The unfulfilled promise of the euro

Tano Santos
David L. and Elsie M. Dodd Professor of Finance.
Columbia Business School. Columbia University

This note offers some thoughts on the euro and the many diagnoses that have been advanced for the problems that currently plague the monetary union. The monetary union should have led to a profound reform of many of the economic institutions of member nations, such as labor markets and pensions. It argues that the conditions in the early years of the euro were not conducive to these reforms. Member nations wanted monetary union for different reasons. I argue that many of these reasons remain in effect today and thus the relatively high support for the euro even in countries that have perhaps suffered the most during the Eurozone crisis. But the monetary union remains in a perilous situation unless there is progress in the minimal set of reforms needed to make it sustainable in the face of more crises.

Misgivings about the euro before the euro

It is difficult to argue, with the benefit of hindsight, that the euro, at least as conceived and implemented, was a good idea. This does not mean that we should undo the euro: Monetary unions are like marriages, the conditions of entry are not those of exit, in particular if children are involved. The euro when it was first imagined was simultaneously a narrow and broad project, one in which European citizens have invested much. It was narrow because it was "just" a monetary union and it was broad because it included countries with very different economic structures and challenges as well as different political cultures and institutions. These countries each had a myriad of reasons to join EMU, some sound, some less so. It is important to assess whether these reasons remain operational. Many, and perhaps most, observers understood the partial nature of the project and that the incompleteness could lead to trouble down the road. The specific diagnosis of what could go wrong proved more elusive though.

Some of the vague reasons that could lead to trouble in the monetary union were anticipated by both policy makers as well as by economists on both sides of the Atlantic.[1] The dominant view from the other side of the Atlantic was best summarized, with characteristic clarity, by Milton Friedman in 1997. First the theory:

"A common currency is an excellent monetary arrangement under some circumstances, a poor monetary arrangement under others. Whether it is good or bad depends primarily on the adjustment mechanisms that are available to absorb the economic shocks and dislocations that impinge on the various entities that are considering a common currency. Flexible exchange rates are a powerful adjustment mechanism for shocks that affect the entities differently. It is worth dispensing with this mechanism to gain the advantage of lower transaction costs and external discipline only if there are adequate alternative adjustment mechanisms."

Then the view on the specific project itself:

"The drive for the Euro has been motivated by politics not economics. The aim has been to link Germany and France so closely as to make a future European war impossible, and to set the stage for a federal United States of Europe. I believe that adoption of the Euro would have the opposite effect. It would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues. Political unity can pave the way for monetary unity. Monetary unity imposed under unfavorable conditions will prove a barrier to the achievement of political unity."

There are two arguments in this paragraph, one more persuasive than the other in my opinion. First is the idea that the need to adjust to divergent shocks would lead to political tensions. The Eurozone crisis has given conclusive proof of this basic point though I would argue that even here there is some room for discussions. The second is that the monetary union is a conscious step towards a political union, a view that is less warranted. Both arguments enjoyed broad consensus amongst American economists (see, for example, Feldstein, 1997) and led some to forecast the immediate demise of the euro (Calomiris, 1998). Rudiger Dornbusch provided a useful taxonomy of the American economists response to the monetary union: "It can't happen", "It's a bad idea" and "It won't last." It remains a useful taxonomy today. The resilience of the euro in the face of these views is simply a thing of wonder.

---

[1] For the view of the American economists, both in academia and policy circles about the euro in the years between de Delors report and the introduction of the formal introduction of the euro see Jonung and Drea (2010).

The view that the need to adjust to divergent shocks amongst trading partners requires either floating exchange rates or some form of fiscal coordination has a long tradition in economics, of course. For instance, economist have understood for a long time, say since Sargent and Wallace's (1981) classic, that monetary and fiscal policy are joined at the hip and thus a monetary union without a fiscal union could potentially lead to severe policy difficulties and tensions between member nations unless there was a quick convergence in economic performance and business cycles across member nations. Incidentally the concern related to the lack of economic harmonization across potential members of a European monetary union dominates many of the ur-texts of the project, starting with the 1969 Werner Report, as shown in James's (2012) history of the EMU. Policy makers were aware from the very beginning, and well before conceptual advances in academia, of the challenges that the project entailed.

Still, it is interesting to note that the emphasis that many were bringing to the debate on the wisdom of the monetary union was on the political side of the project, that the euro was undertaken for political reasons and that its design flaws would lead to the political tensions that it was supposed to eliminate. That is, many economists on both sides of the Atlantic understood that a monetary union needs adjustment mechanisms in the presence of asymmetric shocks and that this need could lead to problems as the ex-post transfers needed to smooth out these shocks would result in political tensions amongst member nations. Unfortunately, this insight, deep as it is, proved rather inadequate to understand the actual dynamics of the Eurozone crisis.

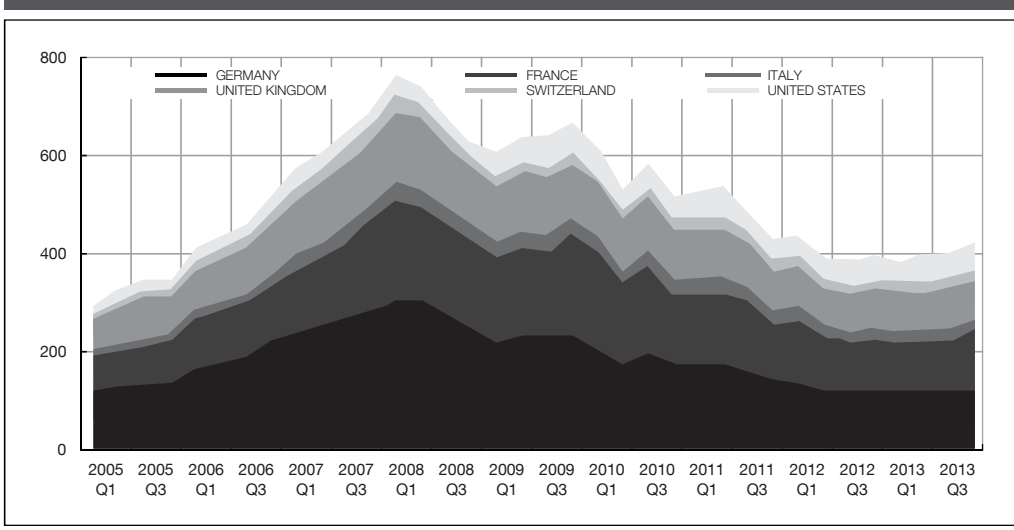
When economists picture asymmetric shocks they imagine economies at different points in the cycle, some doing very well, others very poorly. But, as argued by De Grauwe and Ji (2016), in fact business cycles in the Eurozone were well coordinated in the years of the euro: All the economies did fairly well in the early years and then did very poorly after 2008. It was the amplitude of the cycles and the surprisingly large current account imbalances that led to problems. The problem of smoothing shocks of different amplitudes is that it involves transfers from those who are in a recession to those that are in a very bad recession. This will create tensions as it forces into a deeper recession the countries already in a slump. Incidentally, only this simple insight is already a more productive line of thought: it emphasizes intertemporal solutions rather than purely cross sectional transfers.[2]

[2] Paul de Grauwe has recently emphasized with a recent proposal for the EMS to buy national bonds during recessions and fund those purchases with EMS bonds and do the opposite during good times. This proposal has the very attractive feature that undoes the perverse capital flows that we saw at the height of the Euro crisis.

In addition the nature of the shock matters for the willingness to provide assistance in the presence of adverse shocks. When the crisis came it was in financial markets where it first manifested itself. This is not surprising for prices in financial markets are supposed to reflect information and thus they serve as the perennial canary in the coal mine when the horizon darkens. Banking systems in Ireland first, then in Greece, Portugal and Spain came under severe refinancing pressure and that accelerated the Eurozone response. There were indeed political tensions but the fact was that the different banking systems were closely interrelated. For example the German and French banking systems had significant exposure to any distress in the Spanish banking sector (see Chart 1). Problems in the Spanish banking sector (or in the Irish, Greek or Portuguese) were not solely Spanish problems. They were European problems and quickly were given European solutions, however imperfect, controversial and contradictory.[3] This shouldn't have been surprising to close observers of the evolution of the euro. The early years of the monetary union were characterized by the development of big current account imbalances and large negative net international investment positions in the periphery and positive in the core. Creditor and debtor nations were inextricably linked and that mediated the continental political response to the Eurozone crisis. There were indeed political tensions but they had the mundane flavor, however nasty, of the bickering and bargaining between borrowers and lenders.

[3] For instance, a monetary union requires on many occasions sovereign debt restructuring as an adjustment mechanism but the Eurozone leadership has been reluctant to use this natural form of adjustment in order to avoid debt overhang problems.

CHART 1 **SPAIN: FOREIGN BANKS CLAIMS. BILLIONS OF $US**



SOURCES: BIS and Banco de España.

The unfulfilled promise of the euro

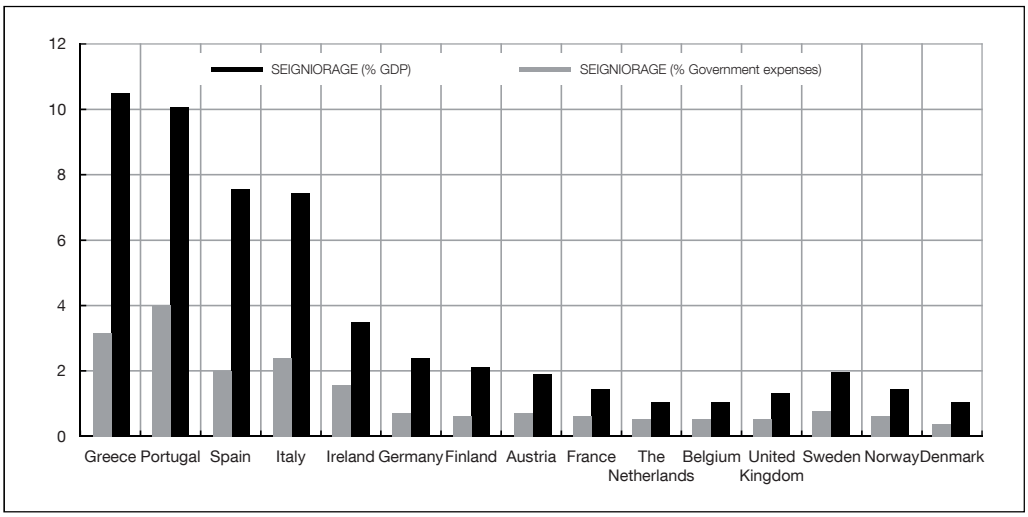
What is surprising about the opinions of such distinguished economists as Milton Friedman or Martin Feldstein is that they emphasized the political aspects of the monetary union but were unwilling to integrate those considerations into their analysis.[4] As Goodhart (2010) has remarked "[t]he main failing in this respect of academic U.S. economists was to look at the European monetary experiment almost entirely through the prism of a narrowly economic model, the optimum currency area (OCA) theory—a model which has been wholly insufficient to explain relevant facts about the life, and death, of currencies—rather than via wider political economy factors." European policy makers and commentators were keenly aware of the arguments put forth regarding the economic complications of the euro project and many diagnosed its potential pitfalls with remarkable prescience (De Grauwe, 1998). Why then the project?

Clearly Eurozone politicians did not understand that the conditions for a successful monetary union were not in place (De Grauwe, 2013). But the truth is that the euro occurs because of a peculiar and somewhat messy coincidence of disparate causes. As James (2012) has shown the many frustrations of exchange rate management in Europe after the demise of the Bretton Woods system were important reasons to pursue the monetary union. In addition it is indeed the case that anxiety over German reunification may have accelerated the impulse towards the euro, though the project was well under way before those political developments, in particular after the adoption of the Single European Act (SEA) in 1986. But here I want to emphasize two others that I believe do not receive the attention that they deserve.

The first is that the euro was simply a way for many potential members to strengthen their institutions as well as to impose discipline in policy choices. Many countries had standard problems of commitment in regards to monetary policy and resorted continuously to inflation and devaluation to address both fiscal and current account imbalances. The development of the welfare state was simultaneously producing a class of voters interested in price stability, from pensioners to long term unemployed workers. It is thus unsurprising that this new constituency for price stability was supportive of a monetary union modeled after stringent German monetary policy habits. Chart 2 shows seignorage revenues as a percentage of both government expenses as well as GDP. The countries are ordered from more to less profligate. Notice that the countries that opted to stay out of

[4] There is another surprising aspect of the monetary union and it is how informed it was with monetarist ideas, in particular real business Cycle Theory. Given that the main source of aggregate economic fluctuations are total factor productivity shocks and that there is little that monetary policy can do about this source of fluctuations, the objective should be one of just price stability (see De Grauwe, 2013).

CHART 2 **AVERAGE ANNUAL SEIGNIORAGE RATES 1971-1990**



SOURCE: R. W. Click "Seignorage in a Cross Section of Countries," Journal of Money, Credit and Banking vol. 30, no. 2 May 1998, pp. 154-171, Table 1.

the euro are those that derived the lowest percentage from currency debasement. It is not unreasonable to assume that the constituencies for price stability in those countries didn't see any need to join the nascent monetary union.

In addition the euro was perceived not only by those constituencies but also the entrepreneurial middle classes and even the political establishment as a mean to transform and reform obsolete economic institutions.

Indeed, the thought of the euro, of the monetary union in general, as an instrument of transformation goes back to the very initial discussions on monetary union. For instance, Guido Carli, the legendary Governor of the Bank of Italy between 1960 and 1975 said in a 1972 speech that *'in accepting the fact that monetary unification precedes economic unification one must bear in mind that the former cannot last unless it is followed by the latter in a fairly short time. Monetary unification is thus instrumental.'*[5] And Lucas Papademos, on the occasion of Greece's ascension to the monetary union in 2001 said,

"After entry into the euro area, the Bank of Greece will be implementing the single monetary policy decided by the Governing Council of the European Central Bank and it will certainly be impossible to improve the economy's international competitiveness by changing the exchange rate of our new currency, the euro. The objectives of higher employment and output growth will therefore have to be pursued through structural

[5] Quoted in James (2012) page 74.

reforms and fiscal measures aimed at enhancing international competitiveness by increasing productivity, improving the quality of Greek goods and services and securing price stability"

The connection between the structural reforms and EMU of course came to a head during the Eurozone crisis. Spain is an example in point. The famous ECB Spanish letter of August of 2011, which was finally released in December 2014, is a remarkable document and one that contains many clues not just about the crisis and the political economy problems plaguing Spain at the time, but also about what did not happen before the crisis. Let me just focus on point 1 of that letter, which is concerned with labor market reforms. There Mr. Trichet points out that Spain needed to tackle labor market reforms aimed at strengthening firm level wage bargaining and thus weakening collective bargaining and doing away with indexation, which, as he rightly pointed out, was `not an appropriate feature of labor markets in a monetary union'. Indeed it is not but then why was it there after more than a decade of Spain being a member of the monetary union, in fact a highly praised member? What happened during that first decade of the euro that something that was deemed untenable in a monetary union survived like the unpleasant plant in one's beloved garden for so long? Incidentally Spanish economists have insisted about the need of labor market reform for several decades now. In fact many argued that labor market reform would naturally happen in Spain in a monetary union precisely to endow it with the flexibility that was going to be needed to make Spain's membership in the EMU sustainable. But labor market reform did not quite happen in Spain during the early euro years, nor did Greek pension reform … Why?

To make my argument more clearly and perhaps provocatively, I want to think of the euro as another step in the deregulation movement that swept the US starting in the 1970s and that reaches Europe in the 1980s. One useful way to understand the deregulation movement is to think of it as a step towards removing the state from the business of allocating capital, either through direct portfolio requirements for banks or implicitly through distortions in prices (for example through the repeal of Regulation Q under the Depository Institutions Deregulation and Monetary Control Act of 1980 in the USA.) The very reasonable idea behind this movement is that the market is better suited to provide this key function in the capitalist system and that institutions would naturally evolve to compete for the now free to move about capital, reforming institutions and improving allocative efficiency and productivity (and tax revenues). It is not coincidental that this movement occurred in a period of very high interest rates, when capital was scarce and the efficiency gains of allowing the market to

perform this role were enormous. The Single European Act first and later the euro allowed European political elites to remove themselves from the complicated task of allocating capital, with the associated rent seeking behavior that was so harmful from a societal point of view. But most importantly the idea was that the monetary union would create the conditions to make structural reforms simply unavoidable. The euro would force the reforms that were proving so politically intractable, whether pension reform in Greece or labor market reform in Spain.

But what if the market does not perform that role of allocating capital properly, because of asymmetric information frictions or simply behavioral biases by part of investors? And even if these issues are not important what if capital is plentiful rather than scarce as it was in the 1970s and thus the salutary effects of competing for capital are much attenuated?

Fernández-Villaverde, Garicano and Santos (2013) argue that the euro did not deliver in its promise precisely because it did not create the conditions that were anticipated by the promoters of the euro. Quite the contrary the euro coincided with very lax liquidity conditions that removed all incentive for reforms, which many thought were key to make the monetary union sustainable. Capital was plentiful during the early years of the euro - witness the enormous drop in interest rates across the world - and there was some severe mispricing going on as shown by the hard to rationalize compression of the sovereign spreads across the monetary union. Both effects combined to eliminate all incentives to adapt to the monetary union and this is where we are still. Whether the euro had something to do with these two causal forces deserves a thorough examination. I think EMU and the drop in interest rates are two unrelated phenomena. Though possible, I think it is more difficult to argue that the euro didn't have anything to do in the equally remarkable compression of spreads. Be as it may my take is that the euro did not have much of a chance to operate as an instrument of national economic transformation under these conditions. This is not to say that good things had not happened under the euro. In particular there has been important investment in infrastructures and an improvement in the corporate business sector in many countries. But it is not enough: Institutions matter and it is in the transformation and reform of those institutions where the euro didn't deliver on its promise.

Conclusion

The euro failed, perhaps only partially but no less importantly, as an instrument of transformation of national economies. When that transformation finally happened it had to occur under conditions that compromised the existence of the monetary union itself. What made the crisis severe is that it delinked "economic time" from "political time". Things needed to happen fast in what concerned deep structural reforms aimed at making national economies more

flexible and thus the monetary union sustainable, but the political time had not changed. The political establishment, which had so thoroughly procrastinated in the early years of the euro, needed to bring together different constituencies to implement those reforms. That process is difficult and needs much bargaining between different parties.[6] It is not surprising that the European Central Bank had to create the liquidity conditions that could potentially bring together "economic" and "political" time. It remains to be seen whether there is enough time.

Economists are always surprised with the failure of the Coase theorem: If it is efficient why doesn't it happen? My answer is that because we systematically ignore the enormous political economy constraints under which our politicians operate, for better or worse. Nothing can happen fast in our democracies. Coalitions need to be put together and social contracts at the member nation level need to be readjusted but for that to happen coalitions have to be realigned, political capital needs to be spent and elections held to give legitimacy to whatever change needs to be brought about. That of course is not a principle we should abandon.

All in all, dramatic and painful as the Eurozone crisis has been, the euro is still there, the majority of the citizens in member nations support the euro (though in Italy the situation is borderline) and it seems that if continued membership were to be put for a vote the no would face a significant challenge (see Roth, Jonung and Nowak-Lehmann, 2016). This does not mean that the survival of the euro is guaranteed or that the situation cannot flip quickly. Recent election surprises, such as the Brexit vote, should serve as a word of caution against complacency. An interpretation of the polls is that there is, as has always been the case, a reserve of goodwill capital among Europe's citizens towards the European Project. That reserve of goodwill is not infinite, but it is there and should be made use of to make the monetary union stable and sustainable.

[6] Alesina and Drazen (1991) is a useful reference to understand how time can be can important factor when it comes to structural reforms.

References

ALESINA, ALBERTO and ALLAN DRAZEN (1991) "Why are Stabilizations Delayed?" *American Economic review* 81 (5), pp. 1170-1188.

CALOMIRIS, CHARLES (1999) "The impending Collapse of the European Monetary Union," Cato Journal, January 1st 1999.

DE GRAUWE, PAUL (1998) "The euro and financial crises", Financial Times, February 20th.

— (2013) "The Political Economy of the Euro," *Annual Review of Political Science,* vol. 16, pp. 153-170.

DE GRAUWE, PAUL and YUEMEI JI (2016) "How to Reboot the Eurozone and Ensure its Long-Term Survival," Vox, February 12th 2016.

FELDSTEIN, MARTIN (1997) "EMU and international Conflict," Foreign Affairs.

FERNÁNDEZ-VILLAVERDE JESÚS, LUIS GARICANO and TANO SANTOS (2013) "Political Credit Cycles: The Case of the Eurozone," J*ournal of Economic Perspectives,* vol. 27 n.º 3, pp. 145-166.

FRIEDMAN, MILTON (1997) "The Euro: Monetary Unity to Political Disunity," Project Syndicate, August 28th 1997.

GOODHART, CHARLES (2010) "Understanding the Euro Requires Political Economy, Not Just Economics," Econ Journal Watch, vol. 7 n.º 1, pp. 59-60.

JAMES, HAROLD (2013) Making the European monetary Union.

JONUNG, LARS and E. DREA (2010) "It Cant Happen, It's a Bad Idea, It Wont Last: US Economists on the EMU, 1989-2002."

ROTH, FELIX, LARS JONUNG and FELICIAS NOWAK-LEHMANN (2016) "Public Support for the Euro," voxeu, November 11th, 2016

SARGENT, THOMAS and NEIL WALLACE (1981) "Some Unpleasant Monetary Arithmetics," Federal Reserve Bank of Minneapolis Quarterly Review, Fall, pp. 1-17.