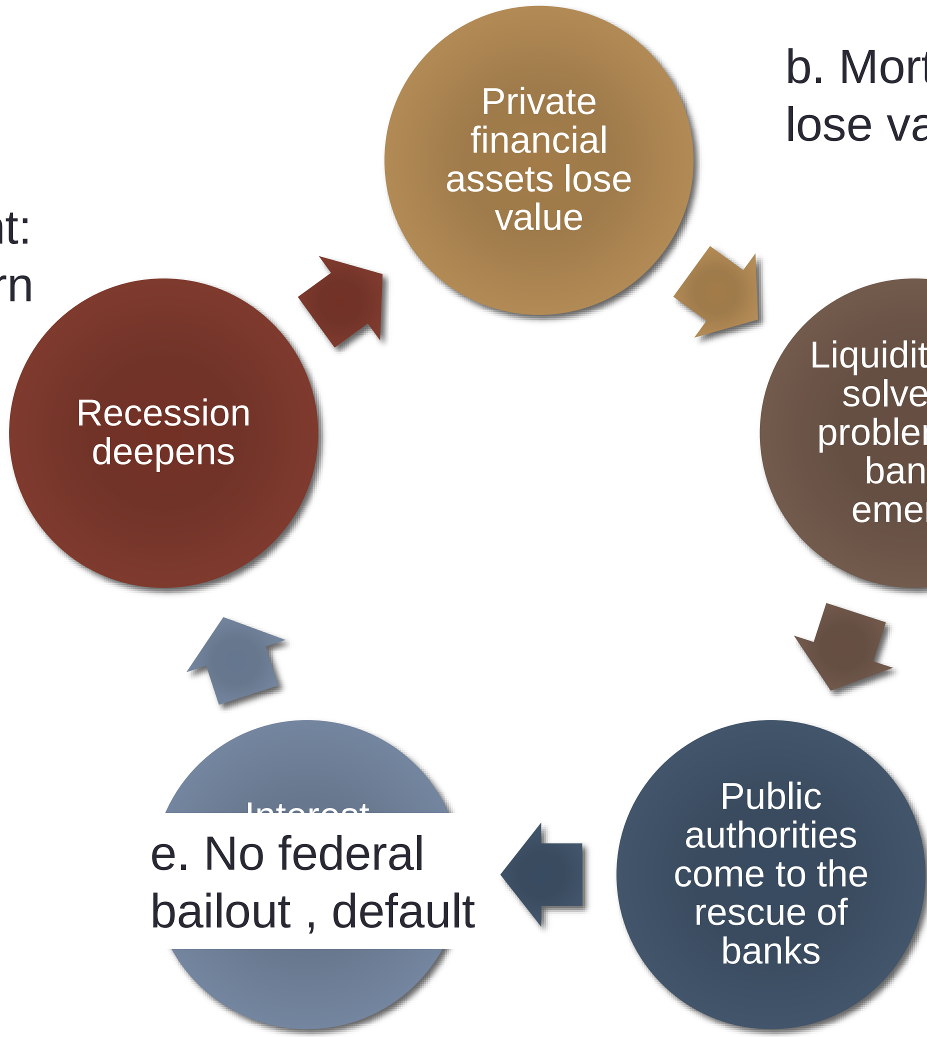
In addition, purely national banking crises:
1873, 1884, 1890, 1893, 1914, 1984-91

IS FISCAL UNION REQUIRED TO AVOID DIABOLIC LOOPS?

Lesson 2 from the €A for the $A

2. Diabolic loops with fiscal union: the crisis of the 1840s

a. Era of internal improvement: Southwestern states in the 1840s



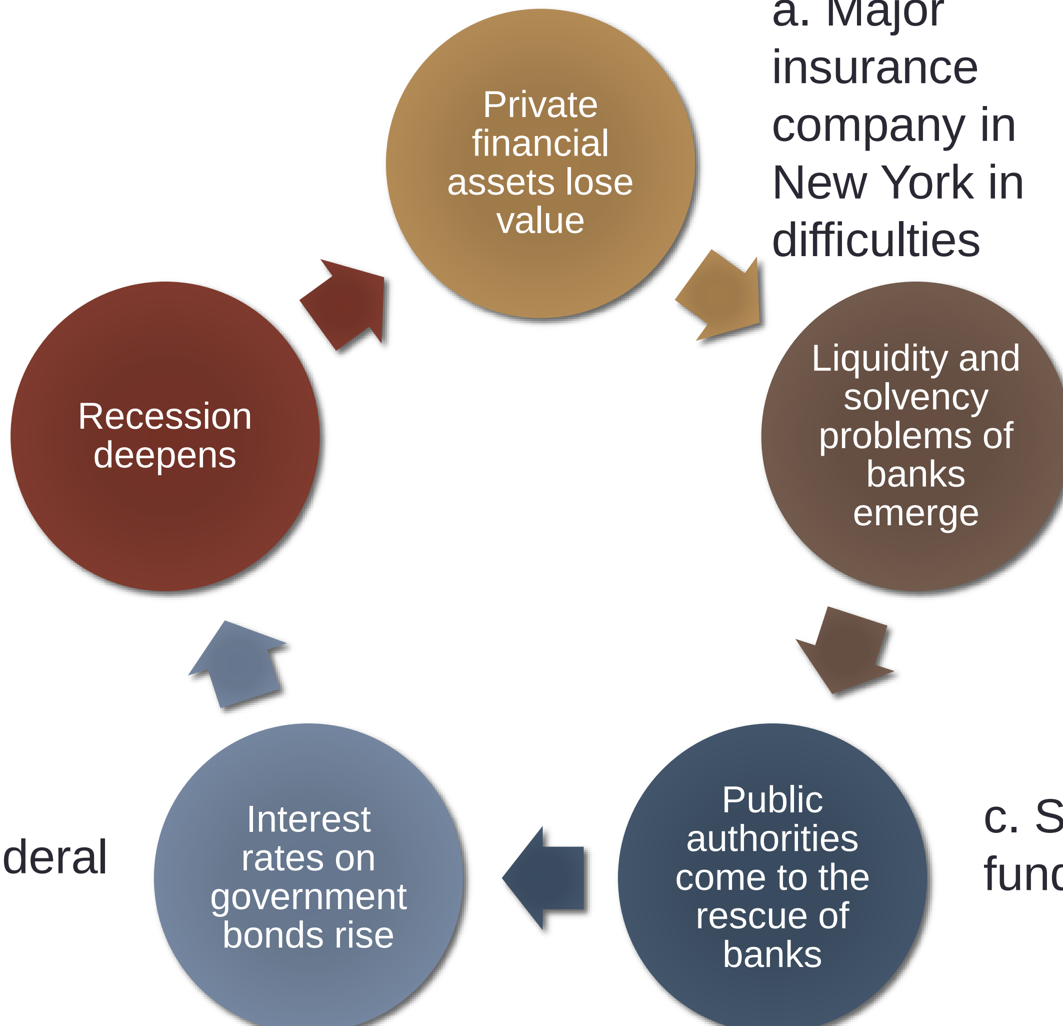
b. Mortgages lose value

c. Too-big-to-save land banks go bust

d. States lose major source of revenue, try to borrow

e. No federal bailout , default

2. Diabolic loops without minimal state intervention: the implosion of free banking



a. Major insurance company in New York in difficulties

b. Free banks sell reserve assets and spread contagion

c. State safety funds go bust

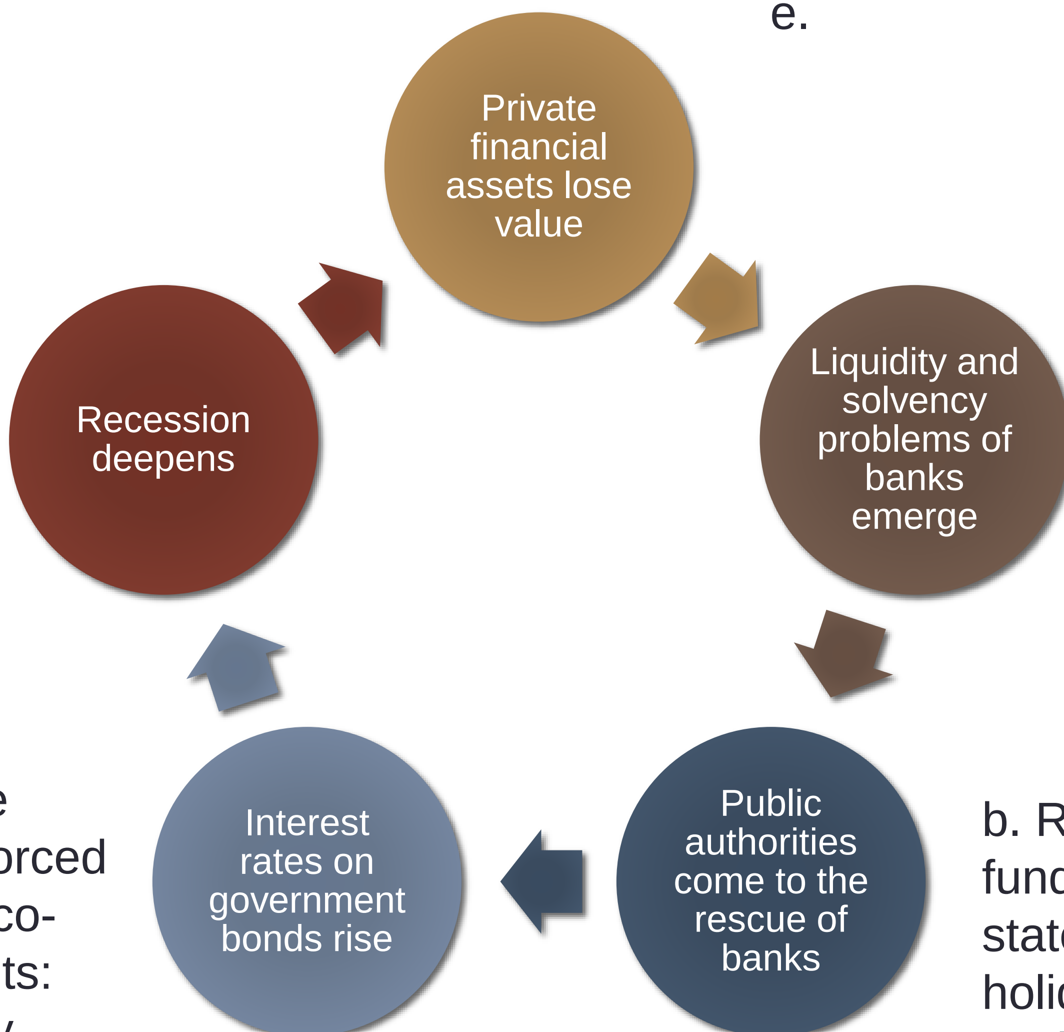
d. No federal bailout

e.

2. Diabolic loops averted: S&L crisis

e.

d.



a. Monetarist stance and financial liberalisation upset ‘thrifts’

b. Resolution fund goes bust; state bank holidays; **FDIC to the rescue**

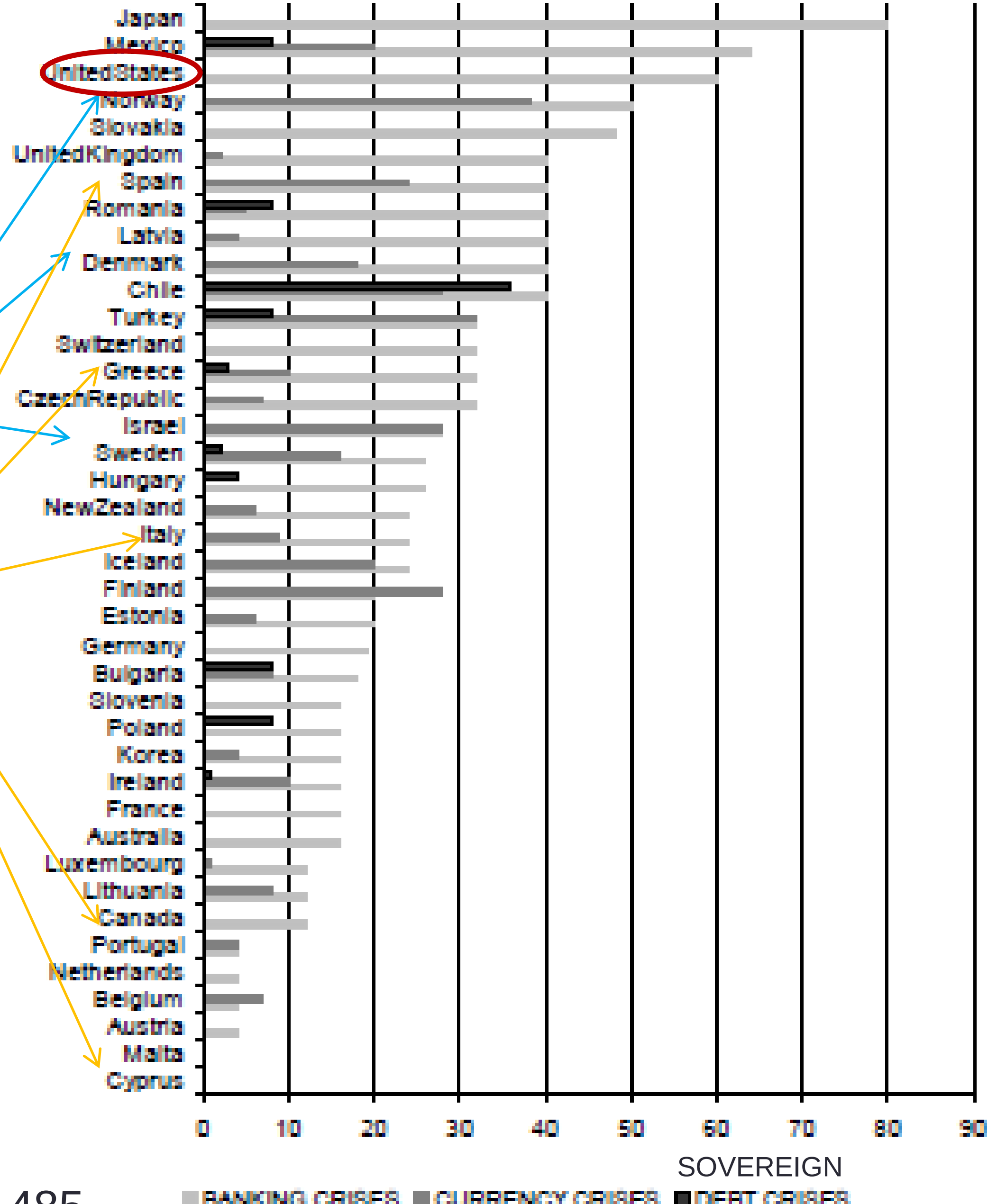
c. Some states forced to high co-payments: austerity

Lesson 2

- Neither fiscal union (without monetary union)
- nor absence of fiscal federalism (libertarian-devolutionist free banking experiment)
- are sufficient to prevent diabolic loops
- $A solution (Savings & Loan crisis):
  indirect bailout of state financial systems through the FDIC
  federal fiscal backup for FDIC through Treasury bonds
- Has not prevented persistent banking crises

No. of quarters that countries spent in crises (1970-2010)

- US banking crises among the worst
- Scandinavian rich welfare states (NO, DK, SW)
- spend as much time in crises as Southern European countries (ES, GR, IT, PO, CY)
- **Banking crises dominate and are leading indicators for other types of crisis**



Source: ECB Working paper No.1485, 2012

IS FISCAL RISK TAKING TO BE PREVENTED IN ORDER TO PRESERVE THE UNION?

Lesson 3 from the €A for the $A

3. Stabilisation with balanced budget rules

- States started to give themselves balanced budget rules after the crises of the 1840s
- Reduced state defaults
- But it also reduced the stabilising capacity of the fiscal federation
  - In principle, there is leeway for US states to let budget balances move counter-cyclically (balance based on budget forecasts, use of rainy day funds)
  - But, in political practice, states use balanced budget rules as a pretext to operate pro-cyclical budgets
  - Fiscal competition has also led to weak unemployment insurance
  - Various studies (Dolls et al 2010, Follette et al 2008, Svec and Kondo 2012) therefore confirm that **US federation has significantly weaker automatic stabilizers than €A without a fiscal union**

Hamilton's Paradox revisited

Originally (Rodden 2006):
The problem of fiscal federations is not that the centre is too weak but that it is **not credibly weak** and thus taken for a ride by member states

Lessons from the €A crisis for US history:

a. Even strong federal bailout capacities are compatible with credible commitment to no-bailout of states
b. This has the price of less cyclical stabilisation in normal times if commitment is enshrined in balanced-budget rules
c. Hamilton's Paradox reappears in the guise of excessive risk taking in the financial system