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The future of the euro zone

By Olivier Klein

Some background to begin with. The European Monetary System (EMS) was put in place to create a fixed but adjustable peg for the various currencies within the zone. From 1979 on, it served to prevent sudden and disruptive fluctuations in the exchange rates of the currencies of the countries within the European Monetary System. However, while proving very useful, it remained a source of instability: external events could cause unsought asymmetrical shocks between the European countries concerned. For example, the weakening of the dollar against other currencies prompted market operators to seek refuge in the deutsche mark. This strengthened the German currency against the dollar but also against the French franc and other EMS currencies. However, the economic trends in Germany and in France or the other countries did not necessitate this movement in their exchange rates.

Moreover, since each country in the zone kept its own currency, the current account balance had to be monitored country by country. Any country needing stronger economic growth – due to faster population growth for example – was regularly hampered by an external constraint: an economic growth gap between two countries automatically resulted in a deterioration of the current account balance of the country with the strongest growth.
The unavoidable effect of this phenomenon was a constraint of alignment on the slowest growth rates among the larger countries within the European Monetary System.

The single currency, created to substitute EMS, was structurally a part of this reflection. On the one hand, a single currency would allow the dollar to weaken with the same impact on all the countries in the euro zone. On the other hand, it could be thought that the creation of the single currency would generate greater leeway for economic policy: the current account balance would be considered at the level of the euro zone as a whole and not at the individual levels of each country. This would supposedly enable a country to stimulate its economy, if necessary, without immediately running into the external constraint, as long as there was no deterioration in the current account balance of the euro zone as a whole. Lastly, a single currency among the countries in question, without any possibility of devaluation or revaluation, would provide economic agents with a more stable forecasting basis for foreign investments and trade, imports and exports, without having to bear the costs linked to currency exchange. The example put forward was the United States, where an individual state can stimulate its economy without encountering any immediate obstacle linked to its current account balance.

Federalism versus convergence

There were two tacit schools of thought when the euro zone was created. Both perceived clearly that a monetary zone could not work properly on its own.

The first school of thought held that, to become efficient and develop a satisfactory system of auto-regulation, the euro zone needed to be gradually rounded out with a greater degree of federalism. On its own, the creation of a single currency was not enough to ensure the regulation needed in the event of difficulties. If a country within the zone experienced an isolated recession, it had to adjust without being able to benefit from any weakening or devaluation of its currency. In the absence of any type of federal regulation, the only possibility left to the country was to reduce labour costs and public spending in order to become more competitive, by provoking a sort of internal devaluation that was inevitably painful at social level and costly in terms of economic growth during the first years of adjustment.

Two conditions for avoiding overly costly downward adjustments were, in theory, clearly identified. Firstly, mobility of the labour force within the euro zone, enabling people who had lost their jobs in one country to find work in another country within the zone. Secondly, budgetary solidarity between the countries with a single currency, so as to organise budgetary transfers from the strongest growth countries to those in difficulty, thereby lightening the internal adjustment needed. This situation is exactly that of the United States, thanks to a shared language and a long tradition of mobility, and a federal budget that is large enough to allow such transfers.

Europe did not have this history of mobility nor the unified legal and social framework that would foster it. But, by continuing to build the union, Europe could achieve a greater degree of federalism that would enable budgetary transfers, on the strict condition of federal supervision of each country's budget as no solidarity mechanism could be developed without ensuring that the policies implemented at national level were serious. This was the line of the first school of thought whose hopes were based on continuing European construction, based up to then on economic aspects, before going on to make the necessary progress at political level.

The other school of thought, which prevailed when people did not dare or want to express federalist aims, was to limit admittance to the European monetary zone to very similar countries that could be expected to continue being similar, which, quite justifiably in this context, led to the creation of convergence criteria. If the member countries of a monetary zone are on the same economic trend and converge in terms of inflation, budget deficit to GDP and public debt to GDP, and stay that way once they are part of the zone, adjustments between member countries are no longer necessary. There is therefore no need to look for greater federalism.

Shared mistakes

In the light of the events of the past few years, both schools of thought were mistaken.

The first, since the increased federalism expected to follow creation of the zone as a matter of course has not occurred and it has proved difficult to conjure international solidarity out of nothing.

The second, since, either for political reasons or because some countries deliberately hid certain aspects of their economies, the countries admitted to the zone were not all chosen based on their strong structural and economic similarities. Mistaken, moreover, because monetary union does not automatically mean convergence will be preserved, even if it existed when the zone was created. On the contrary, it gradually induces structural differences linked to industrial polarisation in some regions corresponding to deindustrialisation of other regions within the zone. A single monetary policy, adapted to the average of the euro zone countries and not to each country's specific economic conditions, combined with the absence of foreign exchange risk, leads in fact to diverging national economic specialisations, which can result in structural current account deficits in some countries due to insufficient industrialisation.

The financial markets were also mistaken. They kept the interest rates for the public debt of the different euro zone countries at very similar levels, even though significant differences were gradually emerging in both public debt ratios and current account deficits.

These policy and market mistakes resulted in a major crisis specific to the euro zone, caused, not by bad results and ratios at consolidated level, but by increasingly major differences between countries within the zone, without any mechanism for regulating such phenomena having been put in place, or even provided for.

How can the vicious circles be broken?

Resolving the zone's intrinsic problems has so far proved extremely difficult, painful and confused.

Two vicious circles have emerged that have accelerated the crisis. The first is that formed by the economic growth rate, the interest rate on public debt and the public deficits of the countries in difficulty. To restore its public finances and competitiveness, a country must drastically reduce public spending and increase taxes while reducing labour costs – even when several countries within the same zone are doing so at the same time. The impact on economic conditions is in this case very negative. The fiscal multiplier in such circumstances – with very weak growth – has been calculated, including by the IMF, to be greater than 1. A given reduction in public spending in Europe generates an even greater contraction in economic activity. The resulting slowdown in growth worsens the public deficit, which worries the markets and pushes up interest rates on public debt. This in turn has negative repercussions on the public deficit.

The second vicious circle consists of the feedback loop between the banks and public debt of a same country. European banks hold, as safe investments, bonds issued by their governments, and by the governments of other euro zone countries given the strong financial integration within the monetary union. Fears concerning the solvency of these countries therefore also trigger doubts about these banks which, if these doubts degenerate into a systemic crisis, can only be saved by their governments, thereby immediately exacerbating the fears relating to the public debt.

With a series of tentative initiatives, the euro zone has tried to feel its way out of this severe crisis and break these circles. Once again, two main tendencies arising from the two schools of thought described above have emerged, even though there has been some cross-over and even convergence between them.

The first argues that finding a way out of the crisis depends on Europe's capacity to move towards greater federalism, a capacity strengthened by the crisis. The second argues that each of the countries in difficulty should itself restore its competitiveness by making sufficient efforts in terms of costs and deficits. Once again, these two tendencies, which are not totally mutually exclusive, have converged toward the European compromises we have already seen.

Thus, after hesitating for rather too long, Europe's political deciders and the European Central Bank decided to create a European intervention fund, thereby pooling part of the debt of the countries in difficulty, and to create the European banking union. European banking union is an essential component of a monetary zone because banking supervision at the European level is necessary. There is sometimes a suspicion that some national regulators overprotect their country's banks or do not wish to see the problems and turn a blind eye. A European level of banking supervision is all the more valid in that our banks are also multinationals in Europe, so as to ensure the same quality and efficiency in terms of banking supervision. But the key argument in favour of European supervision is that there can be no solidarity without shared supervision. For this reason the recent agreement is conditional upon putting in place the other essential elements of banking union.

The solidarity aspect worries healthy banks because they are afraid they will suffer from the situation of the weaker banks. The constitution of a European deposit guarantee scheme, at several different levels if necessary, would provide the basis for European interbank solidarity. One possibility would be to have, in addition to the national deposit guarantee funds, a deposit guarantee that would be triggered, at certain times, after the national guarantees had been exhausted, directly at European level, based on the solidarity of the European banks of other countries. This interbank solidarity mechanism would be supported by a solidarity mechanism between the euro zone states. A European crisis resolution mechanism, with in particular a European resolution fund, is expected to be put in place. Such a fund would mean that bank recapitalisation would not necessarily rely solely on the State concerned, which would therefore break the second vicious circle described above.

The ECB has announced that it now has the possibility of purchasing unlimited amounts of the public debt of countries in difficulty if their interest rates exceed a level considered normal, enabling a gradual return to better solvency, providing they implement a structural policy that allows this.

These fundamental decisions – resolution fund, banking union and the ECB's unlimited, but conditional, intervention policy – have restored confidence and broken these vicious circles, temporarily at least. The issue now being debated in economic circles is whether the efforts made by each country – together with the measures referred to above – can restore the euro zone's structural situation and save it as it is, by ensuring the lasting convergence of the member states.

The alternatives to austerity

The intense efforts being made by the southern European countries have a huge social cost in terms of living standards and employment. On average, the public debt/GDP ratio of these countries has not improved – it has even worsened in some cases – given the multiplication effect of more than 1 of these budgetary measures.

In the case of Greece, the cancellation of a large part of the Greek debt held by the private sector does not appear to have been enough to turn the country around given the considerable social and economic cost of the austerity measures implemented. Italy has decided to implement major structural reforms but is struggling to regain competitiveness and seems to be exhausting itself in uncertain political battles, as can be seen from the recent elections. The improvement in the current account balances of these distressed countries, with the exception of Spain, comes more often than not from a slump in imports due to recession rather than any increase in exports achieved through increased competitiveness.

However, Spain is beginning to see some results in the turnaround in its current account balance and the rise in exports.

The question is whether the painful search for competitiveness though austerity in each of the countries concerned, without adjusting exchange rates, can be successful. The lasting recession it provokes undermines potential growth. Even supposing it is successful in the long term, can the turnaround in public finances and exports be achieved before the social cost triggers a political and social crisis that compromises the European equation and the efforts made?

Assuming competitiveness is restored before any crisis breaks, the question is: should the euro zone regulate itself solely by a downward adjustment in living standards in order to bring some countries, through considerable internal efforts, into convergence with more acceptable public deficit and public debt levels and a better balance of payments? If the industrial basis is weak, balance can only be achieved through sluggish growth that does not boost imports, leading inevitably to a lasting slowdown in the euro zone. Or should regulation of this monetary zone by achieved through a mixture of the structural reforms needed to improve public finances and a European policy of supporting potential growth, by truly coordinating economic policies – stimulation here, dampening there – and transfers between the countries so that the least industrialised countries are not permanently obliged to make downward adjustments through austerity? Such a mixture could help bring about these structural changes without excessive brutality and without triggering a severe recession, thereby making these reforms more acceptable. The structural reforms successfully achieved by Canada and Sweden in the 1990s were greatly facilitated by accommodating economic conditions which made the temporary social cost of these reforms acceptable. This mixture would naturally include better supervision of budgetary policies in particular, because there can be no solidarity without control, in order to avoid moral hazards.

The last question is: can the euro zone develop a greater degree of federalism – supervision, coordinated economic policy and budgetary transfers – that would ensure greater solidarity among its members, without however accepting laxity or “free riders”? This would enable the essential structural reforms to be carried out in a number of countries in an organised and better planned manner over a longer period, and therefore less painfully and with less risk. And to acknowledge and accept the natural diversity of the countries within the zone, including the industrial differences arising from the very existence of the single currency.

This would favour a higher average rate of growth by authorising some countries to have current account deficits while others have surpluses. Or will the euro zone be incapable of carrying out this political change and find itself condemned to requiring, too quickly and for too long, the least industrialised countries to implement austerity policies that bring long-term average growth down to low levels for the whole zone, with all the accompanying political risks. And possibly a risk for the future of the Euro itself.

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