

THINKING ABOUT THE EURO AT NIGHT

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Summary

From a distant look, two items can be applied to the discussion of the Euro these days: The theory of optimal currency areas and what economists usually do when countries fail. The theory of optimal currency areas serves best as a supplier of arguments, why a certain currency union failed and the Euro is an empirical test on the endogeneity versus the specialisation paradigm. The most powerful instrument the International Monetary Fund usually employs to “save” failing economies, a depreciation, is not available in Euroland. Thus a split of the currencies of failing economies is proposed: With all stocks still denominated in Euro, a transaction currency is introduced for flows. This may help to regain competitiveness without leaving the Euro and destroying wealth. With this new rule expectations in financial markets might be fixed.

I. Introduction

Being an Economist - especially a German economist - the Euro these days is something to worry about - even during holidays and at night. Being the results of such reasoning, this paper takes a more distant look at economic theory and what economists usually do. It is obvious that the Euro is a currency union. So the theory of optimal currency areas (OCA) should be applied. With economies within the Euro-area in danger of failing, what is more natural than to look how similar cases have been handled in the past?

This paper starts with a very short glance at these items (II). The actual political situation is briefly considered in section III. Section IV is devoted to a non-conventional proposal and some implications of this proposal are discussed. The paper ends with some concluding remarks (V).

II. OCA-Theory and Past Experiences

As far as I know there is no generally accepted set of criteria for countries that guarantee to successfully form a currency union. OCA delivers a set of widely accepted criteria which to fulfill might be helpful in forming a currency union. But at best these criteria (when not met) serve as an argument, why the currency area has to fail. In a working paper of the European Central Bank (ECB) Mongelli lists up and discusses all these criteria that were worked out in literature. In the end he comes to the conclusion that the European Monetary Union (EMU), i.e. the Euro, is an empirical test on two paradigms: The “endogeneity of OCA” and the specialisation paradigm¹).

The first’s argument runs as follows: In a currency union trade and other interactions between the economies will increase and they will become more and more similar especially in reactions to external shocks and monetary policy. Thus the formation of the currency union speeds up the alignment of the participating economies.

The specialisation paradigm runs into the opposite direction. In the tradition of David Ricardo its supporters assume that each country will produce what it can produce best (i.e. at lowest costs - remember the well-known argument of wine from Portugal and textiles from England). Thus the economies will become more and more different and their reactions to external shocks and a unique monetary policy must differ.

So far on this item. The second one is how failing or in-danger-to-fail economies were dealt with in the past. In recent years there have been several incidents of economies in danger to fail. In fall 2011 a group of economic institutes in their semi-annual analysis for the German federal government gave an overview of such occasions²). Usually it was the job of the International Monetary Fund

(IMF) to give credits to rescue these countries. But the credits given were bound to requirements the countries had to fulfill. One prominent reason for failure was the loss in competitiveness (as we now see in Greece, Portugal, Spain and Italy) and the most powerful remedy was a depreciation of the national currency.

III The Actual Situation

The Great Recession which started in 2008 led to a crisis of the Euro when financial markets came to the conclusion that the public debt of some Euro-land-countries became unsustainable high and the spread for bonds of these countries (starting with Greece, Ireland and Portugal, later Spain and Italy) over German Bunds exploded. Instead to let the IMF do his job, European leaders decided to give up the no bail-out condition of their monetary union and took part in the attempts to rescue those countries.

The job is especially tricky because these countries are members of a currency union and cannot make a monetary policy of their own. The usual instrument in cases of overly indebted countries, a depreciation of the currency, is not available. So the European Financial Stability Facility (EFSF) and the European Stability Mechanism (ESM) were introduced to give those countries credits in cooperation with the IMF. As the volumes of the EFSF and (when in effect) ESM are limited by the contributions of the other Euro-countries, the European Central Bank (ECB), as the only institution that is able to act quickly and has the means to act, bought public debt assets in the secondary market to stabilize those spreads. In fact, public debt is financed with central bank money - an action that according to standard wisdom will lead to inflation.

As the recent days show, the EFSF is not an umbrella as it is drawn in the media and speeches of the politicians, but nothing else than a parachute that buys European leaders time before they touch the ground and softens that touchdown. So the ECB is under pressure to do the job.

In the creditor-countries of Euro-land solidarity with the debtor peoples is not too high. In several northern countries (Finland, Germany, The Netherlands) paying for southern countries is not vote-catching. The fear is that not only that money that is given to the EFSF and ESM will be lost, but that there will be another bill to pay because the ECB is too light-handed in buying public debt assets that will fail and cause losses that will have to be settled by the owners of the ECB according to their share in the ECB - with Germany the most affected. And the danger of inflation is seen.

There are several reasons for the high debt of Greece, Portugal, Spain and Italy (the case of Ireland is a little different), the most prominent is a loss of competitiveness. If these countries were not members of the Euro, the IMF could implement its usual policy: depreciation and austerity. The second is the condition for further credits by the "Troika" of IMF, ECB and the EU-Commission but the first is not available. Austerity alone is very harsh to the people (unemployment in Greece and Spain is up to 25 %, among youths 50 %) and social unrest is not unimaginable.

So, is there a different policy imaginable?

IV Imagine the Unconventional

A strategy to save the euro that is designed to be acceptable by politicians and citizens has to take into account a number of restrictions. And to be successful it has to offer some powerful instruments.

To be accepted a successful strategy has to help European leaders not to lose their faces. Up to now they use to say that the Euro will be defended and survive. And that countries will not have to leave the currency union (although in the meantime in the case of Greece this position begins to melt). A

strategy that enables all countries to stay in the Euro would strengthen the credibility of European leaders. Learning is a good thing, and it is not always wise to cling to position once uttered that cannot be held. But if the whole project is at stake, reliability is an asset.

A second restriction is that the strategy can be accepted by the citizens, especially those in the countries in trouble. If they feel themselves under pressure from Germany or Brussels they will be less willing to accept harsh measures. But if they have the opportunity to choose their own way, they will more likely join in.

What is the most powerful instrument against lost competitiveness? In history this was devaluation. But devaluation within a currency union is not possible. The other way is structural changes (lower wages, more flexible markets) but they take time and cause social unrest. Probably more time than these countries actually do have.

Is there a chance to meet all these needs? Maybe. First we come back to some basic economics, the distinction between stocks and flows. Among others, stocks stand for wealth and flows for productivity. It is in the interest of all Eurozone-countries (especially in the interest of the creditor-countries) that wealth will not be destroyed (as in effect is in cases of "haircuts") and that productivity in the debtor-countries will improve so that they will be able to service their obligations. Thus the basic idea is to introduce a new mechanism for Eurozone-countries that come in danger to fail.

As soon as the interest it has to pay for its debt passes an unsustainable level (politicians may define it as they did with the 3 % of GDP level for public deficit and 60 % of GDP for public debt in the so-called Maastricht-criteria) it has to split its currency into the Euro for all stocks and a new currency for flows. Take the example Greece. Why not stay in the euro-zone and introduce a New Drachme (ND) as a kind of parallel currency exclusively for transactions within Greece? Since Greece joined the Euro, it lost some 13 % of its competitiveness³⁾ the ND should be introduced with a 13 % lower value than the old Drachme had as Greece joined the Euro. So from the start Greece has the same (price-) competitiveness as it had when it joined the Euro.

All stocks will still be denominated in Euro. If a consumer saves money he may change his ND into Euro and add them to his balances. If he needs money from his bank-account it is changed into ND. So the Euro will still be present in Greece and consumers are still used to it.

With wages and prices denominated in ND while the assets are still denominated in Euro, the private sector in Greece has an incentive to save. So the external deficit is reduced and the ND need not depreciate further too sharply.

As Greece stays in the Euro-zone, the ECB still conducts monetary policy for it - just with more instruments exclusively for Greece. The ND floats against the Euro and other currencies and financial institutions in Greece get liquidity (in ND) from the ECB at an interest rate the ECB offers.

In this constellation Greece stays in the Euro, the Euro is not in danger of contagion from inflation in Greece and Greece has the means to get out of the crisis - with the help of the Troika. After some years of devaluation and necessary structural changes Greece may peg the ND to the Euro and even give it up again.

Although the Greek debt is not changed into ND, foreign holders of Greek bonds will probably suffer. But that is part of the indispensable cure. The benchmark is the case without currency-split: Restructuring Greece will take longer, the costs in unemployment in Greece and inflation in the whole

Euro-zone will certainly be higher, Greece even may fail and the danger of contagion (Italy, Spain, Portugal) is much bigger.

And the financial markets? Once this strategy for insolvent countries or countries that are in danger to fail is established, financial markets know what will happen and can form their expectations accordingly. Maybe this will be enough to prevent interest-rate spreads as we saw in the recent past.

And what about practical problems? In times of electronic data processing, networks and the internet the conversion of Euro into ND (or other currencies) and vice versa is no problem. And how to manage the introduction of new coins and notes is an exercise the Deutsche Bundesbank made some 20 years ago when she brought the DM to the GDR and the ECB did in recent years when the Euro replaced other currencies.

V. Concluding Remarks

This paper lacks of stringent model-construction and processing. The reason is simple: As there is neither a theoretical nor an empirical model that is able to analyse the idea of a split currency, no such model could be used. Let me stress another point: the idea of a split-currency is different from a parallel currency. In a world of a parallel-currency two currencies compete in stocks and flows because both currencies are not only used for transaction and measurement, but also for storing values. Usually that currency “wins” that is better in maintaining the value of stored money. In a split-currency as I propose the storing function of a currency is exclusively to the Euro.

Notes

- 1) Mongelli, p. 27ff
- 2) Projektgruppe Gemeinschaftsdiagnose p. 9 - 10
- 3) Deutsche Bundesbank, graph p. 25

Literature

Deutsche Bundesbank, “Zur Problematik mikroökonomischer Ungleichgewichte im Euro-Raum”, in: Monthly Report July 2010, p. 17 - 40

Mongelli, Francesco Paolo: “New Views on the Optimum Currency Area Theory: What is EMU Telling Us?”, EZB Working Paper No. 138, April 2002

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