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Home
This week's print edition
Daily news analysis
Opinion
All opinion
Leaders
Letters to the Editor
Blogs
Columns
KAL's cartoons
Correspondent's diary
Economist debates
World politics
All world politics
Politics this week
United States
The Americas
Asia
Middle East and Africa
Europe
Britain
Special reports
Business and finance
All business and finance
Business this week
Economics focus
Management
Economics A-Z
Business education
All business education
Which MBA?
Markets and data
All markets and data
Daily chart
Weekly indicators
World markets
Currencies
Rankings
Big Mac index
Science and technology
All science and technology
Technology Quarterly
Technology Monitor
Books and arts
All books and arts
Style guide
People
People
Obituaries
Diversions
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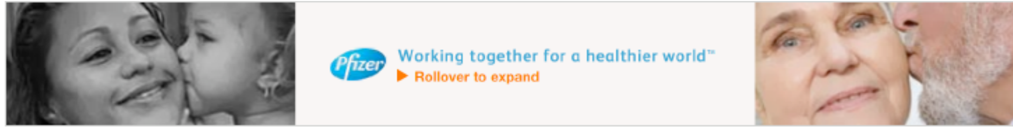

Special report

A special report on the euro area

Soft centre

Jun 11th 2009
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Can a currency survive without a state?

Illustration by M. Morgenstern

LAST November the European Commission set out its proposals for a Europe-wide fiscal stimulus, worth a combined €200 billion, roughly 1.5% of the 27-nation block's combined GDP. The commission has a relatively small budget and no authority to compel member states to shell out extra cash or cut taxes (and, to its regret, little clout to stop them from running up budget deficits). So it had to content itself mainly with a co-ordinating role.

The commission, along with the European Investment Bank, found €30 billion of EU money to contribute towards the €200 billion target, mostly by speeding up spending programmes. Of this, €5 billion was unspent infrastructure money from the EU budget which would normally be returned to the rich member states that had provided it. Three months later governments were still arguing about where or indeed whether this money, a trifling sum in the scheme of things, should be spent. Brussels insiders see this episode as typical of the painfully slow process of putting plans into action. It also illustrated how reluctant governments are to cede control over their own revenues.

There had been hopes that they might become more co-operative. Helmut Kohl, who as German chancellor was one of the midwives of the Maastricht treaty, thought a single currency could not survive without political union; indeed its main appeal was that it would make such union more likely. In November 1991, a month before the Maastricht summit, he told the German parliament that it was a "fallacy" that monetary union could last without political union. By the time the euro was launched in 1999, many people thought

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that some form of fiscal counterweight to monetary union would soon follow. “You didn’t have to be a federalist to believe then that the euro would prompt more political integration,” says Jean Pisani-Ferry of Bruegel, a Brussels think-tank.

The belief seemed well founded on several counts. Money is a form of government debt, so a paper currency, it was thought, must need a state behind it. Historical examples of a currency block not backed by a unitary state are rare, and such few as there have been did not last long. According to the theory of optimal currency areas, a central fiscal policy is necessary because a single interest rate will not suit conditions in all parts of a currency zone. Just as welfare spending and revenue raising help to smooth out regional kinks in national business cycles, a “fiscal euro zone” would act as a stabilising force for a shared currency area.

Rules of the game

What institutional structures would be needed for political union was rarely made clear, only that there would soon be more of it. In the meantime a set of fiscal rules—the stability and growth pact, which put a cap on budget deficits and public debt—would take the place of a central system of revenue sharing. Each country would insure itself against a downward lurch in its economy by running a balanced budget or, in good times, a surplus.

These fiscal rules had another purpose, which was often given greater emphasis: to prevent imprudent countries from imposing costs on others. Big deficits in one country might make it harder for others to compete for funds from savers, driving up interest rates for all. If such deficits were to add materially to the average debt burden, investors might fret that governments will attempt either to inflate away their debts or to pass them on to other countries, so will demand higher rates from all borrowers as protection. The EU treaty contains two clauses to try to limit this transfer of costs. The first bars the ECB from creating money to finance deficits. The second forbids countries from assuming the debts of others (the “no bail-out” clause).

The pact did not work well. The emphasis on the costs to others of fiscal indiscipline meant that countries were careful to behave no worse than their peers, rather than trying to be prudent on their own behalf. In good times public finances tended to add to, not subtract from, demand pressures: fiscal policy often worked against the monetary sort rather than complementing it, as the pact intended. The costs of fiscal laxity were low. Before crisis struck, the slack attitude towards credit risk in bond markets meant that borrowing costs for high- and low-debt countries were similar. When in 2003 the European Commission threatened to impose penalties on France and Germany for excessive deficits, the pact was first suspended and then amended, with get-out clauses for “exceptional” events.

Ireland and Spain had complied with the pact in good times, but had relied too heavily on windfall revenues that evaporated along with their housing booms. Ministers had been able to insist that their fiscal policies were sound because they fitted in with the pact’s narrow guidelines, says Mr Pisani-Ferry. Since fiscal soundness was central to “stability”, they could claim that their overall economic policy was fine too.

Once the crisis had blown up last autumn, the lack of a fiscal centre to the euro zone became a live issue. Initially the euro rallied, but haphazard efforts to shore up banks, and later the economy, undid that early vote of confidence. Scared investors rushed into the safest dollar assets, lured by the liquidity of the vast market for US Treasuries, as the euro area was revealed as a mess of fragmented bond markets. Small euro-area countries with oversized banking industries, such as Ireland and Belgium, found that their bonds were shunned, driving up their borrowing costs relative to Germany’s. Markets were becoming increasingly anxious that a euro-zone issuer might run into funding difficulties, since there was no system for countries to help each other out.

The clunky governance of the EU and euro area worked against a rapid response to the crisis. Political power within the EU is dispersed, residing in state capitals rather than in Brussels. There is no powerful executive to take and enforce quick decisions. National interests got in the way of fiscal-stimulus packages and efforts to co-ordinate bank guarantees and rescues. Germany has the deepest pockets, but its instinctive thrift (and the suspicion that the benefits would be felt mostly outside Germany) militated against swift and co-ordinated action. That made it harder for less affluent countries to loosen their purse strings, as they could not risk looking in worse fiscal shape than their peers.

Good old ECB

The one euro-zone institution that could—and did—act decisively was the ECB. But even its ability to tackle slumps is constrained. Were there just one sovereign issuer of euro-zone debt, rather than 16, the ECB could more easily engage in unorthodox policy measures, such as buying up government bonds to drive down long-term interest rates. It would also find it easier to negotiate an indemnity against capital losses on asset purchases.

Despite the crisis, there are few signs of progress towards better fiscal co-ordination. Earlier this year, as bond spreads continued to rise, policymakers dropped heavy hints that struggling sovereign borrowers would not go unaided. Peer Steinbrück, the German finance minister, said in February that if a euro-area country found itself in trouble, “we will show ourselves to be capable of acting.”

The following month Joaquín Almunia, head of the commission's economics directorate, said that a European "solution" was in place so that any cash-starved country would not have to go to the IMF for an emergency loan. Mr Almunia did not give any details. The German finance ministry later denied that it was working on bail-out scenarios.

The panic revealed another gap in the euro area's fiscal set-up: a process for dealing with a sovereign default, or the threat of one. The larger the number of countries that have adopted the single currency, the more likely it is that one will get into trouble. It would be sensible to have a contingency plan.

One idea is a dedicated bail-out fund for euro-zone members, along the lines of the IMF. This is proposed by Thomas Mayer, an economist at Deutsche Bank, who started his career at the fund in the 1980s. Like the IMF, a European Monetary Fund (EMF) would offer emergency loans for governments unable to finance their budget deficits or roll over maturing debts. In return for this insurance, each member would contribute capital to the fund in proportion to the size of its population or GDP. Loans would come with conditions. A supplicant would have to pledge to put its public finances in order and undertake other economic reforms to persuade bond markets to renew lending.

This sort of proposal attracts two main criticisms. First, it is wasteful to duplicate the efforts of the IMF. Until very recently the fund was struggling to define its role (and raise money) because it had so few lending opportunities. Now it is busy fighting fires again, many of them in eastern Europe, so there is far less talk of staff cuts. But an EMF could stand idle for even longer before it saw action. A second quibble is that a euro fund may find it difficult to impose tough conditions on rescue loans. Better to let the IMF play the role of bad cop, say some, than have protesters burning the EU flag in countries forced to slash public spending or hike taxes.

Mr Mayer retorts that even the IMF has learnt that its interventions work only if countries co-operate. The idea that a financial policeman has to be strict to be effective is dated. He sees a European fund as more than an emergency kitty for cash-starved euro members. It could act as a permanent monitor of economic policies, including government budgets, and issue a seal of approval for countries wishing to take part in a joint bond issue. Over time, the emergency fund could evolve into an institution that improves the euro area's fiscal co-ordination.

The beauty of a euro bond

The hurdle for membership of such a programme would need to be high to persuade countries with good credit, such as Germany, to sign up to it, and to convince credit-rating agencies and investors to rank its bonds highly. But a large collective bond issue could have benefits even for countries with low credit risk, as it would rival America's Treasuries market for liquidity. A single issuer would make euro-area bonds more attractive to managers of foreign-exchange reserves, who want safe stores of value that can be converted into cash quickly and cheaply in an emergency. A joint bond issue could thus enhance the euro's standing as a reserve currency, as well as lowering borrowing costs for all countries that took part in it.

The idea of a shared euro bond has been pushed by Italy's Mr Prodi, George Soros, a veteran investor, and others. That Italy is keen on the idea is hardly surprising: pooling its poor credit ratings with others of higher standing would lower its borrowing costs and reduce the risk, albeit small, that it might have its financing cut off. Germany is understandably cool on the idea. Mr Steinbrück has said that the extra cost to his taxpayers would make it hard to sell politically. Many in Germany feel that even temporary help for cash-strapped partners should be provided by the IMF only, and on strict terms. They resent the fact that Greece and Ireland enjoyed years of prosperity and still found themselves in fiscal trouble. Bail-outs, they feel, only encourage profligacy.

A rescue of one country by its partners could undermine popular support for the euro, says Otmar Issing, the ECB's chief economist for its first eight years, because it would imply a transfer of taxpayers' money without endorsement from the voters in countries that have to pay.

Mr Issing, who had previously sat on the Bundesbank's rate-setting council, once believed that the euro needed more political union to thrive, but has modified his views. Political union, he now thinks, may even work against monetary union if it is founded on a model that would make economies more rigid. EU policies, once in place, are hard to reverse even if they are clearly harmful, as decades of farm subsidies have shown. The euro has little bearing on ambitions for a common foreign or defence policy.

The euro's short history suggests that a successful monetary union does not necessarily need deeper political integration. True, by American standards the euro area's response to the crisis was slow and lacked co-ordination. But that is part of the price countries pay (and consider worth paying) for retaining full fiscal sovereignty. In any case, since welfare benefits are more generous and taxes heavier in Europe than in America, automatic fiscal stabilisers are more powerful in the old continent. A measure of co-ordination is already built into the euro area's fiscal policy.

The stability and growth pact is now too full of holes to be a binding constraint on fiscal policy. In an important sense it was always redundant. If monetary financing is banned and the "no bail-out" commitment is real, then fiscal discipline is largely an issue for individual countries. If they let finances slip, bond markets will exact a penalty in higher borrowing costs, as they have done in recent months.

There are nevertheless a few minimum requirements for a fiscal euro zone. The first is a set of clear rules for what would happen if a euro-zone member were frozen out of market funding. This will be become more important as more countries join. Second is an agreement on how the ECB would be recapitalised in the unlikely event that bank failures were to leave it with big losses on its loan book, or that it were to make large outright purchases of securities that subsequently went bad. A third element of fiscal union is needed to bind not just the euro area but the EU's entire single market: a shared fund for cross-border bank bail-outs. Without an agreement on support for troubled multinational banks, an open EU market in financial services may be impossible to maintain. Ironically, such a scheme would have to include Britain and Sweden, two countries that are outside the euro zone but have lots of banking interests in other EU countries.

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