Why the Euro Failed and How It Will Survive

Pedro Schwartz

The great hopes that surrounded the euro at its birth have failed to come true. It was intended to be a currency as sound as the deutschemark and also a symbol of European unity. It is now reeling under the blows of a prolonged financial crisis and creating discord among the members of the European Union. Clearly, the design of the new money was defective. What its flaws were has been generally misdiagnosed: I will suggest that even if euromembers had kept by the rules of the game the euro could not have worked as intended.

Especially interesting for outsiders is how the members of the eurozone have tried to save their currency. Though some want to go back to the original sound money plan, most are hoping to turn the euro into a currency like the dollar, managed at the discretion of a politically obedient central bank. The urgency to find remedies for the present prolonged economic recession is tipping the choice toward more discretion and less independence, since the temptation to apply short-term monetary painkillers is strong even for those who would prefer a sound money constitution for Europe. Which of the two paths will the eurozone take? The choice may turn out to be futile, given the impossibility of financing the welfare state in all European nations.

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A Quasi-Gold Standard

The euro was originally devised as a kind of gold standard for a system of fiduciary money but with escape clauses to make it less automatic. The main binding condition for euro members is the impossibility of devaluing, just as under the gold standard. However, the anchor would not be gold but an issue rule that the European Central Bank (ECB) could manage with some flexibility, to wit, that money creation would be limited so that the purchasing power of the euro be kept stable one year with another. The ECB has interpreted this remit as keeping the European Harmonized Consumer Price Index (HCPI) within its stated bounds in the long term.

When the crisis struck, it became clear that this rule resulted in excessively low interest rates, with explosive effect. The discipline imposed on the euro members was also to be delayed by the possibility, eagerly resorted to in the boom, of financing balance of payments deficits almost indefinitely through the clearing system of the ECB. In practice, therefore, the ECB strayed too far from the automaticity of an anchored monetary system. The times when the Old Lady of Threadneedle Street increased or reduced the discount rate as soon as the paper pound was in danger of moving above or below the "gold points" was long past.[1]

The Original Design

The new currency was based on the idea that money in Europe was to approach neutrality as much as possible, so that the economy should adapt to changing circumstances through movements in relative prices, not by means of monetary management. The Treaty on the Functioning of the European Union (2008: Art. 127) gave the European Central Bank a single mandate "to maintain price stability."[2]

The present parlous situation of the euro shows that it suffered from fundamental technical defects in its conceptions and that

[1]The gold points around the convertibility rate of one paper pound for one sovereign were determined by the cost of transport and insurance of gold bars in and out of the country.

[2]The ECB is the head and executive institution of the System of Central Banks of the eurozone.

member states took advantage of these flaws to finance unsustainable public policies. This is how the euro was designed.

Solidity of the Currency

Aspiring member states, to be allowed to adopt the euro, had to fulfill the entry conditions of the 1992 Maastricht Treaty. In essence, they had to have maintained their exchange rate with the main European currencies (or later with the euro) within given bounds for two years without needing to devalue or apply excessively high interest rates; they must have kept their inflation at no more than 1.5 percentage points higher than the average of the three best performing (lowest inflation) member states of the EU and their long-term interest rates at no more than 2 percentage points; and their public deficits had at the time of entry to be below 3 percent of GDP while their sovereign debt should be equivalent to less than 60 percent of GDP.

It is the latter two conditions of maximum deficits and debt that have turned out to be important. They were made binding not only for entry but also for permanence. Two years before the euro was launched, the Germany at the suggestion of the Bundesbank proposed signing a Stability and Growth Pact (SGP) that would make it mandatory for all members always to keep their budget deficits and sovereign debt below 3 percent and 60 percent of their GDP under pain of heavy fines. But in 2004 France and Germany had to beg for the Maastricht limits to be temporarily suspended as both deviated from them, due to the Keynesian policies of President Mitterrand and the financial demands of German reunification. There followed in 2005 an easing of the stringent conditions of the SGP—an indulgence that Germany would later rue. In March 2011, after the sovereign debt crisis, a new "Euro Plus Pact" was adopted at the Lisbon Council to make stability conditions more stringent than in the SGP as amended in 2005. Its main practical results have been that a number of actual and prospective euro members have abolished wage indexation, reduced payroll taxes, started to set back retirement age, and amended their constitutions to limit the amount of sovereign debt they can carry.

Management of the Currency

Apart from rampant disregard of the SGP and the charter conditions by some member states, two elements have contributed to the

malfunction of the euro: inflation targeting as the objective of the ECB and the automatic clearing system of the euro.

Inflation Targeting—Though the Bank itself has not declared a strategy of inflation targeting as has the Bank of England, it has in fact defined its obligation to maintain the value of the euro as keeping the increase of the HCPI below but close to 2 percent per year in the mid and long term. However, consumer prices hardly represent all the prices of an economy, certainly not asset prices; and they may take a long time to show the effect of excessive money creation, mainly because of the interplay of expectations and the velocity of money. Instead of trying to watch the HCPI (and by the way trying to fine-tune the real economy), a better goal would be to steady the creation of liquidity in the long term.

Since financial innovation and free capital movements across the world have made the direct control of liquidity through M0 or M3 virtually impossible, a better objective variable would be stabilizing nominal income (Castaneda 2005: 63).

The aim should be to keep nominal GDP (real GDP times the price level) on a predefined secular growth path. The central bank need not distinguish between purely monetary or real productivity shocks. When nominal GDP was observed to grow excessively, the central bank would react with monetary restriction. If the unwanted increase was simply due to a monetary shock with no change in real productivity, the automatic monetary restriction demanded by this rule would result in a zero increase of the general price level (as measured by the GDP deflator). If the unforeseen nominal growth was due to a labor or general factor productivity shock, the monetary restriction would harmlessly result in a fall in the price level "to less than zero," as Selgin (1997) explained. The fear of deflation is rampant in the financial community, based on a misinterpretation of the depression of the 1930s or of the Japanese experience of recent years. But there are "good deflations," as Bordo, Lane, and Redish (2004) convincingly argue.

The procedure would be the converse when money GDP fell from its path of steady growth: if this was due to an unwelcome monetary shock, the automatic money supply increase would maintain the level of liquidity; if due to a general loss of confidence in the economy, the increased money supply would help avoid a "bad deflation."

The rule of stabilizing nominal income would have led the Federal Reserve and the European Central Bank to play a more passive role

than they did during the "Great Moderation."[3] At the end of the 20th century and during the first seven years of the present century there was great surprise that a policy of low interest rates that resulted in a continuous and large expansion of the money supply did not spill over into consumer prices. This development led the Fed, the ECB, and other central banks to think they could proceed with their policy of fostering economic growth with easy money without resulting in consumer price inflation. Asset prices, such as those of property and stocks, were not watched, as they cannot easily be included in a consumer price index. We now realize that nominal GDP grew excessively over the whole period and that a tighter interest rate policy would have been called for.

Automatic Payments Clearance—The ECB manages an automatic system called TARGET 2 to clear debits and credits smoothly across the whole monetary zone.[4] Of course, a currency area is more efficient if payments are fast and liquid, but TARGET 2 has had the unforeseen consequence of enabling some euro members to run unlimited balance of payments deficits with other member states. For example, when Spanish exporters want to be paid by their Italian clients, their banks will automatically process the claims through the Bank of Spain, which will then have claims on the ECB. On the other side, the Italian importers will finance their debts with their banks, which will process the payments through the Banca d'Italia. The latter can automatically run debits with the ECB. The negative entries will be added to the deficit side of the basic external balance of Italy. There is no limit to the debits that Italian banks and the Banca d'Italia can run with the ECB. Since, as is well known, basic balance deficits come from insufficient domestic savings, both sovereign and private, due, in turn, to a permissive interest rate policy. TARGET 2 with its unlimited clearing facilities will allow member states to accumulate large payments deficits.

Optimal Currency Areas

Less important is the fact that the eurozone is not is not an optimal currency area (OCA). Robert Mundell (1961) wrote the seminal

[3]Castaneda and Wood (2011) have called the nominal income rule "a non-active policy rule."

[4]The TARGET 2 transfer system is the second generation of TARGET (Trans-European Automated Real-time Gross Settlement Express Transfer System).

paper on this question. It is unfortunate that his model is often interpreted in static terms. The static conditions for a currency area being optimal are flexible prices and the free movement of goods, capital, and labor—in other words, a single market with free competition. In this sense, the eurozone is not optimal, with the corollary that a single ECB discount rate for the whole area is dysfunctional. Many people conclude that it would be better if the different areas of the zone were able to devalue or revalue in the hour of need. Mundell (1961, 1973) derided the recourse to flexible exchange rates among local moneys to try to counter the rigidity of a single monetary policy. By a reductio ad absurdum he pointed out that in purity the opponents of a single currency for Europe should advocate a different exchange rate for each industry and even each firm. He could have added that in the midterm currency devaluation has the same deflating affects as internal devaluation, though pressing down costs and changing production plans encounter more social resistance.

If one interprets the OCA theory in dynamic terms, then the crucial practical question is not that devaluation is impossible with a single currency but how fast and by what indirect paths the area moves toward the optimum. Under the classical gold standard in the 19th century, societies were much more flexible and took the ups and downs of local employment and the cycle in stride—Britain especially so. Capital moved freely in and out of London, the UK had no tariffs, and even British navies traveled to build railways in Spain and in Russia. Consequently, if a monetary zone is fully open to world finance and trade, and if quick progress is made toward a flexible labor market, then using a single currency becomes increasingly efficient.

The EU has bravely attempted to become a single market for services. The 2004 Bolkenstein Report, named after the Dutch politician who launched it, outlined the reforms needed to make such a market a reality. One of the main proposals of this report was that the "country of origin principle" be applied to the establishment of service firms in other EU states and the provision of cross-border services by firms operating from other EU states. According to this principle, the regulations to be applied to services thus performed both by professional and laborers, should have been that of their country of origin—something widely resisted by left-wing parties and by trade unions in the richer nations of the EU. The final text of the 2006 Bolkenstein Directive gave up this principle (De Witte 2007). Accepting the principle would have been a great contribution to lessening the effect of

differences in language, customs, and labor regulations in Europe. So we are back to hard internal devaluation.

In sum, the disobedience of SGP rules, the use of inflation targeting by the ECB with the consequent delay in correcting overlenient monetary policies, the excessive payments deficits by some members, and social and economic barriers to the single market all made for a brittle euro, whatever the original intent of its framers.

Loss of Independence of the ECB Is Not Inevitable

The Treaty articles referring to the European Central Bank, reproduced in the Appendix, show how far the eurozone has strayed from the straight and narrow. The overriding mandate of the ECB is to keep the value of the euro stable. To reinforce this mandate the independence of the ECB is safeguarded with two prohibitions. First, the ever present danger of monetizing the sovereign debt is forestalled by forbidding the European System of Central Banks to grant credit to European institutions or to member states, as well as purchasing sovereign bonds at issue, though the ECB can buy and sell bonds on the secondary market for purposes of monetary policy—an escape hatch amply used by the ECB after 2010.

Second, the independence of monetary policy is further reinforced by what has been called the "no bailout clause," whereby neither the ECB nor the Union can rescue a member state from the consequences of its own profligacy. This prohibition has also been flouted in the present euro emergency.

Perhaps the very idea of an independent national bank with the monopoly of issue of legal tender money is a contradiction in terms.

The ECB Can Interpret Its Risk Control Framework Widely

Bagehot ([1873]1999), in his fundamental treatise on central banking, set in stone, so to speak, a tradition of demanding that the issuer of money should act as a lender of last resort (LLR). Bagehot explained that a fractional reserve banking system with gold reserves kept at the issuing bank needed a fail-safe procedure for when its commercial banks ran into liquidity troubles though their balance sheet was solid. If a fall in confidence gave rise to an "internal run" on domestic commercial banks, the head of the "club" had to grant loans to its solvent banks though at a punitive rate. Even under the classical gold standard such scares recurred periodically.

The central bank still has the powers to stop imprudent financial behavior of commercial banks or even of member states. As Karl Whelan (2012) explains, " The Eurosystem may suspend or exclude counterparties' access to monetary policy instruments on the grounds of prudence, . . . [and it] may also reject assets, limit the use of assets or apply supplementary haircuts to assets submitted as collateral in Eurosystem credit operations by specific counterparties."

This "risk control framework" has been amply used by the ECB regarding paper discounted by commercial banks for more than prudential reasons. Since 2010 it is very active on the secondary sovereign bond markets where it can buy or refuse to buy sovereign bonds of member states, so that it can also influence the risk premium of the different nations. In at least one case it sent a letter to a member state (Italy) demanding reforms under pain of stopping the purchasing program. Prime Minister Berlusconi did not obey the Bank's suggestions speedily enough; thus, the risk premium of Italian bonds rose dangerously and Berlusconi was led to resign (Whelan 2012).

But the ECB Has Chosen to Be Lender of Last Resort to Member States

The ECB has been unfaithful to the spirit of the treaties by going much beyond the Bagehot LLR rule. Whatever the ECB may say, it has saved member states from bankruptcy by acquiring dodgy financial assets as collateral from commercial banks in need of liquidity.

Now that the ECB can buy sovereign bonds on the secondary market it is insensibly moving to be co-responsible for macroeconomic policy. If nothing else the ECB has made it amply clear that will not allow the euro to break apart. Chairman Draghi on July, 26, 2012, famously said: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." This is a transparent allusion to the ability of the ECB to print money. Its small capital may not limit this power, but there is a limit—namely, the effect of printing money on inflation.[5] Although Draghi's statement, and the simple expectation of ECB action, was sufficient at that time, it is clear that the rules are being changed.

[5]The ECB is not in danger of failure or even in need of recapitalization, because the assets that count are those of the entire Eurosystem of Central Banks, which still amply cover possible write-downs of private and public paper (Buiter 2009).

Before he uttered the words I just quoted, Draghi had ingeniously described the flight of the euro as that of the proverbial bumblebee:

> The euro is like a bumblebee. This is a mystery of nature because it shouldn't fly but instead it does. So the euro was a bumblebee that flew very well for several years. . . . Now . . . after the financial crisis [the] bumblebee would have to graduate to a real bee. And that's what it's doing.

Well, exactly: the euro is changing its spots, or should I say its stripes?

The Political Dimension of the Euro

The euro is very much a political artifact. This has turned the crisis of the currency into an existential question for Europe. The common explanation for the failings of the euro is quite different from mine. Eurocrats and financiers never blame the ECB for being too loose but rather lament that the governance of the eurozone is too dispersed. The catchword is that "there can be no single currency without a central state." The gold standard had no central authority, and money could conceivably be issued by private merchants or companies (Hayek [1976] 2008). Be that as it may, the greater part of the profession believes that a currency cannot subsist without a state backing and regulating it. The flaws I point out and attribute to skewed incentives are thus used by inflationists and euro-federalists as an argument for giving up the impersonal discipline of the old euro. The euro, they say, is showing cracks for the lack of centralized discipline. They would like to see a systematic extension of the lender-of-last-resort function of a central bank to include failed states, the creation of a central authority to discipline member states, and the introduction of a larger European budget to act as an automatic stabilizer. In time they hope to see the ECB turned into a government banker, a single treasury established with a single revenue-raising system, and the legitimacy granted by a homogeneous electorate.

Political Impulse

The political aim of "an ever closer union" led the framers of the euro to impose a *single* currency instead of launching a *common* currency to run in competition with national currencies. In 1990,

John Major, then chancellor of the exchequer in Prime Minister Margaret Thatcher's government, proposed the creation of a "hard ecu," offering people a choice of currencies they could freely adopt. Conceived as electronic money to be used in business and tourism, its value would initially have been equal to a basket of European currencies. It was not supposed, however, to depreciate subsequently relative to any member currency, even if one of them lost value. This would have made the ecu as hard as the hardest currency in the basket. This proposal was along the lines of Milton Friedman's idea of a "real gold standard" under which certificates representing gold deposits would circulate alongside the national currency at a fully flexible rate of exchange between the two, both free of legal tender (Friedman 1961). Parallel currency arrangements of this kind would have saved the eurozone from the epidemic we are witnessing (Schwartz, Cabrillo, and Castaneda 2013). Jacques Delors, then president of the European Commission, rejected Major's plan out of hand because he was more interested in the politics of union than in the economics of competition.

Governance

Not every country is ready to bite the bullet of consolidation as the Baltic States have done. They have borne falls of their GDP of up to 25 percent in a year, only to return to growth after a few months. The original design of the euro should have reinforced the discipline in the eurozone by some clause of suspension and even expulsion of errant members, especially of those states that did not control their budget and balance-of-payments deficits. Imposing large fines on states that find themselves deep in deficit does not make much sense.

Eurozone leaders in this crisis have chosen a different path: first, to save the failing states at almost whatever cost; second, to start building new institutions to finance the defense of the euro against speculators. On the one hand, the EU (and the IMF in a smaller measure) have lent or spent the following amounts: the bailout of Greece, $320 billion committed of which $200 billion paid out; Ireland, $90 billion; Portugal, $104 billion; and Spanish banks, a $134 billion facility of which $47 billion are being paid out—a total of $648 billion promised and $441 billion spent.

To put these aids on a more permanent basis new financial institutions have been created that could be seen as building blocks of a federal or quasi-federal Europe. Apart from the wider interpretation of the ECB remit noticed above, four important financial reforms

have been put in train: two are limited to the eurozone, and two cover the whole of the EU.

The ESM is a bailout fund that takes the place of two previous stability funds. It is supposed to help save troubled national banks. It can muster up to €500 billion ($666 billion). For that purpose it was necessary to amend Art. 126 of the 2008 Treaty concerned with formulating the principle that "Member States shall avoid excessive government deficits." The new text read thus: "The member states whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole. The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

This clearly derogates the no-bailout clause.

The Banking Union is a first step toward centralizing eurozone commercial bank supervision within the ECB. It is flanked by two other authorities covering the whole of the EU: the European Securities and Markets Authority and the European Banking Authority.

The rationale of this institutional evolution is the need to control or reduce moral hazard created by guarantees proffered to save banks and governments from the consequences of imprudent behavior. Once such guarantees are believed to be automatic, two loops appear: the private debt–sovereign debt loop induced by too-big-to-fail banks, and the debt-currency loop caused by the central bank becoming the government's lender of last resort. To stop these vicious circles, powers to inspect, discipline, and regulate become necessary.

Out of the Door, like the Gold Standard

The question boils down to the choice between a stable currency issued by an independent central bank and pliable money managed by a government department. According to its charter, the ECB was not supposed to exploit short-term money illusion to try to foster employment or growth. This and the discipline of the SGP made it very difficult to fight a recession with Keynesian instruments, if this is at all possible. In the end, try as you may, the pain of fiscal consolidation and expenditure cuts, magnified by devaluation or insolvency, cannot be avoided. To this must be added the cost of lower growth due to skewed incentives and much greater volatility. So, one of the advantages of having to guarantee a solid currency is that it forestalls

governments from applying irresponsible fiscal policies as if they were effective for the real economy and can always be financed with foreign debt.

The massive efforts to save Greece and the other intervened economies show how far eurozone leaders are ready to go to keep their flock together. They think all would be well with a more executive, functioning, integrated, protected, and powerful European Union. To the disappointment of all concerned, the Greek quagmire may be slowly sucking in the single currency and its passengers. The euro is at bottom a political project for turning the EU into a state, not a way of opening the European economy to world competition.

When the victors of WWI returned to gold around 1926 they did so in a form that was less costly than the classical gold standard—namely, the "gold exchange standard." Gold coins stopped circulating, gold reserves were concentrated in the United States, and only the dollar was linked to gold while other currencies kept their exchange rates fixed to the dollar. It did not last.

Fixed exchange rates (including their most extreme form, that of a single currency) can have a high social cost in countries where prices are sticky and unionized labor resists cuts in money wages. This was the case in Britain during the 1920s when the rate of unemployment mostly stayed above 10 percent despite the general prosperity. Involuntary unemployment spread after the 1929 crash. One by one, countries left gold and even the United States changed the parity. Competitive devaluation coupled with exchange controls became the norm, with the consequent harm done to world trade. Both the cost of gold in terms of unemployment and the disorder resulting from managed devaluations have stayed in the collective memory.

Conclusion

Much of what was attempted with the creation of the euro can be explained by the wish to have a solid currency and so avoid trade-destroying escapes or anti-competitive social policies. But the barriers to be surmounted if there is to be a single European currency are not only trade protectionism or belligerent trade unions. In the 21st century it is clear that a majority of voters are not ready to accept the need to start paying for their pensions, health services, and the education of their children. My pessimistic conclusion is that the fundamental

obstacle for a neutral and solid currency, both in Europe and in America, is the welfare state and its insatiable demands.

Appendix: Statutes of the European Central Bank

The Treaty on the Functioning of the European Union (2008) stipulates that

> Art. 123: "Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments."

> Art. 125: "The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project."

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