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THE EURO: IT MUST CHANGE TO CARRY ON

DiffGov

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The GLOBSEC Policy Institute is a policy oriented think-tank analysing foreign policy and international environment. It focuses on research which is relevant to decision-makers, business leaders and all concerned citizens. The Institute wants to make an impact so that values of the GLOBSEC organisation – liberal and democratic order in the transatlantic world – are deeply embedded in the agenda of governments.

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POLICY PAPER

The Euro: It Must Change To Carry On

The euro will soon celebrate its twentieth anniversary, but the mood is spoiled by still unsolved problems of the common currency area. The European Monetary Union (EMU) requires a healing of the wounds left by the previous crisis, such as unemployment or stagnation and long-term indebtedness - discernible now in the argument about Italy's budget. The eurozone must also complete its governance architecture in order to be prepared for the next crisis. If the EMU meets these challenges successfully, its role in the world will rise and the European Union (EU) will consolidate around the common currency.

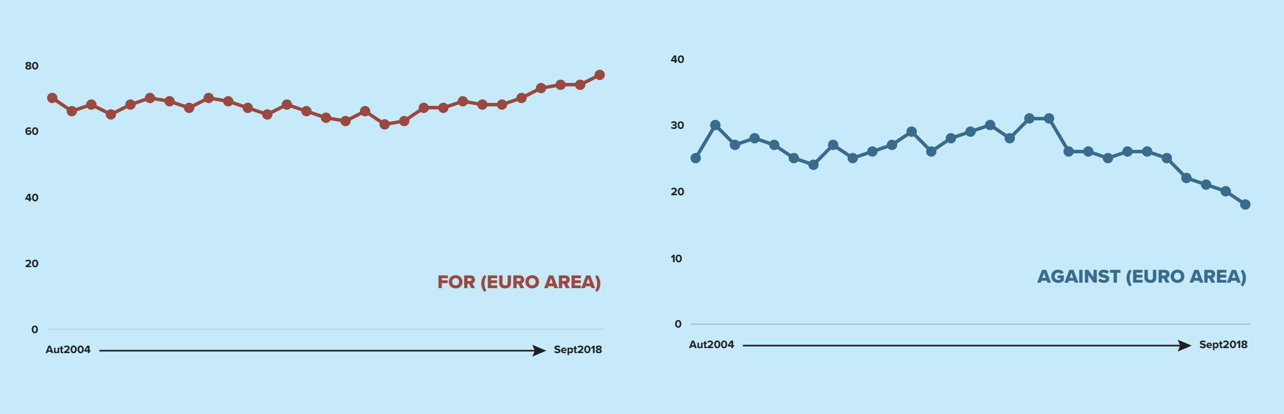
THE EURO: A WAYWARD TEENAGER

In the years preceding the launch of the monetary union, its biggest proponents perceived it as the crowning achievement of post-war European integration. The euro aimed to demonstrate the power of the common economic area and ambitions of Europeans to move towards a quasi-federal state and to play a greater role in the world. But shortly before the twentiethth anniversary of the common currency, there are enough reasons to exercise caution in assessing the last two decades.

If one looks for success, it is seen in the generally high and quite stable acceptance of the common currency among the citizens of eurozone Members States. Apparently they appreciate the easiness in comparing prices, in paying and investing abroad. According to the autumn 2018 poll of Parlemeter, 77% of respondents expressed their satisfaction with the existence of the euro – a rise by 3% since the spring poll published earlier this year.[1]

Support for the euro

QUESTION: WHAT IS YOUR OPINION ON THE FOLLOWING STATEMENT? PLEASE TELL ME WHETER YOU ARE FOR IT OR AGAINST IT: 'A EUROPEAN ECONOMIC AND MONETARY UNION WITH ONE SNGLE CURRENCY, THE EURO'



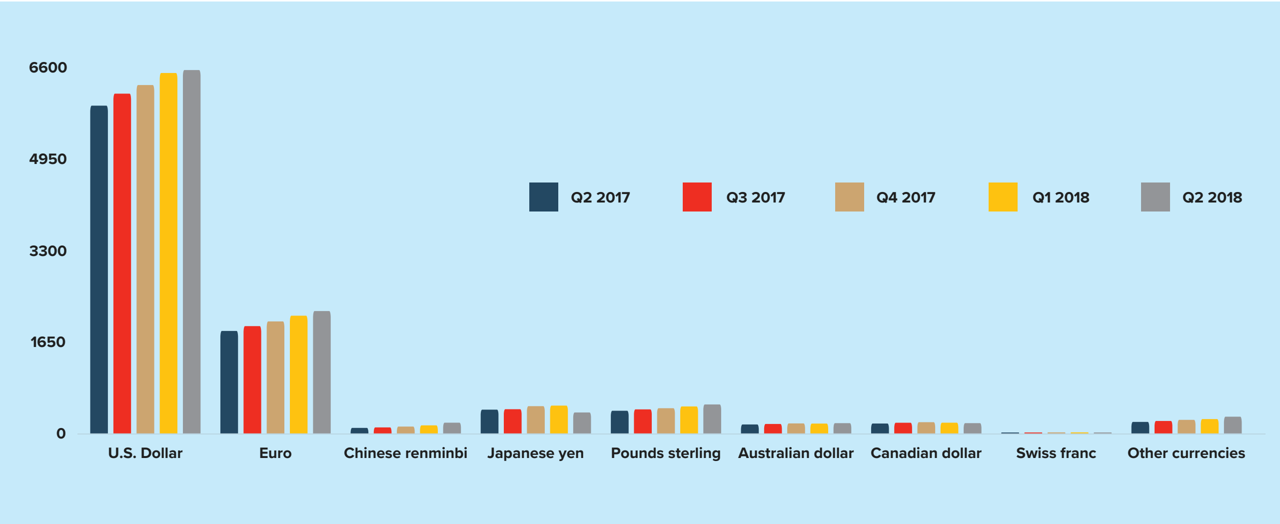
Source: Parlemeter

What propped up this outcome was surely the good economic weather that, since 2014, has granted most of the euro area members growth conditions, falling unemployment and stable public finance.

On the asset side, there is also the euro's rise to an important reserve currency for the world - even if the gap against the dollar remains large.

[1] Eurobarometr, "Parlemeter 2018 – Taking up the challenge. From (silent) support to actual vote," 2018, http://www.europarl.europa.eu/at-your-service/pl/be-heard/eurobarometer/parlemeter-2018-taking-up-the-challenge, accessed November 2018.

World Currency Composition (US Dollars, Billions)



Source: IMF

The bright spots of the EMU are, however, overshadowed by the experience of the crisis between 2008 and 2013, with some aftershocks lasting till 2015. Its source was not only the breakdown of the global economy, but also the design of the union itself. The euro contributed to macroeconomic imbalances between its Members in a period of economic prosperity. Later, when the crisis came, it had no tools to deal with them. Therefore, there are many experts claiming that the euro, instead of becoming a factor uniting Europe, has essentially become its disintegrating force.[2] Proof of this statement is the fact that discussions about a potential break-up of the euro zone have been returning with regular frequency.

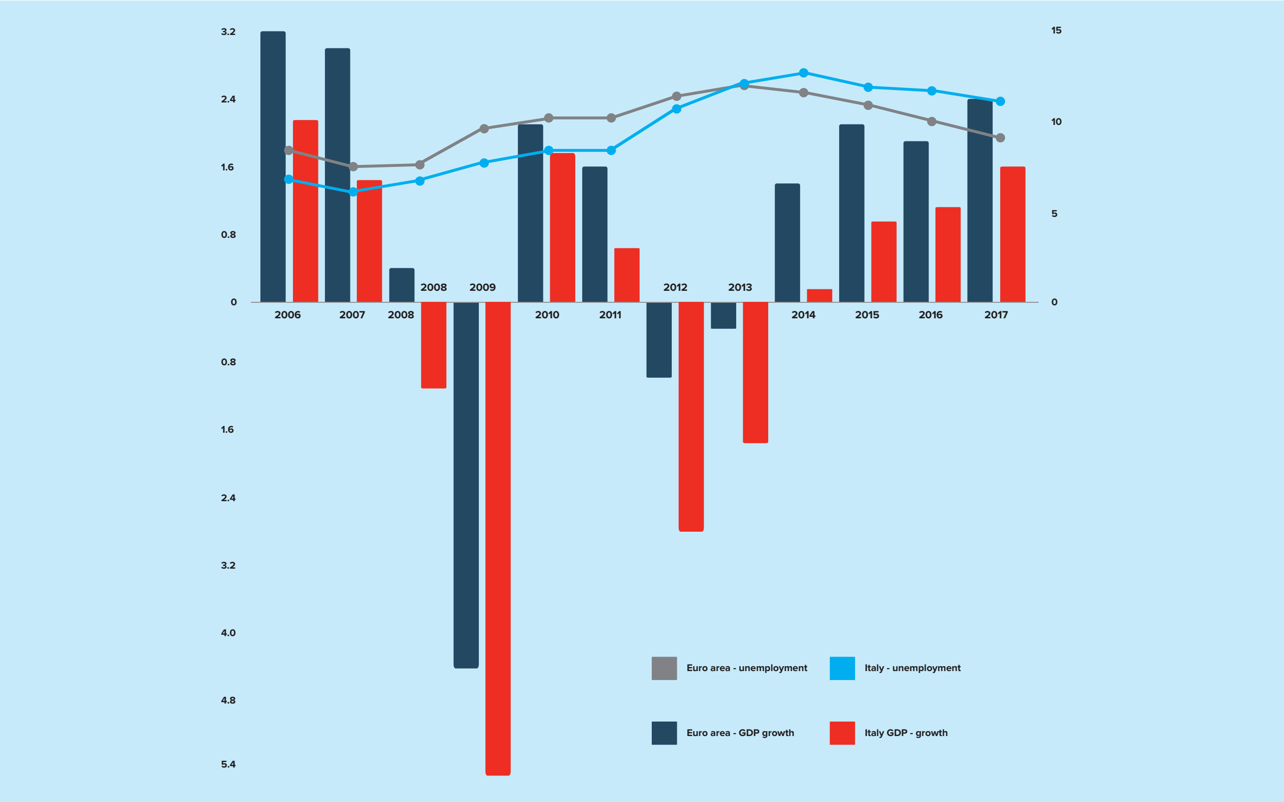
What does the euro need to do to dispel such doubts and turn its next anniversary into a show of confidence? First, it has to find a way to mitigate the consequences of the previous crisis: that is, to solve the gordian knot of debt, stagnation and unemployment in southern countries, particularly in Italy. Second, the euro area must complete its governance architecture in order to be prepared for future crises. None of these challenges is a piece of cake.

The Italian deadlock

Italy entered the eurozone with a debt burden that has been mounting since the 1970s. As the global financial meltdown and panicked selloffs started in 2007, it became clear that tougher times were coming for the EMU's third largest economy, and that it might have problems maintaining its debt if things got worse. It was the European Central Bank (ECB) that started to buy Italian bonds, lowering the risk for the financial sector. But the country was forced into the straitjacket of fiscal austerity and, plagued by structural problems, couldn't really find a way back to growth (see below).

[2] See for example: Ashoka Mody, Eurotragedy: A drama in nine acts (New York, NY, Oxford: Oxford University Press, 2018), pp. 16–21.

Real GDP growth rate in percent (left) and total unemployment rate in percent (right), Italy and Euro area, 2006-2017.



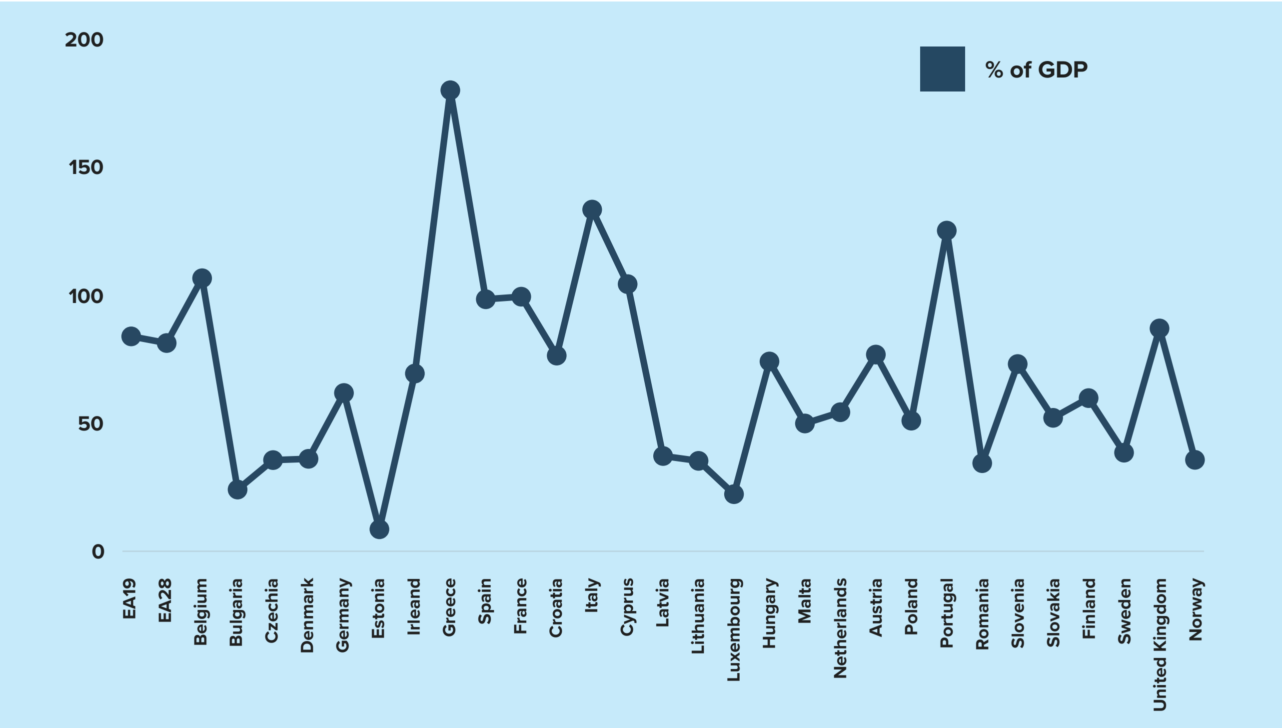
Source: Eurostat

Long-lasting stagnation had been – together with the migration issue - the main factors behind the victory of populists in 2018 elections. The new government of Giuseppe Conte wants to conquer it with higher public expenditure. But the plan to increase the budget deficit to 2.4% of GDP (instead of the previously aimed 0.8%) is at odds with the rules of the Stability and Growth Pact and has raised concern on financial markets about the stability of the Italian economy, and, again, the euro. Instead of trusting Conte's assurances, investors rather sneak a glance at studies like the one by Blanchard and Zettelmeyer[3], who argue that the expected effect of expenditure growth will be outweighed by the negative effects of interest rate increases with the ultimate effect of recession, not growth.

Is there a chance for the eurozone to find a way out of this deadlock? The major question is what to do with the - using the words of the European Commission - "key vulnerability" of Italy[4]: the 132% debt to GDP ratio. The parties of the government coalition in Rome wanted the ECB to forgive €250 billion of the already purchased bonds, but this would be a breach of the treaties and no-go area for the "Hanseatic" countries[5]. Another option is debt restructuring. But such a 'haircut', or a sharp drop in bond values, would be politically impossible for any Italian government because 2/3 of the debt is held by domestic investors who would punish it with immediate withdrawal of support.

[3] Olivier J. Blanchard and Jeromin Zettelmeyer, "Will Rising Interest Rates Lead to Fiscal Crises?," Policy Brief, Peterson Institute of International Economics, July 2017, https://piie.com/system/files/documents/pb17-27.pdf, accessed November 2018.
[4] Letter to the Ministry of Economy and Finance of Italy from the European Commission (29.10.2018), http://www.mef.gov.it/inevidenza/documenti/A._Rivera_Letter_EN.pdf.pdf, accessed November 2018.
[5] It is about Germany and other economies of Northern Europe characterized by more conservative stances towards public finance.

General governmant gross debt by Member States in 2018 Q2



Source: Eurostat

With no quick solution on the horizon, the most probable option is a long-term tug-of-war, or in a more optimistic view, a "grand bargain"[6] which includes more issues than just fiscal discipline. Italy will have to take a step back from its spending ambitions while continuing structural reforms; the European Commission will have to grant the government in Rome some more flexibility in spending; the ECB will keep holding Italian bonds to maintain their low returns; and the Union as a whole must soften Italian suffering with promises of additional investment funds in the coming EU Multiannual Financial Framework 2021-2027. Everyone in this sophisticated bargain will hope for high growth with an additional inflation booster, thanks to which the Italian debt may cease to have existential significance for the Eurozone in a decade or so.

FLAWS IN THE EURO SYSTEM

Although the euro area has carried out some adjustments and reforms in this decade, there is still a well-founded anxiety whether they are enough to make the EMU survive the next serious crisis. It is not only its diversity and exposure to asymmetric shocks that matter here, but also weaknesses of mechanisms that should restore balance.

One of the defects is that the eurozone will never enjoy mobility of labour in a US-like manner and be deprived of using such a large-scale means of adjustment. Apart from different regulations of national labour markets or failings in the mutual recognition of qualifications, the eurozone also faces language and cultural barriers in mobility. As a matter of fact, people can move easily in industries in which the local circumstances are not crucial, or in which the "professional" language is English. But this may not suffice to react in crisis.

It does not mean, however, that labour markets should be neglected from a eurozone perspective. The lower mobility is between the Member States, the higher must be their internal flexibility in employment forms and wages in order to speed up the process of restoring competitiveness. Each country has its own idea how to do it: some, like Germany bet more on the negotiations between trade unions and employers, others on the deregulation of markets. Where the eurozone can intervene is with measures to activate the unemployed, as well as setting common social standards to avoid a race to the bottom in wages and employment conditions, thus avoiding political risks connected with "internal devaluation". In this context, a remarkable innovation would be a joint

[6] David Folkerts-Landau, "Europe must cut a grand bargain with Italy," Financial Times, November 12, 2018.

reassurance for national unemployment insurance systems, which was proposed by German Finance Minister Olaf Scholz in October 2018. Countries experiencing high unemployment would receive time-limited and repayable financial assistance, which will enable them to keep on activation policy in the labour market.[7]

Facing limits in the sphere of labour, the eurozone must attach even more weight to the area of capital. But the picture here is far from ideal too. Financial markets of the euro area are still rather shallowly integrated: the banking space is *in statu nascendi*, taxes are sources of discontent, and the capital markets union will only start operating in the next year. And there is always the uncertainty that in crises, investors do not search eagerly for new opportunities in weakening economies (like cheaper assets), but rather park their capital where it is safe.[8] If this supposition is true, imbalances will be deepened, not reduced.

These flaws would not be that troublesome if there were a tool that is obvious for nation states: a budget, large enough to affect the economic climate and support the regions hit by the crisis. Neither the small EU-budget dominated by the payments for farmers and cohesion policy, nor the "emergency service" of the European Stability Mechanism (ESM) can cover it. That is why in recent years the role of the "pumping station" of capital in the euro area has been taken over by the European Central Bank, which drastically reduced interest rates and at the same time bought government bonds of crisis-ridden states. However, this policy can't be carried out forever.

CHANGES IN THE EURO ARCHITECTURE

Without dealing with its shortcomings, the eurozone may have problems in case of a new crisis. It needs, first, an upgrading of its financial markets in order to create one, unified area for the mobility of capital. One of the big barriers on the way to integration is the still unfinished banking union.

So far, the single supervision and the single resolution mechanisms have been created. A missing element is a joint deposit insurance scheme. The ambitious agenda of the European Commission with the common fund operating by 2024 at the latest proved to be unacceptable for Germany and other countries of Northern Europe. Their requirement is that the banking systems of Italy and Greece reduce the level of so-called of non-performing loans (NPLs) – but that can take years to realize. The same with the high level of sovereign bonds on the accounts of Southern banks, harshly criticized by the Hanseatic countries. There is an expectation, however, that during the December 2018 Euro Summit, Member States of the eurozone will agree at least on the road map for the common deposit insurance.

Even a bigger challenge is a large and autonomous eurozone budget. The idea has a declared proponent in Emmanuel Macron, who advertised it in his speech at the Sorbonne in September 2017. But for many other Member States it is a highly controversial topic. The only feasible proposal on the table is the recent Franco-German idea announced in November 2018 to establish a euro-budget, but within the common EU-budget and so far without details on its financial potential.[9] Few expect it higher than €25-30 billion.

Facing the above-mentioned limitations, the euro area must rely on what is available and feasible. It means, in the first place, accepting the fact that national budgets will further play a key role in stabilizing the economy. It is no accident that there is now a debate in the euro area about how to improve national budget space for manoeuvrability to act by reforming the fiscal rules of the Stability and Growth Pact. So far, its main function has been to discipline governments' spending. However, it has not always served to stabilize: examples of exaggerated tightening of fiscal policy and, as resulting consequences, prolonged stagnation and even increased public debt, have undermined the credibility of the Pact. It is quite likely that the eurozone will go towards easing the fiscal rules to enable Member States to carry out pro-development investments in times of crises. Optimists go even further and expect the creation of new financial vehicles – ESBies (European Sovereign Bonds), that will help to diversify risk among the Member States.

Secondly, having no parachute of a big budget, the eurozone will strengthen its emergency tool: the European Stability Mechanism. This institution could not only be renamed with the more impressive label of the European Monetary Fund, but also act in a more agile way and oversee a larger financial pool. This will help to handle severe liquidity problems in euro area Member States, as well as banking crises.

[7] Andrew Bulkeley, Martin Greive, and Jan Hildebrand, "Finance Minister Scholz wants pan-European jobless fund," Handelsblatt Global, October 17, 2018.
[8] See for example: Dani Rodrik, "Populism and the Economics of Globalization", NBER Working Paper, No. 23559, National Bureau of Economic Research, 2017.
[9] Bjarke Smyth-Meyer, France and Germany eye eurozone budget by 2021, Politico, November 19, 2018, https://www.politico.eu/article/france-and-germany-eye-eurozone-budget-by-2021/

GOOD AND BAD WEATHER SCENARIOS FOR THE EURO

If measures work against the old burdens and stagnation in the South, as well against any new potential crisis, the euro has a chance to achieve more than just survival and crawling to its next anniversary.

First, a credible EMU will enjoy a rapid rise in the importance of the euro as a world reserve currency and enable next steps, for example, creating its own payment system as an alternative to SWIFT. What is more, all this would go hand in hand with ambitions to strengthen the "sovereignty of Europe" recently raised by the German Foreign Minister Heiko Maas.[10] Finally, the success of the euro will also help to consolidate the European Union by attracting more Member States to the currency area. Those doubting deeper integration would be confronted with a rising risk of political marginalization in the EU and thus more willingness to speed up preparations for the euro.

However, if the Eurozone fails to deliver the structure created two decades ago, a collapse awaits. It won't necessarily come in form of a sudden break-up after a dramatic, night meeting of Heads of Member States. Also a slowing deterioration is possible: a scenario that Wolfgang Münchau described in the example of Italy.[11] Facing the rising tensions with the European Commission and other Member States of the euro area on budget rules, the government in Rome could introduce controls on movement of capital to prevent further weakening of the banking sector and also a parallel currency in the form of vouchers allowing for e.g. repayment of tax liabilities. In this way, it would become possible to escape from the straitjacket of the euro without giving it up directly and keeping it still in circulation. If not only Italy but other countries in crisis start to apply this method, the Eurozone will erode, and eventually shrink to a "Hanseatic league" of countries that prefer a conservative approach to macroeconomic policy. But this would be the end of the euro as a measure to integrate Europe politically and upgrade its role in the global economy.

CONSEQUENCES FOR CENTRAL EUROPE

Each of the above mentioned scenarios would have serious consequences for the economic and political future of Central Europe - until now quite divided on the euro-membership question. While small open economies of Estonia, Latvia, Lithuania, Slovakia and Slovenia quickly made decisions to join, others have been either unable to meet the economic criteria for accession or simply unwilling to give up their national currencies. The success of EMU reforms could bring some new dynamics here - in favour of enlargement. Bulgaria, Romania and Croatia could become even more determined than now to adopt the euro, and Hungary — so far reluctant but with society supporting monetary integration — could switch to the pro-euro camp in Central Europe. Poland and the Czech Republic won't change their position on the prevailing advantages of their own currencies. They will, however, try to shorten the political distance from the euro area by demonstrating, for example, adherence to fiscal discipline, joining the banking union or engaging in other projects of enhanced cooperation to neutralize the fact that they remain outside the economic EU-core. The second scenario - a regression of monetary integration in its current form and consolidation around the "Hanseatic League" – is much more risky for Central Europe. Undoubtedly, with unpredictable political consequences it can threaten the whole integration project and thus translate into a substantial strategic challenge for the region. But if such horror scenarios won't come true, the shrinking of the euro could have a paradoxically unifying effect on Central Europe. The existing members would certainly choose to stay in the common currency regime. And for Poland and the Czech Republic, a "smaller" euro that is more cautious in demonstrating federalist ambitions and introducing transfer mechanisms could become a better option than before.

[10] Heiko Maas, "Making plans for a new world order," Handelsblatt Global, August 22, 2018.
[11] Wolfgang Münchau, "Italy is setting itself up for a monumental fiscal failure," Financial Times, October 28, 2018.

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