TIGER

TRANSFORMATION, INTEGRATION and GLOBALIZATION ECONOMIC RESEARCH

CENTRUM BADAWCZE TRANSFORMACJI, INTEGRACJI I GLOBALIZACJI

TIGER **Working Paper Series**

No. 129

The Euroarea: Premature, Diminished, Divergent

Mario Nuti

Warsaw, October 2013

Mario Nuti[1]

Abstract

The main causes of the current Euro crisis are: 1) its premature birth, before the earlier stages of political and fiscal integration, and integration of defense and foreign policy; 2) the diminished nature of the European Central Bank, which is not only independent, like the Fed, the Bank of England or the Central Bank of Japan, but also – unlike those sister institutions – forbidden to purchase government bonds; and 3) the increasing divergence of the monetary, fiscal and real parameters of the member states. An exit from the Euroarea would not provide a solution to the crisis, because of the tight fiscal discipline to which exiting Euro members would still be subjected, and the high cost of leaving the EU altogether. It seems preferable to promote further progress towards the creative evolution of the ECB, and the relaxation of EU austerity, perhaps threatening such an exit with vigour and persistence.

[1] Professor Emeritus, Sapienza University of Rome, dmarionuti@gmail.com, Website http://sites.google.com/site/dmarionuti/Home Blog "Transition": http://dmarionuti.blogspot.com/

The Euroarea: Premature, Diminished, Divergent

1. Expected Benefits and Costs of a Common Currency

The formation of a Common Currency Area is usually expected to generate at least seven gross benefits for its members.

First, a reduction of transaction costs, such as the cumulative cost of converting one currency into another (and then another).

Second, an increase in competition, given the greater transparency and comparability of prices once they are all expressed in a common currency.

Third, a reduction of the rate of inflation, if the management of the common currency is subjected to greater discipline by an independent Central Bank targeting low inflation.

Fourth, the elimination of exchange rate risk in transactions among member countries within the common currency area.

Fifth, a lower interest rate associated with both lower inflation and the elimination of exchange rate risk.

Sixth, in addition to all these factors expected to promote trade integration within the area, the promotion of greater foreign investment, given the investors' ability to repatriate profits freely in the same currency in which they are earned.

Finally, there are the benefits expected of greater financial integration, which would provide among other things a form of implicit insurance against asymmetric shocks.

Conversely, there are also at least three gross drawbacks to be expected by the members of a Common Currency Area. First, the loss of national monetary policy, potentially serious in case of asymmetric shocks. Second, the loss of the national exchange rate as a policy instrument, especially the loss of currency devaluation as a means to enhance national trade competitiveness. Third, the fiscal discipline involved for national governments by membership of the Area.

On balance, there is an expectation of positive net benefits from the establishment of a Common Currency.

2. Actual Benefits and Costs of the Euroarea

The creation of the Euroarea has resulted in a mixture of actual benefits and drawbacks of different sizes, trends and net balance over time. Savings in transaction costs in currency conversion clearly have been grossly exaggerated, since those costs are incurred only for a possible currency mismatch between monetary revenues and expenditures. Prices can be easily expressed in any currency chosen as numéraire, so that greater transparency is a delusion. Inflation has been tamed successfully by the European Central Bank and brought down below the best earlier performance of the Bundesbank, but by 2013 labour unemployment has reached record levels in the Euroarea. Interest rates have fallen with the introduction of the euro and gradually have converged to roughly a uniform low level maintained for seven and half years until 2010 when the spread between national borrowing rates and the lowest rate paid by a member country (Germany on its long term Bunds) has widened spectacularly, together with the cost of insuring against country default with CDS (Credit Default Swaps). Banking integration within the Euroarea turned into a mechanism of contagion. Asymmetric shocks – a serious concern when the Euro was established – have not been a major problem, but the inability to implement an external devaluation has brought about alternative and costly measures of internal devaluation i.e. deflation of wages and prices. Fiscal discipline in the form of concerted austerity, within the whole Union and not only in the Euroarea, has depressed GDP and employment in the area as a whole and especially in the Southern members states, to a greater extent than the resulting reduction of debt thus raising debt/GDP ratios and widening their divergence (on this point see below).

Since the Greek crisis of 2010 and successive crises in other member countries the possibility has been seriously and widely discussed of the Euro-area splitting into its national components with the restoration of national currencies, or at least splitting into groups such as a Nordic and Southern group with a currency respectively stronger and weaker than the Euro as it is today. (See Cambridge Journal of Economics, Special Issue on Prospects for the Eurozone, Volume 37 Issue 3 May 2013, downloadable free of charge). While initial calls for Euroarea break-up were initially expressed by rightwing circles, recently they were joined by leftwing circles (for a critique see Andrew Watt, Why Left-wing Advocates Of An End To The Single Currency Are Wrong, 10-07-2013).

3. The Euro-Area: three failures

The Euroarea has suffered greatly from two major design failures, which are the original sins of the Common Currency, and from the member states' increasing divergence from a common economic pattern instead of converging.

The first failure consists in the Euro's premature birth. The Common Currency was supposed to be the very last stage of economic integration, "crowning" all the other prior stages: after political integration, after fiscal integration including a European budget on a large enough scale to allow for a European fiscal policy, after defense and foreign policy integration. Instead of which when the euro was set up, and still today, there is no European government, but only a movable collection of national Ministers that mostly legislate in place of a Parliament which remains largely a debating Club, next to a powerful European Commission of unelected Commissioners and powerful civil servants with executive powers, while policy-making remains at the inter-governmental level. The European budget was set at a derisory 1%-2% of European GDP (instead of around 20% as the US Federal Budget) and always balanced ex-post (thus without the possibility of a primary surplus, let alone one large enough to service bonds issued by the EU, which in any case the EU has no need or reason to issue because it is not allowed to run a deficit). In both defense and foreign policy only the first embryonic, bureaucratic steps towards European integration were taken.

The approach followed in Euro creation was the exact opposite of what it should have been, technically, not to mention democratically: the Common Currency was established out of sequence deliberately, precisely so as to create, through a kind of "controlled dysfunction", the pressures and tensions that it was hoped would push forward "la finalité politique" and all the other integration stages that are still missing. This was a risky strategy that worked only temporarily and should have been rapidly followed, but was not, by filling in the missing stages in order to succeed.

The second failure of the Common Currency design was the creation of a diminished European Central Bank. The ECB was made independent – following the then fashionable theories of rational expectations and the alleged lack of a trade-off between inflation and unemployment associated with them – like the US Federal Reserve, the Bank of England and the Central Bank of Japan. However – unlike these sister institutions but on the Bundesbank template – the ECB was also totally disconnected from fiscal policy. The ECB was supposed to target inflation at a rate below 2%, though close to it; to disregard employment concerns unless and until the inflation target was met, but above all was prevented from buying government bonds whether they were issued by Europe (which the EU was not supposed to issue, other than through the European Investment Bank) or by member states. And when it was set up the ECB did not have any of the other traditional functions of a Central Bank: bank supervision, bank re-capitalisation and resolution in case of insolvency, deposit insurance – all functions that were retained by National Central Banks, and still are except for some devolution in progress of bank supervision to the ECB.

Inability to fund public expenditure, to supervise, re-capitalise and resolve banks and insure deposits made the ECB only half of a Central Bank, or possibly even less than half. There have been initiatives to establish some version of a "banking union": strictly speaking there is no such a thing, and one would look in vain for such an institution in the textbooks on International

Integration. There are only make-shift provisions to somehow alleviate the lack of those traditional Central Bank functions on the part of the ECB.

The third failure of the Euroarea is, after almost 10 wasted years of successful operation with low and uniform interest rates, the EMU member states' failure to converge to the statutory parameters fixed by the Maastricht Treaty for EMU accession and by the euphemistically labelled Growth and Stability Pact for all EU members. This is true both of monetary convergence – of long term interest rate on 10 year government bonds, and of the rate of inflation – and of fiscal convergence maintaining the budget deficit and public debt respectively below 3% and 60% of GDP. EMU countries also failed to converge to other, real parameters that had never been targeted but – in view of the Euroarea premature and incomplete design – should have been targeted, like labour unemployment, unit labour costs (wage rates possibly remaining uneven but proportional to labour productivity), the trade balance, the share of bad loans in bank portfolios. Instead of converging, the relevant parameters of Euroarea members have become increasingly divergent during the recent crisis.

A premature birth would have been alright if the European Central Bank had been designed on the Bank of England or the Fed or the Bank of Japan template instead of the Bundesbank. Neither a premature birth nor a diminished Central Bank would have mattered if member states had converged to common monetary, fiscal and real parameters. But the combination of these three failures, including increasing divergence, is lethal. The Euroarea as it is today might be able to struggle on still for an unspecified time, but ultimately is undoubtedly doomed.

4. Recent Developments

In 2010 the interest rate spread widened between the Southern members of EMU and the most "virtuous" Nordic members of EMU, notably Germany – indeed too virtuous in view of its excessive success in promoting net exports currently of the order of €210 bn or 6% of its GDP, without any mechanism or policy attempt in Germany or in Europe to eliminate or even reduce that imbalance that has been very damaging to all other EMU and EU members and ultimately to Germany itself.

The history of the following three years to date is that of partial, slow and ineffective improvements, and of the courageous and imaginative unconventional measures introduced by the ECB President Mario Draghi to make the ECB function almost like a genuine Central Bank against stern German opposition.

In 2010-2013 two temporary EU funding programmes provided instant access to financial assistance to Euroarea member states in financial difficulties: the European Financial Stability Facility (EFSF) and the European Financial Stabilisation Mechanism (EFSM). In September 2012 they were replaced by the permanent ESM (European Stabilisation Mechanism, while the

EFSF and EFSM will continue to manage transfers and programme monitoring for the earlier bailout loans to Ireland, Portugal and Greece). However the ESM was somewhat under-funded (€500bn) to be able to cope with a large-scale crisis that might include at least one of the larger member states, and subject to the adoption of recessionary austerity and painful reform programmes under Troika supervision (EC, ECB, IMF).

Two new unconventional instruments were introduced by the ECB under Mario Draghi's leadership, in order to restore monetary transmission mechanisms: Long Term Re-financing Operations (LTROs), through which the ECB provided injections of low interest rate funding to euro zone banks against wide-ranging collateral, and Outright Monetary Transactions (OMT) through which the ECB could purchase government bonds of troubled countries in the secondary markets – a master stroke whose sheer announcement has had a stabilizing impact on financial markets without the ECB spending a single cent yet. Recently interest rate cuts were made, down to a record low of 0.5% and announced to be persistent and possibly ready to fall further down to reach the negative range.

These developments have been persistently opposed especially by German representatives within the ECB Board and challenged as improper or outright illegal (including by bringing complaints to the German Constitutional Court in Karlsruhe). Germany also has been opposing vigorously any suggestion of even partial mutualisation of debt within the Eurozone through the issue of Eurobonds subject to collective and several responsibility of member states – an understandable objection as Germany would risk to end up with sole responsibility as the most creditworthy party (though similar operations both in the early stages of the United States Federation and in 1862 in United Italy are said to have been advantageous to all parties involved).

Of course the ECB has access to large-scale resources which are not recorded in its balance sheet, namely the present value of its seigniorage on the Euro (the profits obtained from monetary base issues, the interest obtained from the investment of past issues, the anticipated inflation tax i.e. the loss in real value of the stock of monetary base caused by expected inflation, as well as the unanticipated inflation tax).

The present value of ECB seigniorage was estimated by Willem Buiter to have a present value of the order of €3.3 trillion (in "The Debt of Nations Revisited: The Central Bank as a quasi-fiscal player: theory and applications", 2011). Its use to retire a sizeable part of Euroarea members' debt in the same proportions in which they hold ECB shares would solve the Euro crisis without transforming the Eurozone into a "Transfer Union", as it would not involve any redistribution across member states. Potentially inflationary consequences of such an operation could be neutralized by reducing the size of the ECB balance sheet (selling assets and reducing loans), sterilizing monetary liabilities, raising obligatory reserves and raising the remuneration of excess reserves in order to induce banks to keep them inactive. However this kind of operation would go against the grain of German and other Nordic members' monetary conservatism and is unlikely to be undertaken.

Hopes have been expressed of a softening of German opposition to the creative transformation of the ECB, or at least of its staunch support for austerity, after the German elections of September 2013. But there are always frequent elections in every country at the national, regional and/or at the European level (next in 2014), and German opposition does not encourage the notion of a change of mind even in unlikely case of political alternation in power.

5. What now?

The missing integration stages and the missing institutions could be filled in, and convergence promoted more seriously and vigorously than in the past. It is not clear whether all this could be done far enough and fast enough to resolve the current crisis, but this is unknown and is not a good reason not to try. Or the Euroarea – as it is being suggested with increasing frequency – should and will split into its member countries, or possibly into a Nordic and a Southern currency areas with different common currencies (it has even been suggested that the two currencies might still be managed by the ECB with different targets and policies).

By exiting the Euroarea and restoring a national currency, a country would be able to conduct its own monetary policy, presumably reflating its economy and choosing its own desired trade-off between inflation and unemployment. It could, if it wished, choose a Central Bank template still independent but also able to fund government expenditure (like the Bank of England), except that this might not be much use seeing that even by exiting EMU a country, as long as it still remained in the EU would have to adopt austerity policies, imposed on all EU members by the so-called Growth and Stability Pact.

The exiting country could restore international competitiveness via nominal devaluation of its currency, instead of having to do it via painful and unpopular internal deflationary policies of wage and prices. And it could default – unilaterally or by agreement with its creditors – and bail-in creditors thus reducing its debt, as it could if even it remained a member but without having to agree with the Troika (EC, ECB, IMF) the terms of the bail-in and without ECB and EC (but possibly still with IMF) assistance. Of course, EMU membership remaining one of the requirements of EU membership, a country leaving the Euroarea would sooner or later, if not at once, have to leave the EU – a non negligible cost of Euro exit.

Exit from the Euro might be forced onto a country by a bank run, in conditions in which the ECB cannot guarantee emergency liquidity assistance: such situation was approached in Cyprus in 2013 when the government initially failed to agree on the terms imposed by the Troika for bailing-in its banks. At that point the only way to maintain liquidity would be the introduction – by the National Bank or the Treasury – of a national currency, say a National Euro, initially issued at par with the Euro. Subsequently the new national currency would inflate and devalue, for it would have to float so that the euro does not disappear from circulation due to Gresham's law. Indeed the new national currency would probably inflate and devalue at shockingly high rates. Interest rates in the new currency as a result would increase fast relatively to those of the euro. Euro exit by several small or just one large country would probably trigger off a run on the banks of other weak Euroarea members and unleash an unnecessary domino effect.

If and when the new national currency regained parity between its floating rate and the rate at which it had been originally issued against the euro, the operation could be reversed: the country could re-join the Euroarea and the National Euro converted back into Euros. Until then Euro cash would become foreign exchange in the hands of households and companies, current accounts and all debt and credits would be converted into the new currency at par, which by itself would reduce the size of all debt. International debt technically would remain nominally denominated in Euro or other foreign currencies (at least for the greater part of debt incurred under English Law), but creditors would have to resign themselves to debtors' default and to de facto bail-in. Devaluation would improve competitiveness if it was real (nominal devaluation not being offset by higher inflation) and sufficiently large.

Frequently there have been suggestions that the new national currency should not replace the Euro but circulate in parallel with it. Unfortunately there are no miracles in economics, a parallel currency would be a messy and doubtful solution. Considering that internal devaluation and default are options even within the Euro, and that fiscal discipline remains one of the obligations of EU membership even for a country exiting the Euroarea the only advantage of leaving the Euro would be greater freedom to default, at the cost of losing some European support by the EU and the ECB, but still subject to both assistance and conditionality by the IMF.

In conclusion there would not be much of a net gain from Euroarea exit, especially considering that exit with default would bar a country from access to international markets for longer (up to twenty years or so) than orderly default and bail-in as in the cases of Greece, Ireland or Cyprus.

As for Germany (and possibly other Nordic countries) leaving the Euro, as recently suggested by George Soros, their exit probably grossly under-estimates German losses from revaluation of the Nordic vis-à-vis a hypothetical Southern Euro.

6. "If I wanted to go to Rome I would not start from here"

Clearly if one had wanted to construct a Common Currency Area one should have not proceeded in the way that was followed by the EMU, and certainly would not wish to start from the current state of affairs in the Euroarea. But starting from here perhaps the best course is to press on as far and as fast as the limited consensus among members will take the weaker and more vulnerable members, towards filling in the missing elements: building some kind of Banking Union; supporting ECB progress towards a de facto proper Central Bank; sustaining political integration and fiscal integration, raising the size of the European Budget; trying to re-launch European investment initiatives and funding European instead of national debt.

To these purposes it would be expedient to threaten an exit vigorously and increasingly rather than actually leaving the Euroarea. At the same time a country could, still remaining in the Euroarea, and if democratic institutions were sufficiently robust, mimic with internal devaluation the effects of an external devaluation that leaving the Euroarea would allow – but only if this is regarded as essential to re-launch growth.