A NOT VERY COMMON SINGLE CURRENCY

PAST, PRESENT, AND FUTURE OF THE EURO[1]

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1. A quick overview of European monetary integration

The attributes of the sovereign are mainly three: to declare war or to negotiate peace (foreign policy), to mint coins (monetary and financial policies), and to levy taxes (fiscal policy) (Bodin 1576 [2010], pp. 74-76 and 82-83). In the past, monetary unions have first taken place within European nation states such as Switzerland (1848), Italy (1861), Spain (1868), and Germany (1871 and 1873). Monetary unions between European nation states have also taken place. This was the case of the Austro-German Monetary Union (1857-1867), the Latin Monetary Union (1865-1926), or the Scandinavian Monetary Union (1873-1931), among others. After World War II, Europe had to make real efforts to progress in monetary integration, starting with the period of the so-called European "bilateralism triumphant" (Triffin 1962), which was follow-suited by several agreements for intra-European payments and compensations (1948-50), and the European Payments Union, which constituted the first steps towards convertibility (1950-56).

During the late 1960s and early 1970s, a new wave of enthusiasm emerged with the early plans for European monetary union: the first and second Barre Plans, the Schiller Plan, and the Werner Plan. The 22 March 1971 Council Resolution paved the way for new attempts towards exchange rate stability that materialised in the monetary European snake (1972-78), and followed by the ERM of the EMS. The 1973 oil crisis postponed these institutional plans until a second wave of European idealism regained momentum in the late 1980s and early 1990s. The Delors Report on the Economic and Monetary Union (Delors Report 1989) played a major role. In turn, the 1992 Treaty of Maastricht embodied fiscal rules to conduct monetary integration while ensuring a responsible fiscal behaviour of partners.

2. The economic rationale for a successful currency area

Is the Eurozone an *optimal* currency area? Which is the characteristic that a country has to fulfil for its exchange rate to be either useless or inefficient? To answer this question we should start with an overview of the economic analyses concerning the theory of optimum currency areas (OCAs), which emerged in the 1960s as a by-product of the theoretical debate between fixed and flexible exchange rates. The *OCAs approach* singles out an economic characteristic to define an economic domain where there is exchange rate fixity *erga intra*, while there is exchange rate flexibility *erga extra*. In an optimum currency area, exchange rates fixity prevails internally without any type of internal or external disequilibrium. Each single characteristic ensures that floating or regular adjustments in nominal exchange rates are *neither necessary nor efficient or desirable* for stabilisation purposes.

The literature proposes several economic criteria: factor mobility (Mundell); openness of the economy (McKinnon); product diversification (Kenen); national propensity to inflate (Magnifico); financial integration (Ingram); and, real exchange-rate changes (Vaubel). While the OCAs approach considers the economic criteria for guaranteeing long-term equilibrium, the *cost-benefit approach* is more operational, as it focuses on the political commitment of countries to form a monetary union by assessing the resulting costs and benefits. Benefits are associated to efficiency and price stability gains, risk reductions arising from exchange rate uncertainty, and gains from using the Euro as a reserve currency; while costs relate to the loss of monetary independence, diverging preferences in national inflation-unemployment relationship, and worsening regional disequilibrium.

Some countries find difficult sometimes to abandon their respective exchange rates as a device for correcting their external imbalances. Nevertheless, there are regions of national countries that consider a good idea to remain part of an economic area and to share a common currency, despite the fact that they show diverging trends in unemployment, inflation rates, wages, non-wage costs, and productivity trends. This compares with the case of a group of EU countries with decentralised national budgets within a monetary union facing asymmetric shocks. One could put this issue differently by asking which policy response we should envisage to face of asymmetric macroeconomic shocks. To answer this question requires a discussion on fiscal issues. Monetary integration calls for some fiscal commitments from national governments. Therefore, we need to analyse the economic rationale of setting fiscal rules under a common currency area, and the resulting EU institutional frame for the Stability and Growth Pact (SGP) and the Excessive Deficit Procedure (EDP).

A centralised EU budget would provide automatic (free of charge) transfers of resources between Member States (MacDougall Report 1977); whereas, within decentralised national budgets, savings from the surplus countries are channelled, through the financial systems, as loans to the deficit countries. This borrowing increases debts in the deficit countries, and reduce their margin of manoeuvre of both fiscal and monetary policies. Furthermore, when debt becomes not sustainable in one country this can spill over negatively on other Member States. It also raises the interest rates and, thus, increases the interest burden on other Member States; and, narrows the margin of manoeuvre of the ECB monetary policy. This calls for stringent fiscal rules to stop irresponsible (free riding) policy behaviour (Delors Report 1989).

However, if financial markets were efficient in managing the financial risks properly, they would attribute different risk premia to Member States, thus, avoiding moral hazard. Yet, financial markets could still fear the contagion effect of a declaration of insolvency in one country. To avoid this fear the Maastricht Treaty prohibited the monetary funding of public deficits (art. 104 Maastricht Treaty, 123 Lisbon Treaty). Today, this makes the payment of the debt burden more difficult for Member States in the Eurozone. Further, to avoid the threat of bankruptcy in one country, the EU established the non-bail out clause (art. 104b Maastricht Treaty, 125 Lisbon Treaty); and, to avoid the threat of non implementation of the previous article 104b, the EU established the Excessive Deficit Procedure (art. 104c Maastricht Treaty, 126 Lisbon Treaty), which, together with the Stability and Growth Pact helps monitor and contain Member States deficits.

Macroeconomic imbalances resulting from asymmetric shocks within the Eurozone call for an enhanced role of labour market flexibility. In the past, when an asymmetric shock occurred and countries still required structural reforms in the markets of goods and services, and factors of production, the behaviour in nominal and real wage growth usually resulted in increased unemployment. Fiscal policy, on the other side, could mitigate to some extent the burden of wage adjustment, and could play an important role in improving productivity. In general, however, smooth shock-absorption requires a flexible wage formation process to circumvent low employment levels, but the risk of hysteresis would remain. To avoid the accumulation of wage and labour cost differentials, which finally result in a widening external cost-competitiveness divergence among Eurozone countries, wage bargaining behaviour should respect at least several rules. These norms for wage developments are the following:

(i) maintain overall nominal wage developments consistent with the goal of price stability;

(ii) keep real wage developments in line with productivity increases;

(iii) avoid wage demands to converge upwards and to catch up with wage increases in neighbour countries; and,

(iv) wage agreements should also better take into account productivity differentials according to qualifications, skills and geographical areas.

3. The launching of the Euro and the global financial crisis

After careful preparation, the ECB was created and the Euro was launched in January 2002. The *one-size-fits all* type of EU-wide monetary policy obliges the ECB to look more attentively at the economic needs of the core countries than to those of the peripheral partners. In early 2000s, Germany and France desperately needed to kick-off their stagnating economies, and exerted mounting pressure on the ECB to loose its stance. The ECB policy flooded the peripherals with a liquidity glut and fuelled speculative housing bubbles. Further, households and companies became over-indebted, and created perverse incentives for wages to grow above productivity.

Like in the 1986-92 period, domestic spending outpaced output in peripherals and translated into higher current account deficits and accelerating unit labour costs (ULCs) and prices, which were diverging between EU Member States. Peripheral's authorities were irresponsible to conduct pro-cyclical overheating fiscal policies, while core's authorities were irresponsible to allow for heavy indebtedness of their banks in the peripherals. Savings and productivity imbalances within the Eurozone reflected the deterioration of both the current account and the external competitiveness between core and peripheral countries. Improvements in core countries showed in larger external surpluses, subdued ULCs, and restrained fiscal budgets. Peripherals required bailout packages and applied internal devaluations, but core countries still show external surpluses.

In the case of Spain, the excess for liquidity fuelled the housing market bubble and exacerbated a huge external disequilibria (current account deficit of 10.5% of GDP). As from 2007, the Spanish economy underwent the worst period in the recent history since the Stabilisation Plan implemented in 1959. In 2008, what was most worrying in Spain was the perception of disorder transmitted by the Government. They limited themselves to take measures against the global financial crisis pretending this was the major and unique problem to cope with. On the contrary, the very problem in 2008 consisted in the downward shift of the potential productive capacity of the Spanish economy, we became poorer and we should have reacted on it. In 2008, we faced a domestic crisis not an external macroeconomic shock, despite the fact that citizens did not feel fully the pain of the forthcoming macroeconomic adjustment. Inaction in the economic field translated into major macroeconomic imbalances: huge external deficit, over-dimensioned and undercapitalised sectors (housing, banking), and lack of structural reforms in sectors (banking, labour market, and health) and policies (fiscal and budgetary).

In October 2008, the proposal of an internal devaluation was decomposed into two:

(i) *a unit labour costs devaluation*: by reducing wages and social security contributions, and fostering productivity, further, since as there was room for manoeuvre in terms of VAT and social security contributions; and,

(ii) *a fiscal devaluation*: by increasing VAT, which does affect export prices, and reducing corporate taxes.

In Spring 2099, Krugman proposed a *wage devaluation*, and in March 2014, the EU Commission and some Spanish economists have proposed a *fiscal devaluation.*

4. The Euro under strain

That the Euro was in trouble became evident after the financial markets' turmoil the summer of 2007. Credit markets became risk-averse and peripheral countries showed high fiscal deficits and strong debt/GDP ratio dynamics. This feature caught the eye of international investors and brought about a *sudden stop* in the external financing for the peripherals. The global financial crisis cast serious doubts about some dogmas put forward by the defenders of the libertarian capitalism, as the one on the efficiency of financial markets. Whereas in the US several episodes of bankruptcy took place within banks, in the EU the banking sector was recapitalised, fiscal measures were taken to support companies and families, and to stimulate the economy; moreover, an institutional framework was set up to improve the financial regulation and supervision. The banking and financial crisis was followed, as usual, by a debt crisis. The current crisis demonstrates that regions of a currency area cannot adjust when facing shocks because of diverging trends in both labour costs and productivity, and in the saving/investment balance. Any shock absorption would require well functioning markets, free movement of factors of production and flexible wage formation processes within the area.

In 2010-2011, successive European Summits accelerated the building up of financial facilities and rescue mechanisms to finance countries facing difficulties and to avoid the contagion effect. Political attention focussed on those funds, hiding the political nature of the Euro crisis, and masking the exchange rate and balance of payments disequilibria in the Eurozone. The sudden stop in external financing, as in 1986-92, brought about a public deficit and a financial crisis in the peripherals. On April 23rd, the Greek Finance Minister activated the aid mechanism, and some weeks later contaminated other economies. At the European Council (8-10 May 2010), the EU faced a dilemma:

(i) either to intervene financially to bail Greece out, and open the door to moral hazard, and future misbehaviour in other members; or,

(ii) to allow Greece to default, and pave the way for a contagion effect

It also created the *European Financial Stability Facility* (EFSF), the *European Financial Stabilisation Mechanism* (EFSM), both substituted by the *European Stability Mechanism* in 2012. Meanwhile, the results are credit crunch in some peripherals, like Spain, and EU-wide financial fragmentation. In March 2005, the European Council reviewed the Stability and Growth Pact (SGP). Further, the financial crisis paved the way for a wide range of institutional proposals aimed at reinforcing of the revised *Stability and Growth Pact*, by means of the following:

(i) *European Semester* (January 2011): to deepen economic policy coordination;

(ii) *Euro Plus Pact* (March 2011): to make concrete commitments of political reforms to improve the fiscal strength and competitiveness, it was initially called *Competitiveness Pact*, and later *Pact for the Euro;*

(iii) *Six Pack* (December 2011): to provide a wide range of macroeconomic indicators to improve the surveillance of Eurozone countries, through the *Macroeconomic Imbalance Procedure*;

(iv) *Fiscal compact* (March 2012): which sets up the equilibrium rule for cyclical-adjusted budget balances (*Treaty on Stability, Coordination and Governance in the EMU*;

(v) *Two pack* (March 2013): two Regulations to reinforce coordination and surveillance of budgetary processes of Eurozone Member States, namely under the Excessive Deficit Procedure, and of Member States with funding problems (*European Stability Mechanism*)

5. Alternative proposals

In my view, monetary and fiscal cooperation between Member States of the Eurozone cannot be imposed through mere compulsory rules. It also requires mutual trust, a *quid pro quo.* New budgetary rules, as they do not tackle the core of the problem, that is, exchange rate misalignments and balance of payments disequilibria will remove neither the doubts, nor the anxiety of investors when financial markets will come again under strain. Despite Chancellor Merkel statements favouring the creation of a European Treasury, it remains very unclear the reasons for her to refuse the launching of Eurobonds.

Therefore, unlike the previous institutional proposals, progress towards a *genuine fiscal union* would require:

(i) a greater coordination of fiscal policies between Member States;

(ii) a larger size and larger redistributive capacities of the EU budget to make it able to fulfil properly its macroeconomic stabilising function. We the Europeans need a common budget with a required minimal size to be used by the ECOFIN as a countercyclical macroeconomic policy device;

(iii) the introduction a genuine European tax, to increase the own resources of the EU, even though this idea is resisted by the German and French, which refuse to increase their respective EU contributions;

(iv) transfers of European funds towards less favoured regions not to subsidize incomes "but to help to equalize production conditions through investment programmes in such areas as physical infrastructure, communications, transportation and education so that large scale movements of labour do not become the major adjustment factor" [Delors Report, pp. 18-19]; and,

(v) the above resources, channelled through the EU Budget, could be complemented by credits from the European Investment Bank (IEB) and the European Investment Fund (EIF).

The latter brings us to the hot debate on a *union of financial transfers*, an issue politically unacceptable to both Chancellor Merkel and the German public opinion, which unveils the *political nature* of the crisis of the Euro. Survival of the peripherals calls for as much fiscal consolidation progress as additional financial resources (capital transfers). Capital transfers will allow the peripherals to widen their capital stock, both public and human, to increase their economies' potential output and support them to compete with core countries on a level playing field. Correcting the balance of payments disequilibria requires compensating for the natural (?) tendency for the bulk of investments and economic activity in Europe to concentrate in the *Blue Banana*: Hamburg-London-Paris-Milan.

Beyond enhanced reforms in the peripherals and capital transfers from the EU budget to them, the correction of the macroeconomic imbalances, would require continue internal devaluations of the peripheral countries, and internal revaluations in the core countries, namely in Germany. If nominal exchange changes are no possible, external disequilibria in the Eurozone can only be achieved through changes in relative costs and prices, therefore, *several alternative scenarios emerge*:

(i) *capital transfers via the EU budget*: this possibility would correct the disequilibria in the long-term, but is politically unacceptable to Germany given the huge amount of resources that this would involve;

(ii) *internal devaluations in the peripherals combined with internal revaluations in the core countries*: on the one side, through a reduction in the absorption of the peripheral economies, which will bring about a containment, or reduction, in the prices of goods, services and assets, which has already started, but has severe limits; and, on the other side, by means of a *labour costs expansion* in the surplus countries;

(iii) *a temporary accommodating monetary and Euro depreciation policies on behalf of the European Central Bank*: this would produce temporary higher inflation pressures in core countries than in the periphery. The prices of goods and services will increase more rapidly in the core than in the periphery absorbing the external deficit of the former and reducing the deficit in the later, which would avoid the dangers and costs of deflation. Central countries will suffer the economic costs of inflation and will see its savings penalised as the banks and households will recover their holdings of sovereign debt in devalued terms, better than suffering a haircut or not recovering it at all. More inflation, however, would reduce the external surplus and stimulate growth, something that would contribute both to alleviate the periphery debt payments, and to fade away the risk of insolvency that the German banks may fear on the debt holdings that they have in their respective balance sheets. Moreover, the costs of inflation would have the traditional advantage of not being self-evident and of being distributed over time; and,

(iv) *combining the previous three*: this could probably be the most plausible scenario, and it would combine capital transfers through the EU budget, internal devaluation of the peripherals and internal revaluation in core countries by wage increases. In the case of Germany, it could re-introduce subsidies to imports and taxes to exports as they already did in 1964, to penalise the exorbitant profits of exporting industries instead of putting the whole burden on the German taxpayer. It is far from being ideal, but it would redistribute the burden of adjustment in the Eurozone in a more equitable way, until the new Treaty comes into force.

The above underlines that the Euro project is strictly political in nature, while its economic rationale is still clumsy, and both rationales are today in direct conflict. Core countries, more particularly the German authorities, have to understand that no country escapes undamaged from a Eurozone crisis. Any alternative has a cost that Germany cannot escape, but there is not such a thing as a free lunch in economics, neither for Germany. The *proposal of an internal revaluation for Germany* would contribute to solve out the Eurozone crisis. There is a need to mobilise the excessive German savings by implementing a *labour cost expansion*, that is, an increase in labour costs, whether wage or non-wage costs. A *labour costs expansion* would expand the German domestic demand, and part of this expenditure stimulate German imports from the Eurozone and, thus, would be growth supportive, whereas an increase in social security charges would strengthen the generosity of the German social protection schemes.

Unlike the *fiscal expansion* proposed by Martin Wolf, a *labour costs expansion* would not penalise the German taxpayer, but the export-oriented German companies. Export companies would have to choose to either increase prices –and then loose competitiveness– or, to maintain competitiveness by squeezing profit margins (exorbitant), a feature that the German authorities do not underline quite often.

6. Looking at the *crystal ball*

Prospects about the Euro are closely linked to the management of the crisis by the ECB, and by the progress on the *Banking Union*. The banking and debt EU crisis unveiled at least three institutional weaknesses:

(i) *Real need to deepen financial integration*

1. The *Banking Union* has made an excellent progress on the *Single European Supervisory* authority will be in force in November this year (2014), and constitutes a not return point.

2. The proposal on the *Single European Resolution* authority, by contrast, is yet clumsy and the German elites are reluctant to it. The limited agreement reached of 20th March was intergovernmental and besides the Treaties.

   The mechanism has a too small financial firepower, that is, 55.000 million in 8 years, and 17.000 million for the mutualised fund by the third year. Its decision-making is cumbersome, and there is no direct link between the rescue fund and the SME.

   It is not very credible as the national authorities could will still be involved in the enactment of restructuring plans. The authorities will oblige to assume losses to the shareholders and creditors, and only then public money might still be requested.

3. In general, Member states want to keep most decision making power. As sovereign States, they do not want anybody to tell them when they should close down a bank. Further, Germany has not approved the deal, and refuses to surrender its power to close down a bank to the ECB.

4. The European Parliament and the ECB, in turn, want a full mandate to resolve an ailing bank case, swiftly and with as little bureaucracy as possible.

5. Without a deal, everything will be pushed back by several months, even into 2015. The latter could worry the markets and create mounting pressure on risk premia for the peripherals.

6. The issue at stake remains the whether there will a common rescue found or not.

(ii) Severe macroeconomic disequilibria

1. A sluggish inflation, the current surplus of the EU and expectations that this situation will remain unchanged for a while, makes the Euro appreciate, puts EU exports in jeopardy, and adds pressure again on the deflationary situation in the Eurozone.

2. The German constitutional court granted green light to the *European Stability Mechanism*. This allows Germany to contribute to the fund provided the Parliament was consulted on any commitment above €190 billion. Germany feared that its autonomy to make decisions by the Executive Committee of the ESM would be stripped, and that German people would be deprived of their right to oversee their expenditure.

3. The rescue fund would not be credible without the German support, thus, as Minister Wolfgang Schäuble said it "*strengthens the credibility of, and trust in, the euro area"* and constitutes a victory for supporters of the Euro.

4. Unlike the ECB purchasing government bonds, the ESM has a degree of democratic legitimacy. If crisis countries manage to recover within that time, their newfound financial strength, combined with the ESM as a last resort, could render the ECB programme unnecessary.

(iii) Policy mistakes from Member States

1. Reforms have been inimical to reach their aims, that is, to foster growth and reduce debts levels. The IMF has demonstrated that austerity is most damaging when it is applied at times of high debts in the private sector.

2. The traditional transmission channels of monetary policy impulses are not working any more, and the current deflationary situation makes harder for peripherals to reduce de debt/GDP ratio.

3. Further, the crisis of the emerging economies will certainly hit the EU economy in the coming quarters.

4. Avoiding the failure of the euro calls for a sound strategy for debt sustainability, which in turn requires the following:

   (i) further progress in the adjustment of macroeconomic imbalances;
   (ii) enhanced progress and shared responsibility within the banking union; and,
   (iii) put at work fiscal and monetary policies as the US and the UK have do so far, to stimulate both growth and inflation.

This change in economic approach, however, requires a new more pro-European political perspective.

1. it is imperative for the EU to swerve the present economic and financial fragmentation of Europe;

2. we need to rescue the EU from the trap of the intergovernmental and post-democratic exercise of power into which it has fallen. This would favour the come back of the so-called *méthode communautaire* to help construct Europe as a *transnational democracy*;

3. it is urgent to put an end to the opportunistic discourse of politicians, which is fuelled by the pragmatics of power, and is guided by the power of demoscopy. These politicians strip the exercise of power and of politics of any normative and moral content. In doing so, we see that Heads of State and Heads of Government *implement the federalism*

foresee in the Lisbon Treaty as an intergovernmental domain of the European Council, which aims at complying with the duties that markets impose on national budgets without any kind of political legitimacy for the resulting macroeconomic restrictions;

4. we need to legitimate the political decisions about Europe through both the National and the European Parliaments, as well as by means of the European Court of Justice. As long as the spotlight of the public opinion is trained on our national governments, European citizens will continue to perceive the building of Europe as a zero sum game. As a result, the Heads of State and the Heads of Government betray the construction of Europe by emptying it of all content when they favour the diktat of the bureaucratic elites against the political legitimacy of the EU as a supranational democratic community shored up by a legal framework (Habermas 2012, p. 77). Amartya Sen is right when he underlines that: “Perhaps the most troubling aspect of Europe’s current malaise is the replacement of democratic commitments by financial dictates — from leaders of the European Union and the European Central Bank, and indirectly from credit-rating agencies, whose judgments have been notoriously unsound” (Sen 2012)

5. German intransigence in four crucial areas must be swayed. First, the reunification, which –once the country overcomes the ignominy of being a people defeated in the war- will allow the German elites to fully exploit the advantages of a brand-new national State. Second, the non-German political authorities that are overwhelmed by their economic plights and surrender to German dominance instead of pushing forward the European project. Third, weak political leadership that renounces shaping economic and social realities, instead of exercising the power vested in it to mould reality and guide public opinion. Finally, the increasing confusion between public opinion’s demoscopy and the democratic political will of the European citizens developed in a discursive and deliberative manner (Habermas 2012, p. 114);

6. there is a need to end up with the German determination to look Eastern. After the fall of the wall and after the country had repaid its moral debts stemming form the Second World War, Germany re-directed its interest towards Russia because of its energy dependency, and for security reasons; and, to China in order to guarantee its industry exports’ markets. From 2007 onward, the percentage of German exports to the Eurozone has fallen from almost 44% to slightly above 35% in 2012; and,

7. Habermas is right when he states that “The Republic of Berlin [...] forgot the lessons that the Federal Republic learnt from history” (Habermas 2012, p. 105), and it is now embracing the road of the most pragmatic of national powers among European States. Yet, this position deprives the EU of the decision-making procedure it needs if the citizens of Europe are to work together to develop their own economic and political will. The new strategic and political course that Germany has set weakens its commitment to the construction of Europe, undermines the credibility of the German political support to the current political initiatives to complete the Eurozone, and strews Europe with little shadowless bushes, creating a hot house for future national resentments. The Euro-sceptical Chancellor Merkel and her Government would do well to learn from Chancellor Kohl and, like him, reconcile allegiance to Germany with loyalty to Europe.

The European Union is a great commercial and economic power, a worldwide savings superpower, and great powers have great currencies (Mundell 1993). The Euro is the political symbol of the European sovereignty. This is the reason why for us, Europeans, the Euro is much more than a single currency.

Now, the Euro has to become also our common currency.

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