The Euro common currency: Ties that bind

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Abstract

The euro common currency project is a currency union without a fiscal union, a banking union, or a political union. Its founding documents prohibit bailouts of member states. For banks, there is no lender of last resort, and there is no common system of bank deposit insurance. The common currency now used by 19 member states of the European Community was devised as a political device to ease trading among member states, to promote economic growth through increasing integration, and to promote peace. Most of the leaders present at the EU founding hoped for an eventual political union, a banking union, and a fiscal union, but the general public has not yet been willing to sacrifice their national sovereignty to create such institutions. With each recession or financial crisis, the euro project is threatened. The policy question now is how to determine the proper role for the euro as Europe sets a path toward sustainable and peaceful economic growth in a world of globalization and nationalist politics.

1. Introduction

Eurozone monetary policy is consolidated at the European Central Bank (ECB), but fiscal policy resides with each member state. Very recently steps toward a banking union have been made by starting to regulate centrally the largest banks. The Eurozone has had the euro in place for more than 15 years and has weathered the cycle of growth and recession. Austerity measures imposed on the southern tier are causing economic distress, while the northern ties nations are comfortable. It is timely that we should assess the success and the future of the euro.

The current Eurozone project is the fourth attempt in Europe for a common currency. In 1838 the German Monetary Union was formed by the Northern German Confederation, the Kingdom of Bavaria, and the Austro-Hungarian empire. It eventually failed during World War I. The Latin Monetary Union was formed in 1865 by Belgium, France, Greece, Italy, and Switzerland, and it broke down in 1926. The Scandinavian Monetary Union was formed in 1872 by Denmark, Sweden, and Norway. It failed at the beginning of World War I in 1914. (See Chorafas, 2013a, pp 176-180). Only time will tell the fate of the euro.

Successful monetary unions require parallel fiscal unions and strong fiscal discipline. The Maastricht Treaty (1992) did not include such provisions. A side agreement, The Stability and Growth Pact (1997), specified required fiscal standards for admission to the European Community (EC). Each member was to hold their annual inflation rate to 3%, to limit annual fiscal deficits to 3% of GDP, and to keep their national debt below 60% of GDP. Very few nations have achieved these standards without "creative accounting".

2. The Evolution of Nation States and Central Banking

Throughout history a series of monarchs, emperors, and kings have fought to capture and hold territory. For the past 10,000 years until the twentieth century, strong rulers amassed great armies, attacked their enemies, and captured their people, land, animals and other forms of wealth. Defeated peoples were taken captive or forced to pay taxes to the ruler. Rulers used the taxes and the labor of slaves to enrich their empires and to build up military strength for future excursions.

This process typically continued until a new threat emerged to wrest control from the incumbent. Within Europe, the Romans, Germanic tribes, Saxons, Austrians, and others have struggled to assemble empires and to master trading over great distances. In some cases, families held power for many generations. Mercantilist nations sought to build wealth and power through colonization of distant lands with valuable resources. Trade in gold, furs, cotton, tobacco and other luxuries lifted the standard of living for a growing class of merchants and artisans. That process has led to an organized system of nation states to govern people and territory. National borders are mostly well established. Now we are at the stage of treaties among nations and potential combinations of nations to form a more perfect bond.

By the fifteenth century, Europeans explored and dominated the world while establishing massive trading networks and market mechanisms. These massive trading and production networks became possible only after Europeans achieved stable nation states that could regulate markets and protect their interests with strong Naval forces in remote regions. Each nation state controlled its monetary and fiscal policy, and it lived with the consequences of its actions.

As nations developed, they formed alliances with other nations for common purposes, such as to promote trade or to reduce the chance of war. The early EU leaders saw the common currency as a step toward fiscal union and banking union that would promote economic growth and peace. Proper governance of money remains an unsolved mystery in the eurozone.

3. The End of Fixed Exchange Rates

At the end of World War II, the major industrial nations met in conference at Bretton Woods to plan a transition to civilian life. They established the International Monetary Fund (IMF), the World Bank, and the General Agreement on Tariffs and Trade. In addition, a system of fixed exchange rates was established under which each nation pledged to keep its currency within a stated range of other currencies - by buying or selling their currency as necessary. After a few years this system became a burden to some nations, because their fiscal policies differed. Until 1971, the US stood ready to redeem dollars for silver, but that policy was terminated by President Nixon. That spelled the end of the system of fixed exchange rates, and since then the world currencies have been valued by market forces. Not surprisingly, some nations have attempted to guide the value of their currency to smooth out fluctuations or to gain competitive advantage for their exports.

The new era of flexible exchange rates made international trade more costly for nations that ran budget deficits and had higher inflation. In the 1970s European leaders began discussions of a common currency that would eliminate cross-border exchange rate volatility within Europe and facilitate trade and investment. The northern tier states, led by Germany, feared moral hazard and wanted strict limits on national debts and deficits. The southern tier states, led by France, preferred a more forgiving structure that could assist nations in difficulty – potentially with cash transfers from the other states. Some in the southern tier of Europe would like to see “Eurobonds” issued and guaranteed by the EU (and the possibility of debt forgiveness), but the northern tier states, especially Germany, oppose that idea as a promotion of moral hazard. (See Blyth).

4. Basic Requirements for an Embedded Common Currency Regime

Robert Mundell pointed out that in a common currency area, exchange rate adjustments would not be available to address external economic shocks. In case of an external shock, internal adjustments would be needed to stabilize the national economies. These could take the form of austerity measures or transfers from other member states. If such measures were not forthcoming, then national economies could not restore equilibrium, and the people and firms in the lagging economies would suffer high unemployment, falling incomes, and reduced public services. With separate currencies, affected nations could devalue their currency, and that would help to increase exports, reduce imports, increase employment, and improve the balance of payments. (See Mundell).

Additional factors that would facilitate a rebalancing of weakened economies can be free mobility of labor and capital across borders. (See Mundell, 1971).

Mundell and others have developed the theory of an "optimal currency area". No actual common currency area in history has met all the theoretical requirements, but a review of these requirements can shed light on the current problems in the eurozone and the prospects for the euro in the future. A group of nations sharing a common currency must have in place similar institutions that allow a single nation to maintain a healthy economy. Foremost is a political union that can translate the will of the people into laws administered by a legitimate government. In modern states, since the days of the Enlightenment that has meant some form of democracy. If a group of nations come together to adopt a common currency, the political union that would be necessary would involve a sacrifice of sovereignty to some extent. Member states would need to become subject to political decisions made by others. Another requirement of a successful common currency area is a banking union, which must include a central bank as a lender of last resort, supervision of banks, resolution authority over failed banks, and a system of deposit insurance. Such a banking union could lead to cash transfers to nations in difficulty, which the more wealthy and stable nations may not accept. And finally a fiscal union is required for a successful common currency, which requires each nation to balance its budget or limiting deficits, and control its external debt. A fiscal union may allow the issuance of common debt instruments backed by all member states. Such a set of institutions limits the options of member states and reduces their sovereignty. (See McNamara, pp 21-32).

When the economy of each member state is healthy and in balance, the common currency area works well. It is in times of stress or crisis that the common currency area needs the political union, the banking union, and the fiscal union to be in place and functioning smoothly. In 2000-2007 the EU enjoyed a healthy economy. Once the US subprime mortgage crisis emerged in 2007, it lead to a worldwide financial crisis in 2008, including the Greek debt crisis and the banking crisis in Spain, Italy and Italy. These events exposed the limitations of EU institutions. To some extent the EU authorities crafted policy on the fly, in consultation Germany and France, and with some rulings from the courts. An important lesson to be learned here is that when forming a common currency area, necessary institutions and arrangements must be put in place in advance.

5. The Beginnings of a European Common Currency

In 1951 the European Coal and Steel Community was formed as the first effort to achieve a "common market" in Europe. The Treaty of Rome in 1957 established the European Economic Community. The Common Agriculture Policy evolved in the 1960s. (See Matthijs and Blyth and James).

During the 1980s the major European nations used the European Exchange Rate Mechanism ("snake") to manage exchange rates among nations. It became increasingly more difficult for some nations to abide by the agreement. The value of the US dollar declined in 1977-78 and that led Europeans to look for an alternative to the dollar as a reserve currency. This uncertainty about the value of the dollar led to the creation of the European Monetary System in 1979. (see James, p 10).

Political events also prompted European action. In 1989 the Berlin Wall fell, leading to the reunification of Germany. European leaders formed the Economic and Monetary Union (EMU) to seek "an ever closer union", and to present a united European front to the forces of globalization that were rising around the world. European leaders also believed that this "ever closer union" would promote trade and peace, after so many centuries of war and jockeying for power and land in Europe. The result was the Delors Report in 1989. This report by the European Commission led directly to the Treaty of Maastricht in 1991 and the adoption of the principle of "the free movement of capital, goods, and people". The euro was adopted as an electronic common currency in 1999, and euro currency and coins began circulating in 2002. (see Matthijs and Blyth, pp 2-6).

6. The Missing Political Union

The European Parliament has been largely excluded from the decision-making process related to the euro. Monetary policy is vested in the ECB, and fiscal policy is set by each nation with EU guidelines, which are often ignored. Fiscal guidelines have been set by the European Commission with little input from the European Parliament (see Schmidt, pp 96-114). Many important decisions are made by bureaucrats, and formal rule changes must be made by treaty, which require unanimous consent of the 19 nations. Some people in Europe have been frustrated by the power vested in the EU bureaucracy, and this frustration has contributed to exit or populist movements in the UK, Spain, Greece, Scotland, Poland, and others.

When the European sovereign debt crisis erupted in 2010, technicians rather than elected representatives, established the European Financial Stability Facility (2010), the European Stability Mechanism (2013), and a limited banking union (2013). Throughout Europe the average citizen has not participated in these actions, and unfortunately there is a huge divide between the goals and methods desired by the people in the core northern tier nations (Germany), and those in the southern periphery nations (France, Italy, Spain, Portugal, Greece). One suggested reform, for example, is for the European Parliament to elect the President of the European Commission. (See Schmidt, pp 94-96).

7. The Euro in Times of Financial Crisis

Following several financial crises, central bankers and the Bank for International Settlements (BIS) have worked to regulate banks and encourage increased bank capital. Bank capital standards have been tightened and "risk adjusted". This means that for commercial banks sovereign debt of any member nation required no capital banking, while mortgage-backed securities required some backing, and whole loans required the most backing. Clearly the credit risk of nations fluctuates over time, but political considerations prevented bank capital standards from reflecting these differences. So, over many years, banks in Europe have bought higher yielding bonds issued by southern tier nations to increase their portfolio yield. This policy led to a large capital flow from banks in the northern tier states to governments in the southern tier ("target funds"). When a southern tier nation threatens to default, the safety and soundness of the large commercial banks across the Eurozone is at risk. (See Sinn, pp. 38-80).

A common currency across nations with a single central bank controlling monetary policy necessarily imposes the same monetary policy on all participating nations. If nations adopt differing fiscal policies, then the performance of their economies will differ, and coordination of fiscal and monetary policy will not be achieved. The absence of a banking union exposes the higher risks and interest rates in southern tier banks, so bank deposits flow to northern tier banks. As a result, the common monetary policy will serve some nations to the detriment of others. This result has emerged in the Eurozone today, as the euro common currency has driven nations apart rather than producing convergence.

8. The Strong Influence of Germany

In 1990 West Germany and East Germany embarked on a massive reunification effort. A fundamental principle in the German Basic Law is parity of living standards across the federal states. To achieve this goal, Germany imposed a special income tax and transferred more than one trillion euros from west to east over ten years. In some cases, public facilities in the east greatly exceed the quality of facilities in the west. As a result, within Germany increasing public opposition to the transfers has occurred. This experience has turned German public opinion against public transfers and has made people weary of moral hazard. This same feeling is applied to the southern tier nations as they need assistance to cope with unemployment above 25%, rising taxes, cuts in pensions, and deteriorating government services – all worsened by the austerity policies required by the "troika" of the ECB, the European Commission, and the IMF. (See Newman, pp. 117-130).

9. The Subprime Mortgage Crisis

The US was faced with a crisis in the subprime mortgage market in 2007. That US crisis directly led to the worldwide recession and banking crisis in Europe in 2008. The subprime mortgage crisis resulted from poor mortgage policy since 1992 which required the housing agencies, Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Association (Freddie Mac), to buy an increasing proportion of mortgages issued to lower income home buyers. The target proportion of mortgages made to lower income buyers was 26% in 1992, and by 2005 the target was 55%. Fannie and Freddie could achieve their assigned targets only by reducing lending standards, which they did. By 2005 many residential mortgages were being issued with no down payment and no verification of income. There was rampant speculation in some real estate markets, such as Florida and Las Vegas, because developers could use the prevailing very low interest rates and adjustable rate mortgages to attract new buyers. Excess demand drove real estate prices to record highs, attracting additional buyers. Many of these "subprime" mortgages eventually defaulted. Because almost all agency mortgages are pledged as collateral within mortgage-backed securities (MBS), the investors who owned MBS noted the rising mortgage delinquencies in 2007 and started selling, causing MBS market prices to fall. Although the MBS were not obligations of the US government, it was quickly decided in December 2008 that the agency MBS would be guaranteed by the US government, and the agencies were brought under conservatorship of the government, where they remain today. The federal government injected $184 billion into these agencies in exchange for preferred stock. The agencies have now returned to profitability, and more than that amount has been repaid to the Treasury in the form of dividends.

10. The European Sovereign Debt Crisis: Testing the Euro

The US sub-prime mortgage crisis spread worldwide, leading to a European sovereign debt crisis in 2009-2012. This crisis in the Eurozone exposed the faults of a common currency and common monetary policy. Greece came close to defaulting on its bonds in 2010 (and again in 2012), and the crisis could have led Greece to exit the Eurozone. Banking systems of Ireland, Spain, Portugal, and Italy were at risk. EU rules did not allow direct bailouts, and extraordinary measures were taken to avoid a collapse of the euro or the exit of a member nation (Greece). Several nations in the southern tier were in recession with unemployment rates above 25%. Meanwhile nations in the northern tier were enjoying relatively strong economic growth and full employment. Because of the common currency, none of these nations could use devaluation to balance their economy.

In a system of flexible exchange rates, devaluation can help restore balance and equilibrium. A nation in recession can devalue its currency relative to the currencies of its trading partners. That boosts productivity and makes the weak nation's goods cheaper to others, increasing exports. The devaluation also reduces imports by making them more expensive at home. The resulting improvement in the trade balance adds to GDP and helps the weak nation restore economic performance and jobs.

Because devaluation is not possible within a common currency area, a weak nation must undergo an "internal devaluation" by cutting government spending, including wages and pensions, and increasing taxes. This policy of austerity has been required of Greece by the "troika", consisting of the European Central Bank, the European Commission, and the International Monetary Fund, in exchange for financial assistance. Greece remains in recession with unemployment above 25%.

To the extent that austerity policies weaken the economies of already weakened nations, they encourage skilled workers to depart for better opportunities elsewhere. This effect leaves fewer taxpayers to shoulder the tax burden at home. Austerity policies also promote relaxed local regulations, as nations compete to attract industry and investment. (See Blyth, pp. 178-226).

The austerity policy forced by the troika has been criticized as counterproductive and destructive. (See Stiglitz, pp 177-213 and Blyth, pp. 51-93). The alternative to austerity could be massive government deficit spending financed by Eurobonds, and debt forgiveness. In addition, a move away from austerity could include a broadening of the ECB mandate from only controlling inflation to also achieving economic growth and full employment. The northern tier states dominate the EU institutions and strongly resist such policies.

11. The European Central Bank and Outright Monetary Transactions (OMT)

Mario Draghi, president of the European Central Bank (ECB), announced in September of 2012 that the ECB would stand ready to purchase "unlimited quantities" of European sovereign bonds in the secondary market. That was soon after his statement of July 2012 that he would do "whatever it takes" to save the euro. This new policy, called "Outright Monetary Transactions", would be subject to certain conditions for nations in financial crisis. OMT appears to violate the Lisbon Treaty and the Fiscal Compact, and it is strongly opposed by German and other officials. Any such bond buying was to be "sterilized", meaning that the ECB would borrow the funds from the banking system to execute bond purchases, so the money supply would not be increased. This strategy was designed to satisfy those concerned about potential inflation. Concerns about moral hazard remain, as sovereign nations would face reduced pressure to control their deficits and debt. (See Chorafas, 2013, pp. 119-143).

The ECB and southern tier nations remain intent on propping up the financial system and postponing the day of reckoning when budgets are balanced and debt is under control. Some seem to hope for eventual forgiveness of debt or a period of robust growth that will restore solid financial strength. The northern tier nations that would have to finance such relief are in no mood to cooperate with such an outcome.

12. Alternative Solutions of the European Financial Crisis

Among the most powerful leaders of the EU institutions, the majority viewed the financial crisis in the southern tier nations as largely a result of excessive government spending, overly generous pensions, local corruption, and ineffective collection of taxes. These same leaders, dominated by Germany, feared moral hazard and were strongly opposed to debt forgiveness or cash transfers to nations in distress. The solutions to the financial crisis implemented by the troika involved creative ways to extend credit while imposing stringent austerity measures in the southern tier. The troika insisted on wage cuts for government workers, pension cuts, increased taxes, and reduced public spending. These measures deepened and extended the recessions in the southern tier, where there was no possibility to use monetary policy to restore equilibrium. There has been considerable debate as to whether such austerity measures can work or are appropriate in such a situation. (See Blyth, pp. 51-93). The stark reality is that continuing problems in the southern tier nations are high unemployment, falling or stagnant real growth, and continuing deficits. There is little evidence of a congruence among the nations of the Eurozone to achieve an "ever closer union".

As previously stated, a sound economy for a nation or for a region depends on effective coordination of monetary policy, fiscal policy, and trade policy. Within the Eurozone, a common monetary policy has been adopted with the establishment of the European Central Bank. Although the Stability and Growth Pact set fiscal goals for deficits and debt, these goals have not been achieved by some nations – mostly those in the southern tier. Possibly the only way to achieve these fiscal goals is through a fiscal union. Such a mechanism would require a supervisory board with authority over taxation and expenditure matters within each member state. Traditionally, elected politicians have made these decisions. Usually the forms of taxation and exemptions, spending categories and exceptions, timing of payments, and the use of creating financing very in each nation. For a supervisory board to have full control of these issues would restrict the powers of elected politicians and invade the sovereignty of member states. It seems that the member states could never agree to such controls over their current powers. If so, then a fiscal union cannot be successfully implemented. The next possibility would be a political union.

A political union would be a mechanism to jointly decide on matters of fiscal and monetary policies. Such a mechanism would retain the decision powers of elected representatives, but it would make each member state subject to majority rule in some form. The experience of Europeans since 1999 with the European Commission in Brussels indicates little public support for strengthening the powers of agencies beyond national borders. For example, public referendums on the Lisbon Treaty failed in France, Holland, and Ireland until references to "a closer political union" were removed. (See Chorafas, 2013a, pp. 171-194).

13. Conclusion

If none of these steps can be successfully implemented to stabilize the euro, then we will need to consider how the euro regime might end. There always will be financial crises, and each crisis seems to call for emergency lending, bank bailouts, drastic central bank policy, or even cash transfers or debt forgiveness. Each financial crisis is different, and each one places new stress on the Eurozone institutions and ability to restore calm to the markets. We may eventually arrive at the point where an end of the euro is the best choice. There are several ways this result may play out.

After the Greek brush with exiting the Eurozone in 2010-2012, it seems likely that one or more weakened states might exit, leaving most members and the euro in place. Issues of redenomination of debt would have to be negotiated. An alternative could be that one or a few healthy members, such as Germany, might grow weary of periodic crises and decide they are better off with their own currency than with the euro. A third scenario could be that the Eurozone splits into two regimes with a "northern tier euro" and a "southern tier euro". Within each region, internal and harmonious fiscal policy might be much easier to achieve.

While we cannot know what the future holds for the euro, the repeated stress of financial crises, bailouts, and "whatever it takes" policy may force a new direction in the Eurozone.

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