

The future of European Monetary Union [1]

Type: [Think Pieces](#)^[2] Written by **John Chown** | Thursday 2 February 2012



Introduction [1]

Until a couple of years ago, any suggestion that the great experiment of European Monetary Union was in trouble met with a hostile response, but since then the problem has become more obvious and much has been written on it in the daily and weekly press. The 10th anniversary of the introduction of the currency and an apparent period of relative calm seems an excellent opportunity to stand back and look at the broader context. Where are we now, how did we get there and where do we go from here?

European Monetary Union (not an obvious "optimum currency area") was launched with fatal design faults: the long awaited, but disappointing, 1995 Green Paper [2] completely failed to address the real economic problems which those of us looking sympathetically but critically at the project had identified. The rules adopted made the change "irreversible" with no provision for countries to leave, or be expelled from, the union and no mechanism for dealing with asymmetric shocks. Creating the euro in such an inflexible form was a disaster waiting to happen, but had believed and hoped that, given the political will behind the project, the need for changes would be recognised and acted on before it was too late. This has not happened and the taxpayer's money has been thrown at a futile attempt to "save the euro", when the real problem is to prevent a financial catastrophe. Whether this was deliberate is a matter for future political historians but Peter Osborne and Frances Weaver (CPS September 2011) think they were "Guilty Men?". See also Irene Kyriakopoulos, *World Economics*, October-December 2011.

This paper gives only a summary of recent events and a critical analysis of the measures. None of them is likely to prove a pain-free solution particularly if introduced at this late stage. (Theory would predict, history confirms, and George Soros knows to his profit, that early and properly considered action to deal with a financial imbalance, though expensive, is cheaper in the long run than delaying with fudges.) There are no simple solutions (this is not a submission for the Wolfson prize!) but I discuss the problems of the ones proposed (including fiscal union) and very tentatively examine possible alternatives.

Whatever else happens, Greece will surely have to default and leave the Eurozone. This would have been expensive and messy even if it had been done at the first sign of trouble. It will now be far more of a problem, cost more and be very difficult to deal with contagion. Most of the relevant recent talk has been on Spain and Italy - we have heard little about Portugal.

Early history and the pensions time-bomb

Geoffrey Wood and I had worked and written on the general concept of monetary union from the early days when it was being discussed. My book "A History of Monetary Unions" (Routledge 2004) summarises

the issues. Our joint 1989 pamphlet "The Right Road to Monetary Union" [3] had earlier suggested the immediate use of the `basket ecu? as a secondary currency. This, a road obviously not followed, would have immediately achieved most of the promised "transaction costs" which we still do not enjoy, (Graham Bishop still claims this as an achievement of the EMU.) and later progress would have been driven by market choices rather than politics. Later, I worked with Christopher Johnson's ?Sherpa? group looking at the prospects for the introduction of the euro from the point of view of the UK. My accepted role in the group was to draw attention to problems in the hope, dashed by the Green Paper, that they could be solved.

When the final details emerged, it was obvious to us that there was a disaster waiting to happen but we did not know when and how. One long-term shock which seemed inevitable unless there were urgent policy changes, involved pensions. My 2001 paper for a Chatham House economics meeting under the title "Will the Pensions Time Bomb blow apart EMU?" analysed the figures produced by Eurostat that year [4] showing a huge difference in the effect of the pensions time bomb on different member states. This continues to be a key problem and will certainly have to be taken into account when we come to reorganise the structure of the Eurozone. These figures showed that the UK should certainly not join, given that UK pension liabilities were largely backed by independent pension funds (some €1 trillion) while very similar expectations while the equivalent in France and elsewhere were an off balance sheet liability of the State. Very oddly, the Commission very recently claimed that the UK pension funds needed ?topping up?. This may be correct but what about the others? The problem persists on `unchanged policies?. The French made a very modest change in increasing the retirement age from 60 to 62, but one of the Presidential candidates now `promises? to reverse even this!

This problem has been recognised for a decade but it would have taken at least another before it was obvious in actual budgetary outflows. We knew that another shock might hit earlier - and one now has. There have been rifts in the Eurozone for some time, partly because of the convergence of interest rates to a level which was not right for everyone (the ?Impossible Trinity?). The apparent benefit to the weaker countries proved to be a dangerous trap, leading to an over-borrowing (e.g. Greece), or an unsustainable asset price bubble in Ireland. The more general financial crisis did not cause, but simply precipitated, the crisis.

The rake's progress ? Greece

The current phase of the crisis began with Greece. Why does it cost so much to bail out such a small country and why was it delayed so long? It was obvious that Greece is insolvent and could never meet its obligations. It had a continuing primary deficit and the attempt to solve this by deflation is making the long term problem even worse. Early action to deal with Greece and to take convincing steps to prevent contagion would have cost less than what is happening now and would have given time to find a long-term solution.

In October, we all thought it was decided to allow Greece to impose an alleged 50% "haircut". Because of the `banking? problem, the relevant authorities seemed desperate to avoid having this treated as a technical default precipitating credit default swaps. Soros pointed out that this would only effectively be 20% on the original proposals (still not agreed) while even a 50% effective rate would still leave Greece with unsustainable level of debt. Since then, both Greece and Italy have acquired "technocrat" governments but thanks to earlier inaction more countries are now involved. Far from converging, the spread on different sovereign bonds has widened enormously, and several countries including France have now had their ratings down-graded.

Greece should never have joined the Eurozone which only tempted the country into an unsustainable

economic policy, and however it got there, it was an obvious case for the classic solution of devaluation and default. There are excellent examples of such a policy succeeding. In Russia, it took only eight months for a substantial recovery to begin. There was a similar experience in Argentina, [5] and from the UK's exit from the ERM and more recent events in Iceland. (In all these cases, though, postponing necessary action added substantially to the transitional costs.) What would have happened if there had been a well-planned debt restructuring on Brady bonds lines? Either way, instead of throwing money at Greece, Germany, the IMF, the ECB, and others could have incorporated an element of subsidy into the deal and where necessary recapitalised banks or at least the banking system. Was it wise really to bail out failed banks while leaving the regulatory delays restricted new entrants into the market?

How they are trying to solve it

Most of the solutions have involved throwing money at the problem sometimes indirectly by borrowing from third parties, but more usually by "quantitative easing" ("printing money" in my schooldays), but this will only buy time, a commodity which, when bought at taxpayers' expense, politicians do not, typically, use wisely. The main concern has been with the banking system which was inadequately reformed after the 2008 crash and many banks continue to hold the debt of the less stable countries although the figures have now been reduced. In spite of Germany's objections to a "fiscal union" and a "no bail out clause", the support fund now looks like needing at least €1 trillion. The European Financial Stability Fund was based on packaging high risk debt into tranches which they hoped would achieve AAA status. Financial markets have short memories, but surely not this short.

"Eurobonds" guaranteed collectively by the Eurozone Member States would achieve little. If these are the pro rata liabilities of each State, they certainly would not have the AAA rating (which several of them have actually now lost) assumed. Bonds of even the Netherlands, Austria and Finland, surely core countries, have at times traded at around 100 basis points above Germany, and as for the others?! If they are jointly and severally liable, this would in the last resort fall on the Germans, which they certainly won't accept and if they do, it would even threaten their own rating.

The current proposal, if the agreement between twenty five countries survives a discussion of the small print, would enforce fiscal discipline on German lines on weaker Members. This will inevitably mean tax rises and expenditure cuts and a sharp contraction in the economies which will adversely affect all of us. Given that the exchange rates of these countries are uncompetitive, the only alternative to devaluation (the classic remedy) is deflation. As often noted, "if the Greeks started behaving like Germans they wouldn't be able to buy German cars."

Internal devaluation by deflation is actually working quite well in Ireland where the problem was an unsustainable property bubble which could not be checked by interest rate policy. The country's finances were sound enough but they then made the big mistake of guaranteeing the banks.

One rather mischievous thought: if "quantitative easing" effectively increases the money supply proportionately across the Eurozone, it could generate inflation in all relevant countries. If this caused prices in Germany to rise (unthinkable?) and (possible but not inevitable) the weaker countries took the opportunity to create an internal devaluation by holding down nominal prices, this would offer some of the benefits of devaluation and also reduce the real cost of Euro debt. To be effective without damage, it would have to be unanticipated inflation and the ECB would then need to convince markets that this had created a one-off adjustment rather than a continuing propensity to inflate.

A fiscal union?

It is in theory possible, but difficult, to create a monetary union without a fiscal union. The essential conditions are balanced budgets and great labour market flexibility, including wage flexibility. And even unions which had those, such as the Latin Monetary Union, could not survive all the strains that hit them. In fact, all such unions (unless they preceded political union) eventually came to an end.

The latest proposal would involve a botched fiscal union. It is hard to know what this means. Politically, it would fall far short of a federal union (which would require a very different constitution) but economically may go even further as even these typically give more freedom, on tax and expenditure to States, Provinces and Cantons.

There seem to be two main issues, greater transfer of funds from the stronger to the weaker Members (will the Germans accept that?) and a far more central control of broad economic policy in Member States. (Who would take the decisions?)

Over the years, there have been many proposals for "tax harmonisation" and although these have got nowhere, it has been argued that one cannot have monetary union without something approaching a common tax system. This is the reverse of the truth: the only economic weapon left to Member States for dealing with asymmetric shocks would then be on the "expenditure" side! What is now being proposed is actually more central control of expenditure.

Some members of the EU political class keep persisting in trying to find some way of creating a "tax collectors' cartel" forgetting that this would weaken the competitive position of the EU with the outside world notably, for different reasons, North America and Asia. Fortunately, tax is one of the issues which requires unanimous agreement, although attempts keep being made to bypass that, including the recent pressure on Ireland and the suggestion of introducing a Financial Transactions Tax (by finding a loophole in the unanimity provisions of Article 113). [6] This issue, like so many in the EU, raises the question of whether the State exists to serve the citizens, or the citizens to serve the State. Can tax competition be reconciled with the free movement of capital within the EU? I have written on this over the years, see (e.g.) the 2007 paper I gave at a conference in Trier, "Eliminating Tax Obstacles for Cross-Border Operations.

A full fiscal union would have to include only those who had signed up for it. Any country considering signing up for such a union would be well advised to compare their properly calculated Balance Sheet as a nation with those of the intended partners. This would obviously mean looking at the present level of formal debts, projected budgetary cash flows and other figures which are at least in theory readily available to the enquirer but they would need to look much deeper. There are several other ways in which the nation's solvency (and therefore whether it will contribute to, or make claims upon, the group as a whole) can be seriously affected.

Part of the deal will and indeed already does involve substantial fiscal transfers which probably fall outside the scope of the intended eurozone rules. This will be viewed differently by different countries. Voters in the paying countries will not like this while the beneficiaries will take a different view. They may, but should not be, encouraged to delay taking internal remedial action. Help should be carefully designed to ease the transition rather than to postpone action.

In the United States, the individual States have their own credit ratings even though the country is far better placed to act as a union having a much higher degree of labour mobility than multilingual Europe. Switzerland is a rare example of a multilingual federation - but we do not think the type of people who are pressing for a closer union of Europe would welcome the degree of taxing rights enjoyed by Swiss Cantons and Communes. Instead of political parties competing to bribe voters for their money, Cantons compete to attract people and business, keeping tax rates sensible. Some forms of social payments are handled at the

level of the Communes which it is said ensures efficient monitoring - people realise that neighbours who are cheating the system are cheating them. The Australians have complex arrangements for leaving their States with a degree of control over some taxes and expenditure, calculating the Federal contribution on perceived standard needs rather than on actual expenditure.

A two-speed Europe?

If some Members under the leadership of German formed a smaller eurozone with transfer capabilities, proper central sanctions on government expenditure and a Central Bank capable of being a lender of last resort. Those staying outside would divide into three categories: the "opt out" countries, notably ourselves, Denmark and Sweden, who would clearly not join; Those like Greece and maybe others which would leave the eurozone, devalue and default and an intermediate group including those mostly in the CEE who are committed to membership and will have to choose one side or the other.

A multi-speed Europe would raise several major problems, most obviously about which assets and liabilities could be converted into a new currency, the impact on the banking system and the inequitable way in which the inevitable loss of capital assets would be distributed partly to the benefit of the well advised who will have already moved their money. This will keep the lawyers in business for many years.

This raises a very delicate diplomatic problem. The inner group wouldn't want outsiders having an equal say in their relevant discussions and for them the unanimity rule on tax policy would not work. The non-members, including the UK, would need to negotiate considerably less interference, particularly in financial regulation and employment policy in case these could be abused by the fiscal union group to force us to share their uncompetitive practices. We economists need to ensure that those negotiating really understand what is at stake. It would be politically unwise to see this as an opportunity to "bring back powers from Brussels" but we must take great care to ensure that our own markets are protected.

The weaker countries would have to be given the right to opt out of the eurozone, raising very difficult questions which may, or may not, involve default. It must be made absolutely clear that their debts, both internal and external, were entirely their own responsibility - an aim intended (unsuccessfully) to be achieved by the Stability and Growth Pact.

What could have been done ? plans for the future?

My "History of Monetary Unions" inevitably covered "dis-unions" but most of the interesting unions based on non-metallic money (the Soviet Union, Austria-Hungary, former Yugoslavia etc.) collapsed at a time of hyper-inflation which solved that problem while creating others. There are more useful lessons from two "sort of" unions ? Bretton Woods and the Sterling Area.

The Bretton Woods (40th anniversary in this case) approach involved initially fixed exchange rates bolstered by international transfers negotiated by the IMF but with the right, and indeed the obligation, to change the rate when there was a "fundamental disequilibrium". There were many examples often in Latin America. The original design of EMU should have included such a workable proposal for exit. This could well be on the lines of the "living wills" to deal with the problems of banks deemed too big to fail, making sure that both countries and banks could not be treated as too big to fail. Is it too late to achieve that?

The essential step is to make it absolutely clear that each Member State is responsible for its own debts. They could then make their own arrangements, on the classic gold standard procedures, for maintaining external balance: surely there should be a "living will" procedure as proposed for banks for dealing with the inevitable occasional default in a less damaging way. "Convergence" would cease to be an intelligent tactic

for investors (if it ever was) and interest rates on each country's debt would reflect investor perception of its government actions and give early warning of possible troubles to come. There would remain the problem of how to adjust interest rates to deal with internal problems when the international balance was perceived to be satisfactory.

The Sterling Area, being informal, worked well for many years, but because of that, quietly fell apart when it became less relevant. The only Monetary Authority was the Bank of England, others had neither any say in UK monetary policy, nor (after they ceased to be colonies) any obligation to follow it but they had, in the Area's heyday, strong incentives to remain in the club, which had substantial benefits for most of the time including freedom from exchange control. The "early leavers" such as New Zealand introduced their own currency without any immediate or expected change in parity. This arrangement had some similarities to, but was distinct from the Currency Boards used in the old colonies and which could be an alternative for smaller EU members.) [7]

The same result could have been achieved economically, but certainly not politically, by countries accepting Germany's Bundesbank as the monetary authority and voluntarily adopting their currency. This could be achieved either by simply shadowing the currency, adopting it by "dollarization" like Panama, Montenegro and Zimbabwe, or by the more formal procedure of a Currency Board familiar in the old colonies and introduced in many countries as diverse as Estonia and Hong Kong. This could well be the right answer for smaller EU Members. Note issues and the monetary base would then be the responsibility of the Central Bank or Currency Board of the country concerned.

Countries which leave the Eurozone and others (even outside the EU) might well find that a "New Euro" becomes widely used as a secondary currency creating the partial advantages of our old 1989 proposal. It may even become the currency of choice for internal contracts, a role which the US dollar once had. This might reach the stage when they would accept "euroisation" and partly or wholly abandoned their own currencies. A currency board could be used which would have, these days, to involve any "lender of last resort" holding "euros" not only against banknotes but against the prudential reserves of banks.

There are broader issues of future world monetary arrangements. The November 2011 issue of "Central Banking" has several articles extolling the virtues of gold bonds and a "hard SDR", and discussing other approaches.

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[2] Green Paper on the Practical Arrangements for the introduction of a single currency. Commission of the European Union 31 May 1995.

[3] John Chown and Geoffrey Wood "The Right Road to Monetary Union", Institute of Economic Affairs, 1989

[4] Eurostat's "2009 Ageing Report" gives updated and very detailed figures covering all 27 members.

[5] John Chown, "Currency Crises Compared?", [Argentina, Turkey, Russia] Central Banking, Volume XIII, No. 2, November 2002, pp. 64-68.

[6] I have given oral evidence to the House of Lords Committee on this.

[7] My book discusses briefly how colonies created independent currencies and, at rather more length, the history of the Irish pound. Exchange control policy at the time means there were no real helpful measures

from these.

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