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The euro is irreversible

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Abstract:
There, with these few words which are all at the same time – political, psychological, financial and economic – (and in that order), everything has been said! At last, there is an explanation to the problems and difficulties encountered at present in the management of the euro zone, in the strategic wager that led to its birth. No political leader of note had dared challenge this until 11th July 2015, when the "solution", a temporary (five year) exit from the euro zone by Greece, prepared by Wolfgang Schäuble, the German Finance Minister, was leaked to the press. Then there was a total change in situation and the Greek issue was "dealt with" as a matter of urgency: Greece accepted the "effort to be made", the other countries would "help".

So, what point are we at now? Have we found a solution? Is this just a lull? It is neither of these of course. Since then, further tension has grown in various euro zone countries (independentist movements, countries that have become extremely difficult to govern, increasing criticism of the ECB) and on its periphery (the Brexit). Over the last few days, Europe's slow economic recovery has been a cause for concern, and increasingly the risk of a world crisis is bringing down the stock markets.

Until Mario Draghi, the ECB President, said that "there are no limits" and that he would act "within the remit of his inflation mandate, close to, but below 2%" to support activity in the euro zone. The world markets recovered. But for how long? They believe that the euro is irreversible and it is decisive, but we have to tread carefully at the moment. Confidence in a currency is never a given, it comes from serious, long term effort and the passing of tests.

And so how should we understand the euro zone's wager and its difficulties in implementation? How can we understand its importance; not just that of it being "a monetary zone" but that of being the "biggest economic entity in the world"? Where do we go from here?

SO WHY DO WE SAY: THE EURO IS IRREVERSIBLE?

A monetary zone is a political act, not the enactment of a chapter of monetary theory: this cannot be repeated enough. It entails bringing a group of countries together around a single currency in order to strengthen their geopolitical influence and their economic efficacy, both of these being linked. Of course this process is long term and complicated. A monetary zone is not automatically optimal. It becomes so over a period of time, a long time; in other words, by withstanding the shocks that it has to suffer. It does not become optimal in the strict sense of the term, but it does become increasingly credible, depending from the beginning on the strength and compatibility of its various components. It especially becomes so according to the centripetal ambitions and impetus towards integration, which appear to be increasingly powerful in comparison with the centrifugal forces of disunion.

In Europe's case creating the euro zone on the template of the ECSC, with some countries drawing closer economically and financially. They shared the same parameters, in this case the famous Maastricht criteria (inflation, long term interest rates, government debt and debt/GDP ratios). These criteria were then observed over a two year period, the time required to see how each country fitted in with the others, in other words, how they started to converge towards the (nominal) targets put forward and therefore, through this nominal prism, towards other member countries. It was intended for the economic-financial base to be created in this manner.

A QUALITATIVE LEAP

Then the single, so-called irreversible currency was introduced. This was a qualitative leap. It implicitly supposed that all of the euro zone members understood the rules of the game, that they would follow them, notably in terms of necessary disinflation and budgetary deficit, in the knowledge that, in the euro zone no country could be saved by another, nor could it be financed by the European Central Bank if it did not follow those rules.

The irreversibility of the euro is therefore an extremely strong commitment to external credibility vis-à-vis all of the other countries and all of the monetary zones in the world, based on a commitment to internal credibility on the part of the political, economic and social forces that created the monetary union. By saying that the euro is irreversible, they are guaranteeing that they will not deviate from the rules that created the single currency. These rules are quite simple in fact:

- For private business economic competitiveness is the zone's foundation. It enables long term employment, which in turn comes from cost-competitiveness (wage moderation –therefore social dialogue, and cost moderation – therefore the quality of public administration) and non-cost competitiveness (innovation with profitability, training and flexibility, thanks to quality social debate within the company),
- Budgetary efficiency enables the co-existence of the States in the zone without debt and without massive transfers. This comes from a quality debate between elected representatives and the electorate of each country, which are supported by their national administrations.

CORRECTING MISTAKES

In this context if a country diverges from the path, this first becomes evident in terms of inflation. It will have more than the others if it has more wages (private and public) than the others. Then its competitiveness declines. There is a real consequence in terms of the external deficit which increases without any visible effect, since we are in a single currency: firstly businesses weaken, with an impact on employment, lower tax and budgetary revenues, then there is rising deficit and debt. Very quickly financial consequences follow suit, with the rise of long term rates in comparison with the countries that are doing relatively better.

This negative string of adverse effects should "normally" lead to a virtuous cooperative solution. The country which diverges from the rest has to moderate wages and public demand, therefore slow down in order to restore private competitiveness, export more and improve its public accounts.

A PERSISTENT DOUBLE ERROR

But the gap in terms of convergence can also lead to two other less virtuous types of behaviour. Firstly, the country might continue its deviant behaviour, and "play" with the rules; or there is a quest for another type of growth that places emphasis on internal goods and services rather than tradeable goods and services. We know where the path of "persistent deviation" leads. "Small countries" came under pressure (Portugal) when they drew away from government deficit rules, but not the "big" ones, which managed to avoid this: France and Germany in 2003. Behind the taboo of a country exiting the euro zone, with its internal rules and sanctions, as well as the ban on the monetary financing of deficits by the Central Bank, the idea was to strengthen the Union's credibility via the respect of the rules. The following of budgetary and deficit rules was to be decided either by a country from within – a better solution – or from the outside – under the pressure of its peers. But in 2003, this was not the case for the two biggest countries. These double standards had a negative effect – even though as a result a bid was made to "refine" them. The price has to be paid if you do not practice what you preach but not necessarily by those who infringe the rules. Not necessarily straight away. Rules never cover everything but they have to be improved in mutual transparency and supervision. Otherwise they weak their vengeance.

It was then decided to test the path of "innovative deviance". Indeed the countries in the south quickly saw that it was difficult to follow growth via external competitiveness according to the German method. At the same time they soon realised the interest of domestic growth, taking advantage of Germany's credibility and the interest rates which it enabled. In other words, the south fell into debt as soon as it entered the euro zone with its German rates, ie at least 300 base points below its former financing conditions. Entry into the euro zone was a positive interest rate shock to begin with for Spain, Portugal and Ireland, in which they supported growth via …. real estate.

THE CASE OF SPAIN

The case of Spain is a perfection illustration of this trend. The production of housing in Spain grew and grew, fuelled by low interest rates and the banks' extremely aggressive credit distribution policies. The results were spectacular. The countries in the south, and not only Spain, soon caught up on the European average, after the rise of the relative share of construction in the GDP. Wages started to rise also, undermining competitiveness. But developments in terms of foreign trade are invisible in this model. The important thing is growth, with employment and more importantly, the fiscal revenues that go with it. And, as always, this works as long as "the building industry is working."

But there came a time when the surplus production of housing in the south became evident. Property became difficult to sell, stocks rose. Building companies suffered. The banks and savings banks worried, right up to the moment the bubble burst before their very eyes. The banks collapsed, recession set in. The budgetary deficit and the government debt soared. Long term rates rocketed.

On the edge of the abyss, Spain and the other countries in the south, called on the others for help. They responded positively, which shows their fundamental solidarity. But of course aid went together with commitments that the countries would switch path. There would be less internal and more external growth. They then undertook a dual internal devaluation (since with monetary devaluation is no longer possible with the single currency). This meant wage devaluation first, via the reduction of wages and retirement pensions, therefore their production costs. Then followed fiscal devaluation with an increase in their taxes. A recession was the mechanical result of this particularly painful adjustment, often called "austerity". By reducing domestic demand and prices it enabled an increase in company profits and growth was boosted via exports, since competitive cost had been reduced …. to the detriment of the others. Many jobs, which were mainly linked to the real estate industry, were lost. Both banks and businesses condensed and the grey economy developed, with the loss of fiscal income as well as the human costs that this implied.

It was to curb this fatal risk and to enable the rationale of dual internal devaluation that in June 2012, Mario Draghi delivered his now famous phrase, stating that he would do "whatever it takes". For him this in fact meant putting some sort of psychological halt to the rise of long term rates. Otherwise they would sweep away the countries of the south and then the euro zone. These few words associated of course with the credibility of their source and that of the ECB, were enough to bring back calm and to bring down the long term rates. It was later that bank support and consolidation measures were to take place, including the introduction of a structural solution in the event of a local crisis (Outright Monetary Transactions - OMTs), again with strict rules regarding their granting and behaviour. The advantage of this was that the deviant path was closed – likewise the exit to the euro zone. This applied to Ireland and Portugal, with a possible domino effect on the banks, as it did to Spain and Italy. But this meant extremely high amounts of aid and loans from the other members in the Union, aids and loans conditioned by reform, proof of the zone's solidarity.

WHAT THE GREEK "GAME" HAS SHOWN US

From the very start it was quite singular. We know that Greece embellished its accounts in order to enter the euro zone (a budgetary deficit announced at around 3.5% of the GDP, whilst in reality it was three times that figure). In other words it could not have survived in the euro zone with an initial, excessively high exchange rate– which, together with a higher budgetary deficit than originally thought– the result of a long established practice of tax evasion and high public spending, would have handicapped its competitiveness. And so, Greece pursued the path of "catching up via construction", benefiting from its natural assets, (nature, history, culture ….), plus the recruitment of civil servants. But the crises soon caught up with it, since it was the weak link in the chain. Real estate, bank, fiscal and budgetary crises piled up and weighed on this already fragile economy. An exit from the euro zone was still being considered then. But exit raised serious geopolitical, financial and monetary questions. To put it plainly –the risk of the euro zone's economic slowing, in the wake of a serious recession in Greece was not very high due to the country's weak influence in the zone (2.3% of the GDP in 2013).

The geopolitical issue was much more serious. Greece indeed lies in an unstable area: Macedonia, Serbia, with Russia and Turkey close by – at a time when crisis was growing on the other side of the Mediterranean. It is now receiving more immigrants from Libya and Syria than Italy, without having the military and medical means of that country at its disposal. Throwing Greece out of the euro zone was then seen as a danger in that it might create an extremely fragile State, or maybe worse, in this region of high tension.

Greece's financial problem was significant too, of course. It had to find an extra 80 billion € for the country to be able to overcome the obstacle of immediate reimbursements and to introduce restructuring policies, forcing it back on to the "virtuous path": privatisations, reductions in public spending, making the labour market more flexible, opening of the goods market, raising VAT in particular. All of this, which was deemed socially and politically impossible and was rejected by the Greeks, was thrown back in their face under the pressure of their peers, since their banks were now closed. No one knew what the response would be, even after the vote by the Parliament, then it was implemented and was successful.

The monetary issue was the most important of all. Indeed, the Greeks drew on the repeated commitments that "*everyone would do everything possible, so that Greece would not leave the euro zone*" so that they themselves might make more measured efforts. In the traditional game of "chicken" (an expression from the game theory in which each one tests the other's resistance to fear and has no pejorative connotation between countries) Greece suggested that it had less to lose than the big countries from leaving the euro zone. Hence it was up "to them" to help it. This was true, until Germany did in fact call for an exit, albeit temporary on 11th July 2015 (as mentioned above).

Of course we might always criticise the German approach. It opened up Pandora's Box. How could they be certain that five years would be enough for Greece recover growth? What dangers were there of contagion for other countries that wanted to "offer" themselves the luxury of devaluation and be expected then to "return to the fold" … But we have to admit that the German approach was also part of the game in that, in the sense of the game theory, they destabilised the Greek position.

Hence the German threat of exit (supported by other countries in the north and east of the euro zone) seemed just as credible at least as the previous guarantee of not having to leave. Greece had to give in, since there is no cooperative solution in the Prisoner's Dilemma. It had to approve the programme that the other euro zone members were "offering" it and do this rapidly and under the external constraint of what it should have done itself over a much longer period of time. It remains for us to hope that for all of this to work, without any political or social drama, that the other euro zone members will help Greece with a cancellation of the debt. Otherwise we shall find ourselves in a lose-lose situation.

WHY "NO EXIT": THE SPECIFIC RATIONALE OF THE EURO ZONE

The case of Greece, the most dramatic of all, has demonstrated what it means not to follow the rules in a monetary zone – if not "imperfect" (they are all incomplete of course) but above all lacking adequately powerful corrective systems. Greece is paying the price right now. The design of the euro zone, once its members are admitted without the possibility of leaving, means in effect that they are individually responsible for their budget and the specific improvement of their competitiveness. In exchange the euro zone, with its credibility, its low rates and the means available to it, offers a public good that is complementary to the work undertaken by each and every one. It is not a full monetary union, which still entails a union of transfer. In France for example, it is clear that the region of Ile de France pays in part for some others, without this being a real problem. But given the way the euro zone has been set up Germany should not pay for Spain for example, at least if everyone follows the rules *a priori*. It is only in extreme cases, during that of the world crisis for example, that specific solidarity budgets (special loans) can be introduced. And this is all the more founded, in Spain's case, that it respects the Maastricht criteria! This proves that monetary unions that exclude unions of transfer and which are based on rules alone have three faults:

- The dangers of having no sanctions against those who do not follow the rules, France and Germany in this case,
- The imperfection of the rules, the Spanish case being typical in this situation,
- And especially the neglect of monetary effects of a monetary union, even if it is imperfect and incomplete.

Beyond what happened in May in Germany and in October 2003 in France, followed by the changes to the rules in the calculation of excessive deficit, notably granted to France which caused a general slackening, not only did the euro monetary zone deviate from its own rules … it simply forgot the euro. And all of this is interlinked.

THE EURO ZONE IS NOT A CO-OWNERS' SYNDICATE.

In no way is the euro zone– as is often suggested – a co-owners' syndicate, which comes to agreement (with greater or lesser ease) over the optimal management of their costs, giving value to a property comprising each one's home, plus all of the parts they share together. Why? Because the euro itself has changed the situation. Since the single currency removes the risk of devaluation, everything is undertaken to ensure the creation of a single market that reduces transaction costs, which polarises wealth. Major regions are created, large units and networks emerge, beyond the former national economies. What is produced here is no longer produced there and this creates social and territorial inequalities, which in turn make change obligatory. Beyond the management rules required of everyone, there is an accelerator inherent to euro zone that is demanding and disruptive: and it is the euro itself. It has been neglected.

This is why the euro zone has to become more open, to enable the mobility of people and capital – we are aware of the problems this entails. This is why it has to support innovation in order to enter the new communication, IT and sharing economy – and we are aware of the costs of this. This is especially why it must revise its governance in greater depth and in a more integrated manner. Early integration entails strengthening its strategic choices, beyond sectoral agreements and other Erasmus programmes, which do indeed take it forward, under the guidance of the Eurogroup, the influence of which should be increased, possibly via being led by a head of State or government. More generally, the euro zone requires more means to be able to undertake a growth policy within the zone itself. It needs a bigger budget to protect itself and manage its borders. It needs a higher budget based on its own funds and not those granted by the States, which at present makes Europe and the euro zone dependent on the States. In addition to this the euro zone needs to strengthen its political integration to support and accept more transfer functions, under extremely strict conditions of course. For a long time the USA have been striving towards a "*more perfect union*". Europe is targeting "*e pluribus unum*". This unity implies more unified strategies, improved sharing of responsibilities, more transparent internal counterbalances. We have to assess what needs to be done (save that it is mainly obligatory) for the euro zone to withstand the present shocks.

CONTINUED DIFFICULTIES, BETWEEN MOUNTING INTERNAL AND EXTERNAL TENSION

The euro zone survived the most acute problems set by the Greek crisis, but we can see that social and economic issues remain, made worse by migrants, the major share of whom Greece is receiving. At the same time political tension is rising both in the north and the south. In the south on the far left, there has been increasingly structured response to austerity. This is leading to countries that are difficult to govern. In the north there are far right movements which want less of Europe (Netherlands and Finland). They are using the zone's problems and the migrant crisis to fuel their discourse.

In this context the euro zone's monetary policy is increasingly asserting its dominance; because the rest is lacking. The quantitative easing now underway for more than a year with the purchase of 60 billion € in treasury bills (and "assimilated" papers) per month,

has brought the rates (and to some extent the euro) down. This monetary policy is helping to jump start economic growth but if, and only if "reform" is introduced, in other words if markets become flexible, and the States modernise – which is not necessarily the case. Low rates are helping the economy adapt to the new situation, but the economies (and their political bodies) have to do this. Otherwise the risk will be all the more serious for the countries that are not playing by the new rules, which after the real estate market are now "surfing" on quantitative easing.
When in January 2015 Mario Draghi said there "were no limits" to what he would do, he was repeating even louder, more widely and with greater risk his "whatever it takes" of June 2012. Months have passed, major crises have been settled but other challenges will arise. This time Mario Draghi is taking an even greater risk, and the Central Banks, notably the Buba, is not following him – not totally and not always in any case.

IRREVERSIBILITY IS NEVER GIVEN

The impossible "exit of the euro", which is now symmetrically demonstrated as being "its irreversibility", shows that the euro zone is a monetary union of rules that are not working efficiently. It is not functioning correctly because the rules – and even less so their spirit - are not enough adhered to; then, because by nature (human) rules never work "well". They constantly have to be revised to be improved. Finally and especially, the system is not functioning well because of its very success, - the union which has resisted unprecedented turbulence and aims to move forward in an ever complex, tense world. We must not forget this. "Exiting the euro", spectre or threat, is obviously not the appropriate answer to integration that must necessarily be deeper, with a transfer union gradually put in place, which needs some extremely fine, responsible, transparent tuning, together greater political integration. The irreversible euro, is not a phrase we should constantly repeat, to say that there is no danger, therefore our efforts can be relaxed, moderated, spread over time. The euro is not there to prevent us from making an effort nor to frighten us. On the contrary. It is there for the creation of a more perfect Europe. This is more important now than ever before.

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NB: this text is adapted and updated from the article "Sortir de l'euro: un spectre ou une menace crédible?" published in Questions internationales n°76, November-December 2015, with the kind permission of the review's Editorial team.