IDEAS

THE EURO TEN YEARS ON

NEW RULES FOR A HIGH STAKES GAME

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It is not the euro that has failed but the European governance structures and the problems of having a common currency without a common fiscal policy. Ultimately, the euro's troubles stem from a lack of discipline.

EURO • CENTRAL EUROPEAN BANK • BAILOUT
SOVEREIGN DEBT • INTEGRATION

On January 1, 2002, the euro began to circulate among the countries in the Euro Zone. It had already been in use for three years in financial markets, but until then it had not reached the cash registers and wallets of the citizens of the 11 members of the European Union that adopted it. It was also adopted by Monaco, San Marino and Vatican City although they are not members of the union.

When the euro's first decade was celebrated in 2009, it was eulogized by analysts as a strong currency that was in good health and that since its launch had gained 22 percent in value against the dollar. Today, 10 years since it went into general circulation, there is less to celebrate. The euro is not enjoying its finest hour. What has gone wrong? What has changed in the past three years?

THE EURO HAS NOT FAILED

The euro has not failed as an umbrella against a combined currency and banking crisis, as has been the case in emerging countries. Nor has it failed as an anchor against inflation, with the European Central Bank (ECB) as guarantor, nor as a vehicle for integrating the single European market. It's not the euro that has failed, but the European governance structures. We have seen this in the successive crises in the euro area and bailouts of countries on the periphery, the so-called PIGS (Portugal, Ireland, Greece, Spain) that are without doubt the weak link in the euro area.

Viewing these countries in the order in which they fell, we could reverse the English acronym and talk about the GIPS: Greece, the first to fall, Ireland six months later and Portugal six months after that. Let's hope that Spain doesn't need a bailout. In Greece, the crisis was triggered by the high budget deficit. In Ireland it was a failure of the banking system that pushed the budget deficit up by 30 percent. Portugal fell victim to its low growth outlook, made worse by austerity plans. To these we can add Italy's recent problems and so could speak of the PIIGS or GIIPS.

In reality, Spain suffers from the same problems as the three countries that have already fallen: high budget deficit, problems in the banking sector and poor growth outlook. That said, it suffers from them to a lesser extent. On the plus side, it has a dynamic export sector of goods and services that has been able to hold its own in the world market since joining the euro.

Spain's big problem is low growth, and in order to change the situation measures need to be taken to increase productivity and competitiveness. It is regrettable that Spain didn't carry out reforms at the beginning of the crisis, between 2008 and 2009, because this would have allowed it access to more credit, and as a result would have faced less austerity than it does today and therefore the outlook for growth would be better.

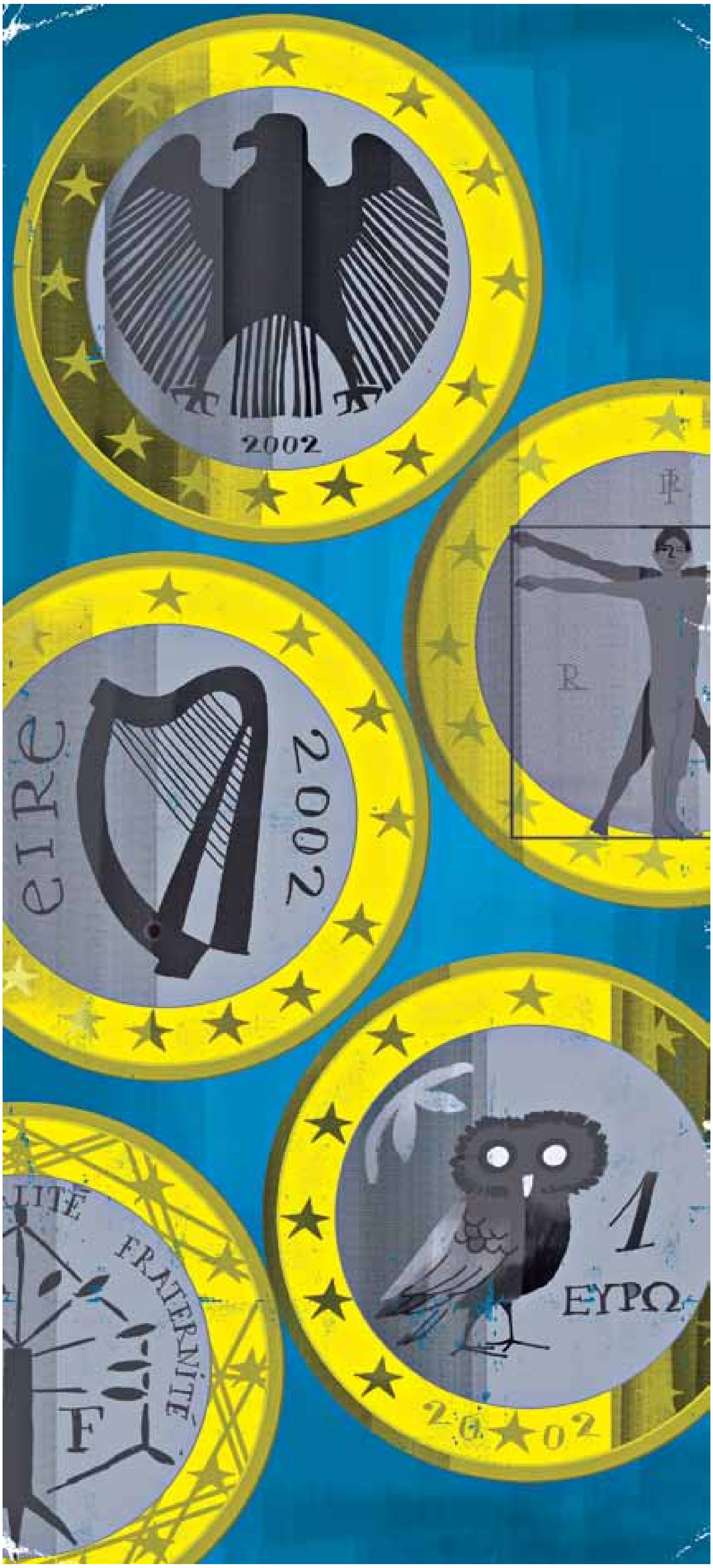
LACK OF DISCIPLINE

For the euro area to be viable and if a common currency is going to suit all, there cannot be significant imbalances between countries. However, this equilibrium has not been achieved, as demonstrated by the ECB raising interest rates which has a negative effect on the recovery of peripheral member states. Indeed, it is widely believed that this rise will make the recession in Greece, Ireland and Portugal worse, and will slow already weak growth in Spain.

The euro area is not an optimum monetary zone because, unlike the United States, it doesn't have a common fiscal policy or labor market. It was designed with the idea that its viability would be based on a combination of internal and external discipline. We can now see that these good intentions were not enough. All three pillars required to sustain this discipline have failed, that is to say: internal rigor, the fiscal discipline of the Stability and Growth Pact (SGP) and the way in which the no bailout clause has been interpreted by the ECB.

Internal discipline implies that countries have to improve their productivity because they cannot gain competitiveness through currency devaluation. Spain has lost much of its competitiveness since the advent of the single currency, in relation to the overall euro area and particularly in regard to Germany, by some 30 percent. It has not been the only one affected in this way. The other peripheral countries have also witnessed a widening gap in their competitiveness with Germany.

The fiscal discipline of the SGP has also failed, with limits of 3 percent of public deficit over GDP and 60 percent of public debt over GDP. In fact, although the SGP has been broken on 68 occasions, including by France and Germany, no sanctions have been applied.



THE EUROPEAN CENTRAL BANK HAS TRIED TO MAKE UP FOR THE LACK OF A COMMON FISCAL POLICY BY BUYING BONDS IN THE PERIPHERAL MEMBER STATES.

To all of this we must add a very lax interpretation of the clause in the Treaty of Europe that says that there will be no bailout for fiscally irresponsible countries and which prohibits the ECB from buying sovereign bonds. This relaxed reading has allowed for the rescue of Greece, Ireland and Portugal and has meant that the ECB has bought these countries' bonds while putting its own balance at risk and, therefore, the money of European contributors. These bailouts can partly be explained by the need to protect European banks and to avoid financial contagion between countries that might result from the exposure of some banks to the sovereign debts of peripheral member states.

The result of all these failures has been to make the Euro Zone vulnerable to speculative attacks on the sovereign debt of the member states. As long as the problems of public debt continue, so will these attacks. At the moment, Spain does not have a problem of solvency but could have a liquidity problem if the refinancing of the debt in the context of a speculative attack on Europe's periphery becomes very costly.

WHAT IS THE SOLUTION?

Faced with this delicate situation, what measures can be taken? At present, the strategy for dealing with the problems of the European periphery consists of trying to buy time until the arrival of an economic recovery that would strengthen the banks and improve the outlook for growth in countries such as Spain and Italy. It's a risky strategy, because something unforeseen (such as, for example, a massive speculative attack on the peripheral debt) could undermine it. The ECB has tried to make up for the lack of a common fiscal policy through buying bonds in the peripheral member states, but this policy has been stretched to breaking point.

Thus, solutions for keeping the euro afloat must involve drawing up clear rules of the game which allow countries with liquidity difficulties to be helped while at the same time maintaining incentives for fiscal responsibility and the convergence of levels of competitiveness of the various countries.

In theory, two "pure" solutions could be applied. The first consists of putting complete trust in the discipline of the market and ensuring that a country would only be bailed out if it had liquidity problems and if this was done without the need to impose fiscal rules. The second way is to move towards fiscal centralization and integration with countries ceding significant areas of fiscal sovereignty. This measure would require a greater level of political integration.

However, politically speaking, it does not seem likely in the short term that Europe will opt for solutions of market discipline or fiscal centralization and integration such as in the United States. Instead, it will have to look for mixed solutions that integrate market discipline and external fiscal discipline in the various member states.

The last CESifo report on the European economy proposed a crisis resolution mechanism combined with fiscal and banking supervision procedures within the European Union to make the euro area viable. Governments are already moving in this direction, with measures such as the "euro pact" designed to create a financial stability fund. They have also put forward proposals about fiscal supervision and reforms to improve the competitiveness of the most laggardly countries.

It is still too soon to assess whether these measures will be sufficient because their effectiveness depends largely on the details. However, we can predict that, although governance reform in the Euro Zone is progressing, the current period of turbulence will not end until the euro area has a reorganized banking system and until some credible growth outlooks emerge in the peripheral countries, that is, in the GIPS or GIIPS. The storm will pass but it will still be a while before we see clear skies. Until then, best not leave the house without an umbrella.