Where Do We Want the Euro to be in 2020 and How Do We Get There?

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Great Expectations

European Monetary Union (EMU) was supposed to be a harbinger of growth and stability for its member states, yet the euro zone debt crisis is now in its fourth year and continues to rumble on, in a seemingly endless cycle of crises, summits and false dawns. The currency union creaks under the deficiencies of the euro zone's fundamentally flawed design, while its survival and capacity to prosper depend on its ability to fix these design flaws. The stakes are high.

The new single currency was introduced with great pomp in electronic form in 1999, and then in physical form in 2002. This project is arguably the most ambitious experiment in monetary union ever undertaken, and was the latest step in the post-war process of European integration. A group of sovereign European states chose to combine their national currencies and transfer control over monetary policy to an independent institution, the European Central Bank (ECB). The group included some of the largest and most powerful economies in the world. The euro instantly became the second most important currency on the planet, and the euro zone expanded from its original eleven countries to its current membership of seventeen.

According to its proponents, EMU is an indispensable step in the long, slow journey towards integrating the European Union economies. The euro was expected to become a global reserve currency which would rival the US dollar and deliver all the privileges that result from that status. The single currency was also expected to become a stabilising anchor for its member economies, providing a degree of protection against the instability of large exchange rate fluctuations, and embedding lower inflation and interest rates.

However, the sheer persistence, severity and systemic nature of the twin sovereign and banking debt crises have cast grave doubt on the inherent stability and coherence of EMU. Although a misguided and incompetent political response has certainly not helped, it is nevertheless clear that the architecture of EMU, as currently constructed, and its internal inconsistencies have gravely exacerbated the crisis. Many of these architectural flaws can be remedied, and ultimately the success or failure of EMU will come down to political capacity and will. The euro entered its teens on 1 January 2012 and now is the time for reflection. Where do we want the euro to be in 2020 and how can we get it there?

This Time is Different

While there have been a number of successful monetary unions, the history books are full of examples of failed experiments. Experience suggests that having some pre-existing form of centralised political union greatly improves the chances of a monetary union succeeding. Classic examples of resilient monetary unions include the USA, the UK and even the former USSR. Yet the normal fate for currency unions is eventual failure and dissolution. Most such unions around the world are now just historical footnotes.

In Europe, there was a Latin Monetary Union (LMU) based on the French franc, and centred on France, Belgium, Switzerland and Italy, which lasted for most of the late nineteenth century. While the LMU had no single currency, the four main countries all minted their own gold and silver coins that were then considered legal tender in all of the other countries. The union was officially dissolved in 1926, but in practice had failed long before then. The Scandinavian Monetary Union (SMU) between Sweden, Denmark and Norway was a similar venture set up in the 1870s.

Both the LMU and the SMU broke apart because there was no central institution to enforce a common monetary policy and because of divergent fiscal policies. France also attempted to set up a 'universal currency' in 1867. The universal currency was intended to be centred on the minting of universal gold crowns of equivalent value. However, France was unable to convince the UK or the USA to take part in the scheme.

The Gold Standard

Perhaps the most famous example of a *de facto* currency union was the gold standard. The gold standard developed internationally from 1870 onwards and was a system of fixed exchange rates based on convertibility to gold at set prices. The system temporarily broke apart under the pressures of World War I, and then came under severe pressure again following the stock market crash in 1929. The gold standard finally unravelled in the early 1930s, as virtually all countries abandoned gold convertibility. The turbulent 1930s were characterised by floating currencies and by a long sequence of competitive beggar-thy-neighbour devaluations. These race-to-the-bottom policies were blamed for disrupting trade, increasing instability and prolonging the Great Depression.

In a bid to prevent this happening again, there was a movement by the victorious powers of World War II to establish an international monetary system based on the convertibility of certain national currencies into United States dollars. The outlines of this system were agreed in July 1944 at Bretton Woods. The US dollar was itself backed by convertibility into gold, and this effectively meant all participating currencies were indirectly pegged to gold and therefore to each other. A key purpose of the system was to provide the stability needed for post-war economic recovery, although countries could still devalue their currencies under certain conditions.

The Bretton Woods system began to fray in the late 1960s, as the United States became increasingly unable and unwilling to sustain the dollar exchange rate with gold. Dollar convertibility into gold was eventually terminated by the United States in 1971, and the major European economies broke their links with the US dollar over the course of the following two years. The Bretton Woods era was characterised by sustained economic recovery, low unemployment and strong growth in real economic output. As a result, the Bretton Woods system of pegged currencies became associated with macroeconomic strength in the minds of European policymakers.

Stabilising Exchange Rates in the EEC

The years that followed the collapse of the Bretton Woods system were characterised by the shock of the oil crises and by prolonged stagflation.[1] The currency instability of the 1970s prompted a series of attempts to stabilise exchange rates in the European Economic Community (EEC).

The first such attempt was the 'Snake in the Tunnel' system which aimed to peg all of the EEC currencies to one another within narrow bands. By the mid 1970s, the Snake had been reduced to a rump zone based around the Deutsche Mark. A renewed attempt at monetary coordination was made in 1979 with the launch of the European Monetary System (EMS). The EMS was based on a system of narrowly fluctuating exchange rates known as the Exchange Rate Mechanism (ERM), which in turn was centred on an artificial currency called the European Currency Unit (ECU).[2] The Deutsche Mark quickly became the anchor currency of the EMS.

European Central Bank, Frankfurt *© Istock Photo*

The system was characterised by devaluations by many of its member states in its first decade and it began to buckle following the shock of German reunification in the early 1990s. Germany's post-reunification expansionary fiscal policy to support the rebuilding of the former East Germany, combined with ultra-tight monetary policy, forced other countries to keep interest rates at extremely high levels to support their currencies and prevent capital outflow to Germany. A number of European currencies increasingly came under speculative attack, and sterling's membership of the ERM was spectacularly suspended on 'Black Wednesday', 16 September 1992. Italy then withdrew on the following day.

As with previous failed attempts to fix exchange rates, the system had been undermined by conflicting policy goals in the different countries and by the inability of member countries to harmonise their monetary and fiscal policies with each other. The ERM was effectively dismantled in 1993 when the fluctuation band for national currencies was extended to 15 per cent. The major European currencies subsequently floated against each other within these bands between 1993 and 1998.[3]

Towards EMU

Despite these setbacks, the process of integration continued apace in the 1990s under a group of policies aimed at a European Monetary Union (EMU).[4] These policies were designed to establish convergence between the various European Union economies in areas such as rates of inflation and control of the public finances so as to create the conditions for a viable currency union. The push for currency union was motivated by the belief that unpredictable exchange rate fluctuations were incompatible with a fully open and competitive internal market. Yet one of the main lessons from the experience with ERM was that systems of fixed exchange rates tend to buckle under the strain of divergences in domestic policies and objectives. A single currency and single monetary policy under the control of an independent central institution was therefore pursued in preference to yet another system of fixed exchange rates.

Eleven European Union Member States were deemed eligible to join the single currency in 1998 when their national currencies were made convertible to the euro at established rates. The euro was officially launched the next year, with monetary policy and enforcement falling under the authority of the independent European Central Bank (ECB). The desirability of the euro was hotly contested in academic and policy circles. In particular, there was considerable debate about whether the euro zone economy was an 'Optimum Currency Area'. Robert Mundell defines an Optimal Currency Area as a region for which the benefits of adopting a single currency or a fixed exchange rate system outweigh the costs of relinquishing the exchange rate as an instrument of internal adjustment within the region itself.[5] It is still unclear whether the euro zone will prove durable in its current form or is destined to go the way of earlier failed attempts at monetary union.[6]

An Asymmetric Union

The current crisis has exposed existing limitations and design flaws in the euro zone. Of particular importance is the absence of a central institution or mechanism capable of softening what are known as 'asymmetric shocks'. Asymmetric shocks occur when one or more economies within a currency union are disproportionately impacted by an economic shock.

Consider an asymmetric shock for Ireland. A sharp appreciation of the euro against sterling will reduce Ireland's exports disproportionately more than it will reduce the exports of other euro zone economies. This is because the United Kingdom is a proportionately more important trading partner for Ireland than it is for the euro zone as a whole. A country or region-specific banking crisis is perhaps the classic example of an adverse asymmetric shock.[7] Members of a monetary union afflicted by adverse asymmetric shocks can become plagued by destabilising and prolonged collapses in demand and persistently high unemployment.

The euro zone does not have mechanisms in place to soften asymmetric shocks. On the other hand, consider what happens when an asymmetric shock such as a hurricane or a region-specific recession hits a monetary union such as the United States or the United Kingdom. The effects of these localised shocks are automatically softened by transfer payments from the central government because a monetary union such as the United States is constructed on a federal political system with federal taxes. In the aftermath of the asymmetric shock, the depressed economy pays less in taxes and receives more in transfer payments from the central government. These 'automatic stabilisers' help the affected economies to recover.

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Unfortunately, this is not how it works in the euro zone because there are no euro zone taxes and therefore no reserve fund to access if a member state is hit by an adverse shock. Rather, the reduced levels of tax receipts and increased levels of spending on social protection put pressure on the member state's public finances. Unless they have built up large reserve funds, euro zone members can only adjust to these shocks through painful and prolonged austerity and through internal devaluations with all the brutal social consequences that these entail.

Multiple Equilibria and Negative Feedback Loops

When the euro zone countries gave control over their currencies to the ECB Governing Council, they unwittingly exposed themselves to the risk of a negative feedback loop of spiralling interest rates and eventual insolvency. As the crisis erupted, the weaker member states found the risk status of their government bonds reduced to that of emerging economies.[8] Paul De Grauwe and Yuemei Ji show that markets systematically misprice sovereign risk in a herd-like fashion that produces what are known as 'multiple equilibria'.[9] In another study, De Grauwe argues: '... in a monetary union, countries become vulnerable to self-fulfilling movements of distrust that set in motion a devilish interaction between liquidity and solvency crises'.[10]

The multiple equilibria problem arises because individual euro zone member states lack the ability to finance their debts by issuing currency, and lack control over a central bank they can lean on to flush the domestic banking sector with liquidity and thus ease pressure on sovereign bond prices.

Crucially, the member states do not have a lender of last resort for their sovereign borrowings. Unlike countries in control of their own currency, it is possible for euro zone member states to run out of money and become unable to pay their creditors. Following an adverse economic shock the weaker countries can come under recurrent speculative pressures from the markets. Such speculative pressure becomes self-fulfilling as the member state's debt servicing obligations become increasingly unmanageable. Once the negative feedback loop is seen to have taken hold, the markets become even less willing to lend and the sovereign debt dynamics become increasingly untenable. The country is now trapped in a bad equilibrium.

At some point, the country's cost of borrowing may become so unmanageable that it finds itself unable to access the international markets at a sustainable price. At this stage, the country becomes dependent on international bailout mechanisms. Greece, Ireland and Portugal have already succumbed while Spain and Italy have come under pressure.

The vulnerability of the European banking system interacts toxically with the multiple equilibria phenomenon because the banking system's ability to lend to sovereigns is impaired and this reduces the demand for sovereign bonds. Spain and Italy are currently being supported indirectly by the ECB's desperate injection of €1 trillion in cheap money to the financial sector.[11]

The most straightforward solution to the multiple equilibria problem is to mandate the ECB to operate as a lender of last resort to sovereign borrowers at a sustainable interest rate. However, the ECB is expressly forbidden under European Union law to perform this function for sovereign borrowers. Changing the mandate of the ECB requires treaty change.

Writers coming from a range of viewpoints have proposed eurobonds of one form or another as a solution to the multiple equilibria problem.[12] Eurobonds are similar to sovereign bonds but are issued jointly by the seventeen euro zone countries. The money would be lent to the euro zone countries as a whole through a central intermediary, and then forwarded on to the member governments. Treaty change may be required before eurobonds can be introduced, as Article 125 of the Lisbon Treaty states that EU Member States are not liable for the obligations of other members.

Daniel Gros and Thomas Mayer have pointed out that although the ECB is barred from lending directly to euro zone member states it is already acting as lender of last resort to private credit institutions.[13] They suggest that a viable solution to the sovereign debt crisis would be to award the euro zone's permanent bailout fund, the European Stability Mechanism (ESM), a banking licence. Once registered as a private credit institution, the fund would be able to engage in large-scale purchases of government bonds, using its substantial existing resources, and then could use these bonds as collateral to secure its own funding from the ECB.

This credit institution would effectively function as the lender of last resort for sovereign borrowers. Moral hazard concerns could be accommodated by offering different interest rates to different countries, depending on the member state's own actions and its particular context. The credit institution would announce the interest rate it is demanding in advance of the bond auctions, and this would create a ceiling on sovereign bond prices. This solution would not diminish the reality that Greece and perhaps other member states require substantial debt write-downs. However, it would at least prevent countries falling into bad equilibriums in the future, thereby enhancing euro zone stability.

Optimal Currency Areas and Central Regulation

To qualify as an Optimum Currency Area (OCA), a currency union should ideally have labour and capital mobility across the region as well as a risk-sharing system involving automatic fiscal transfers. It is also important that member states have similar business cycles.

The ECB Governing Council sets the interest rate to suit the euro zone as a whole. However, the overall needs of the euro zone as a whole are not necessarily consistent with the needs of individual members, as the different economies are likely to be experiencing very different inflation and growth rates. Unfortunately, the current euro zone architecture lacks the policy instruments to accommodate its seventeen member states' divergent places in the economic cycle.

The single interest rate actually spawns asymmetric shocks by overheating economies in the good times and exacerbating recessions in the bad times. The property booms in Spain and Ireland were straightforward asset price bubbles, caused in part by an interest rate set by the ECB to suit the needs of the euro area as a whole – but a rate that was far too low for the needs of already booming economies. The result was a negative real interest rate which spurred excessive levels of private lending and private borrowing and triggered debt-fuelled booms.

This boom inflated housing prices far beyond their underlying values. In the Irish case, poor regulation, pro-cyclical fiscal policies and a range of property-related tax breaks also contributed to the boom and bust. When these prices collapsed in the wake of the 2008 financial crisis, the real economy and banking sector in both Spain and Ireland were saddled with massive levels of debt which will drag on those economies for years to come.

The one-size-fits-all interest rate generated a misallocation of resources that amplified the boom and bust cycle within individual economies. There was also a big build-up of debt in Greece, France, Italy and other countries prior to 2008. It is important to stress that the build-up of debts prior to 2008 in most euro zone countries – Greece being a spectacular exception – was primarily a private sector phenomenon. Government borrowing only ballooned after 2008 and that was in response to the recession. It was the financial sector and private borrowing which got out of control.

Despite the drawbacks of the single interest rate, it simply is not feasible to have separate interest rates for each economy in the euro zone. So what can be done? There is a clear need to monitor a wider set of indicators than just the inflation rate. The so-called 'six-pack' rules for economic governance are intended to fulfil this role for governments.[14] However, it is also crucial for the success of a monetary union that supervision and regulation of the banking sector be conducted at the central level, including an early warning system to identify developing imbalances and advise individual member states well before things get out of hand. Centralised banking regulation and centralised bank resolution mechanisms are essential prerequisites for the long-term success of the currency union.

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Crisis Response

The official response has been to treat the euro zone debt crisis as a problem of fiscal discipline in member states. New fiscal oversight and supervisory mechanisms have been put in place and bailout mechanisms created to fund loan facilities for the countries shut out of the international markets. Access to these loan facilities has been made conditional on austerity policies being adopted by the affected member states. The result is internal devaluation and austerity in the periphery without countervailing fiscal expansion in the core countries. These policies naturally deepen the recession in the weaker countries.

The euro zone is also likely to continue to suffer from major and chronic imbalances in external payments due to the competitive weakness of some countries particularly those in the periphery. These imbalances are a continuing threat to the political stability of the monetary union. Countries can no longer resort to exchange rate devaluation to restore competitiveness and if surplus countries do not increase their own domestic demand, those with large current account deficits, such as Portugal, face a long and difficult process involving fiscal consolidation, reduced domestic demand and falling wages.[15]

The Euro Zone in 2020

It is clear there are immense political and socio-economic difficulties involved in maintaining stable exchange rates even among countries that are close trading partners and have well-developed financial markets. Changes in competitiveness are reflected in current account imbalances over time that would ordinarily be punctured through currency devaluation under a floating currency regime. In a currency union without fiscal union, the less competitive economies must instead suffer higher unemployment and lower growth as the economy rebalances. This can be a prolonged and painful process.

The weight of history and the experience of the crisis suggest that some degree of fiscal federalism is probably a necessary component of an effective and sustainable monetary union. This does not mean the euro zone has to become a full fiscal union, nor does it mean that each member state must have identical tax systems or levels of public spending. Full fiscal union is undesirable given the substantial democratic deficit that exists at the euro zone level.

Nevertheless, an intra-regional insurance system involving counter-cyclical transfers is crucial to the smoothing out of asymmetric shocks and also to ensuring the political sustainability of the euro zone in the long-run. This insurance system should be run by a dedicated institution and could be funded directly from a hypothecated tax such as a portion of member states' VAT receipts. The insurance system could be required to run a small surplus over the medium-term with its resources drawn down by regional economies based upon strict protocols, and ring-fenced for competitiveness-enhancing projects. It would effectively function as an automatic stabiliser and would ameliorate the severity of recessions.

The euro zone's lack of a lender of last resort is another missing piece of critical institutional architecture, and this design flaw downgrades weaker member states to the status of emerging economies. Giving the ESM a banking licence and a mandate to purchase sovereign bonds is a viable solution to this problem. The moral hazard issue can be managed by automatically differentiating the interest rates that the ESM offers to sovereigns – for example, by offering better rates to a member state that adheres to the six-pack rules.

If a European institution with sizable fiscal resources is created, then the quid pro quo must be better oversight and enforcement of budgetary discipline at the euro zone level. The 2008 financial crisis illustrated the vulnerabilities caused by decentralised financial regulation and oversight. The ECB's mandate should be expanded to target more than just inflation, and the ECB should be given responsibility for regulation of all euro zone credit institutions. It is clear that a common framework for regulating the financial system is required, including a common bank resolution framework.

Europe now has a choice. The euro zone can be made to work if it is properly designed. However, we must be conscious always of issues regarding democracy and social justice. The currency union has taken a disturbing turn since the crisis began, with more powerful member states appearing to run roughshod over the concerns of smaller members. Private debt has been socialised, entailing a massive transfer of wealth from ordinary people to the financial sector, while most of the democratically elected governments have been revealed to hold less power than the ECB Governing Council.

While the new six-pack rules monitor a wide range of economic indicators, it is notable that this list of indicators does not include poverty rates or income distribution or indeed any other social indicators except unemployment. This needs to change. The euro zone of 2020 should be a union that puts social justice centre-stage. While we can solve the design flaws, we also need to make sure that the European machine serves society and not the other way around.

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Notes

1. Stagflation refers to a period of stagnant economic growth coupled with high inflation.
2. The ECU was calculated based on a basket of European currencies and each national currency had a central rate against the ECU around which the national currency could narrowly fluctuate.
3. The Irish punt was devalued by 10 per cent in 1993 which greatly improved Ireland's competitiveness. The following half decade – between 1993 and 1998 – was the first time the Irish currency had ever floated. This period coincided with the fastest rates of economic growth in Ireland's history and with the emergence of the 'Celtic Tiger'.
4. The Treaty of Maastricht entered into force on 1 November 1993. Maastricht established the completion of the EMU as a formal objective for the European Union.
5. Robert A. Mundell, 'A Theory of Optimum Currency Area', *The American Economic Review*, Vol. 51, No. 4, September 1961, pp. 657–65. For a review of the relevant literature, see Luca Antonio Ricci, 'A Model of an Optimum Currency Area', *Economics: The Open-Access, Open-Assessment E-Journal*, Vol. 2, 2008-8, 14 March 2008.
6. Two of the most enduring international currency unions are the West African and Central African CFA franc unions. These currency unions have existed since 1945 and were

pegged to the French franc until 1999 and thereafter to the euro. The West African CFA has eight member states while the Central African CFA has six member states.

7. The Irish banking crisis is estimated to have cost the Irish State over 40 per cent of its annual GDP. This was far in excess of the scale of the banking crisis in any of the other euro zone countries and is a good example of an asymmetric shock.
8. Reinhart and Rogoff argue that an 80 to 90 per cent debt to GDP ratio is the danger zone for emerging economies (see Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princton NJ: Princeton University Press, 2009).
9. Paul De Grauwe and Yuemei Ji, *Mispricing of Sovereign Risk and Multiple Equilibria in the Eurozone*, Brussels: Centre for European Policy Studies, January 2012 (CEPS Working Document, No. 361).
10. Paul De Grauwe, *The Governance of a Fragile Eurozone*, Brussels: Centre for European Policy Studies, May 2011 (CEPS Working Document, No. 346).
11. The ECB provided banks across Europe access to €1 trillion in three-year loans at low rates through its Longer-Term Refinancing Operations.
12. Although the catch-all term 'eurobonds' is often suggested as a solution to the crisis there are, in fact, a wide variety of ways in which eurobonds could be implemented. See, for example, the blue bond proposal of Delpla and Weizäcker (Jacques Delpla and Jakob von Weizäcker, 'The Blue Bond Proposal', *Breugel Policy Brief*, Issue 2010/03, May 2010); the E-bond proposal of Juncker and Tremonti (Jean-Claude Juncker and Giulio Tremonti, 'E-Bonds Would End the Crisis', *Financial Times*, 5 December 2010) and the ECB bond proposal by Varoufakis and Holland (Yanis Varoufakis and Stuart Holland, *A Modest Proposal for Overcoming the Euro Crisis*, Levy Economics Institute of Bard College, Policy Note, 2011/3, 2011).
13. Daniel Gros and Thomas Mayer, *Refinancing the EFSF via the ECB*, Brussels: Centre for European Policy Studies, 18 August 2011 (CEPS Commentaries).
14. The 'six pack' refers to a set of five new Regulations and one new Directive which came into force in December 2011. These new measures aim to strengthen economic governance within the EU by increasing not only fiscal surveillance (aimed at preventing and responding to excessive debts and deficits) but macroeconomic surveillance of Member States.
15. There has been a tendency since the crisis began to conflate fiscal consolidation with economic recovery. For a wider discussion on the need for a Marshall Plan for Europe, see Tom McDonnell, *The Debt and Banking Crisis: Progressive Approaches for Europe and Ireland*, Dublin: TASC, 2011 (TASC Discussion Paper).