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The Euro

Will it still be around five years from now?

Five distinguished thinkers offer their views.

The cloud will not go away. Peripheral members are likely to drop off. The big question mark is France.

SAMUEL BRITTAN
Columnist, **Financial Times**

It is not given to human beings to foresee the future. But the attempt to do so can often shed light on present problems. When the euro was launched, first as a unit of account in 1999 and then as an actual circulating medium in 2002, the driving force was political, not economic. It was seen by European leaders as a backdoor way of moving towards a federal Europe. Economists and businessmen, especially in Germany, were much more skeptical, but reluctantly went along. The big weakness of the project was seen to be the lack of a common fiscal policy to support it. This in turn reflected the fact that it was a currency with a central bank but without a government. Previous so-called currency unions were all ultimately based on a precious metal such as gold or silver. The euro is unique, backed neither by precious metals nor by a political authority. What is surprising is thus not the weaknesses brought to light by the Greek crisis, but that its market performance was above expectation for so long. Indeed, in the first decade of its existence, it rose by nearly 40 percent against the dollar.

As long ago as 1996, financial journalist David Lascelles produced a spoof futuristic account in which a member government ran into serious trouble, including riots in the street, when it attempted to introduce a fiscal austerity package in the face of a domestic recession, while the German government was prevented by domestic political opposition from taking a lead in a rescue package. ("The Crash of 2003," Centre for the Study of Financial Innovation). Like many such prophets, Lascelles was premature, as he dated the crisis to 2003, not 2010. More important, the country that he envisaged triggering the crisis was France. He could not imagine that the trigger to be pulled was Greece which, despite its romantic cultural affinities, is a long way removed from the present EU heartlands and accounts for little more than 2 percent of the EU gross national product. Indeed, Greece was hardly expected to become a member.

These very facts have given the Greek authorities more bargaining power than they perhaps have realized. The costs of contagion if the country were to default on its debts and leave the euro are very large. The ungainly acronym PIGS has been invented for the members most at risk—Portugal, Italy, Greece, and Spain. Portugal has already suffered a credit rating downgrade. The stakes are so high that the euro is likely to survive the present turmoil with Greece remaining a member. But the cloud will not go away. What has been so far lacking is any serious consideration of the Greek economy. The problem has been discussed very narrowly in capital market terms, with little analysis of whether the economy is overheated or faces deep recession. And there is not enough discussion of how far Greek costs have risen above the level of its euro partners. An "internal devaluation" involving a slashing of nominal wages by up to 20 percent, on Latvian lines, is difficult to imagine in the Greek case.

At some stage, peripheral members are indeed likely to drop off. In the long run, the big question mark, however, is France. So far that country has exceeded expectations and managed to maintain cost competitiveness against its neighbors, but who knows how long this happy conjuncture will last? Without France, the euro will not disappear but become a central European currency based on the German-speaking countries and the Benelux.

But there is a deeper problem. Fashionably gloomy commentators are pessimistic about most major currencies. They point not only to the euro's travails, but to the supposedly grave U.S. and UK fiscal deficits. Against whom can all these currencies fall? Are the yen and renminbi to inherit the earth? This is the last thing the Japanese and Chinese governments want, owing to their commitment to export-led growth. And even if gold becomes fashionable again, it has to be bought with existing paper currencies. The world may face political or economic Armageddon, but hardly because of exchange rates.

The euro will still be here—and with the same member countries.

HANS TIETMEYER
Former President, Deutsche Bundesbank

I am convinced that the euro will still be in existence five years from now, and the member countries will be more or less the same as they are today. I also expect the euro will continue to be a stable and strong currency, just as it has been during the first eleven years of its existence.

True, during the past months the euro has faced some serious difficulties. In particular, news of the long-running fiscal misbehavior in Greece has fostered mistrust in the markets for fiscal financing there and in other euro countries. But I am confident that the International Monetary Fund, together with the other euro countries, will support Greece both to overcome the actual difficulties and to return to more and lasting budgetary discipline in all euro countries. This is important in order to rebuild the necessary market confidence in the euro for the future.

It is also critical that the common rules, established in the Maastricht Treaty and the Stability and Growth Pact, not be undermined or eroded by misguided political decisions. In this context, the offered common support for Greece must not be misinterpreted as a normal bail-out which could set a precedent in the future. The responsible political authorities must make this clear. All euro member countries must understand that solidarity can only function if it is based fully on following the agreed rules.

In particular, the common control procedure for national fiscal discipline urgently needs strengthening. I personally—before the euro's introduction in 1999—emphasized the need for an efficient supranational procedure for regularly controlling budget discipline in all member countries, not only at the time of eurozone entry, but also afterwards. Any national failure must be punished directly. The so-called Stability and Growth Pact of 1997 was an important step, but its application by the EU Commission and the EU Council was—as I had feared at the beginning—not strong enough. And instead of strengthening the controls, the political authorities in 2005 actually weakened them.

Especially in light of the recent experience with Greece, the euro group must now begin a real strengthening of the control procedures. An important step could be the involvement of a truely independent and neutral institution at the pan-euro level.

The other oft-mentioned problem for the euro is the divergence in the current accounts of some euro member countries. This development, obvious for some time, reflects mainly a growing divergence in the members' international competitiveness politics. To address this problem, some politicians are arguing for the establishment of an "economic government" for the eurozone. I am skeptical of such an idea. An economic government for the eurozone could be misused for exerting pressure on some members to reduce competition among the member economies and to follow less stability-oriented national policies. Such protectionistic pressure could easily undermine the internal economic dynamic and competitiveness of the whole euro area.

In my view, the euro's outlook is positive if, in addition to the European Central Bank, all national governments and parliaments will respect the common fiscal policy rules and give more encouragement to innovation, competition, and flexibility in their national economies. Nobel Prize-winning economist Bob Mundell was right in underlining as early as 1961 the need for adequate economic flexibility and mobility in a currency area with different nations and countries. The politicians in all the member countries must understand that the longer-run benefits of the euro depend to a large extent on their own political efforts. More lasting fiscal discipline and more structural flexibility in all euro countries will improve the potential for growth and employment and strengthen the euro in the longer run.

The question is whether it will be a stable, dynamic currency. That's unknowable.

C. FRED BERGSTEN
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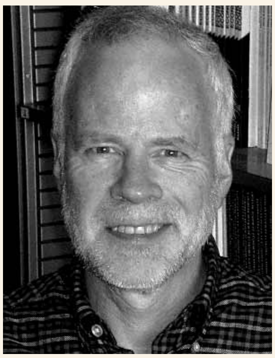
The euro will clearly exist in five years. The question raised by the crisis of the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) is whether it will again be a stable and dynamic currency, with real prospects for moving up alongside the dollar as a global money, or a beleaguered target of speculation based on doubts over its long-term viability as well as its current value. The answer lies in the unknowable but rapidly evolving politics of the European integration movement.

European integration, while taking occasional backward steps, has moved forward inexorably for more than half a century. It was driven by the top-down resolve of virtually every leader in virtually every European country to overcome the horrific history of inter-European conflict by forging an ever-expanding union, mainly through increasing the economic links among the countries of the continent. That geopolitical imperative was almost always able to trump the parochial concerns of vested interests and national reticence, including and indeed especially in "paymaster" but guilt-ridden Germany, leading to a steady ceding of sovereignty to the supranational institutions of the union.

The current crisis poses an existential question concerning the continued pre-eminence of the traditional European model. A bottom-up revolt against bailing out profligate Greeks, Portuguese, Spanish, and maybe even charter-member Italians challenges the primacy of the cooperative outcomes of the past. The historical glue that held Europe together may no longer prevail. Given the rise of populist referenda, it may no longer be possible to move European integration forward through the will of political elites—even if that will still exists, which is uncertain.

The advent of the postwar generation to political leadership and strong majorities of voting publics across the continent could presage a return to traditional nationalistic reactions that downgrade regional solidarity. If that happens, Europe may regress rather than simply stagnate. Its integration process has always operated on a version of the bicycle theory, positing the need for steady progress toward intensified cooperation to head off the omnipresent risk of backsliding. It is far too soon to know whether the joint response to the immediate Greek crisis reaffirms and perhaps even revives the familiar pattern of solidarity, albeit after even more dangerous dithering than usual, or the last gasp of an increasingly resistant European polity.

The fate of the euro hangs in the balance. It was the political decision to move Europe further forward via monetary union, rather than technical economic benefits or any groundswell of business demand, that produced the common currency in the first place. Its first decade turned out to be a honeymoon period, but the Greek crisis brutally exposed the halfway house of monetary union without either a fiscal corollary or a robust governing structure. Only a renewal of political commitment to effective European solutions, filling the obvious institutional gaps and (once again) subsuming national proclivities to the broader purpose, will enable the euro to resume its progress toward becoming a solid financial foundation for Europe itself and a significant player on the world stage.



The probability of disappearing: Vanishingly small.

BARRY EICHENGREEN
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The probability of the euro disappearing in the next five years is vanishingly small. The economic costs to a country like Greece of reintroducing its national currency would vastly exceed the benefits. The technical difficulties alone would be considerable: remember, it took the better part of three years from the start of monetary union in 1999 to prepare for the introduction of physical euro notes and coins in 2002.

Above all there are the political costs: a country abandoning the euro—much less all countries abandoning it—would be a very considerable blow to the larger project of European integration. Europe's leaders and, more broadly, its societies have too much invested in that project to allow the problems associated with the single currency to torpedo that larger project.

The one conceivable way that the euro could disappear would be if Germany decided to abandon it. A eurozone without Germany would not be attractive to the other members, so Germany leaving could cause a parade of other member states to follow. Germany doesn't face the same barriers to exit as the PIIGS—Portugal, Italy, Ireland, Greece, and Spain. Were Greece to seriously contemplate leaving the eurozone, residents would start shifting their bank deposits to Germany. We saw a hint of this in the first week of April, just before the terms of the EU-IMF rescue package for Greece was announced. If talk of abandoning the euro and reintroducing the drachma ever got serious, Greece would experience the mother of all banking and financial crises. And that's precisely why abandoning the euro and reintroducing the drachma will not happen.

Germany is the one country that could contemplate reintroducing its own currency without precipitating a banking crisis, since the presumption would be that the new deutschemark would strengthen against the euro rather than weaken. Such talk would excite capital inflows than outflows. Large-scale capital inflows can cause problems, as Germany itself learned in the 1960s and 1970s. But those problems are of a less serious variety.

So Germany's decision on whether to keep the euro will be decided on political rather than narrowly economic grounds. We have heard much talk in recent months about how Germans have grown more euro-skeptical. They are no longer burdened, it is said, by the feelings of guilt that shaped the decisions of the post-World War II generation. They are no longer willing to make financial sacrifices, it is said, on behalf of the European project. Where Chancellor Kohl was born before World War II and briefly served in the German army, Chancellor Merkel is of a different generation and, we are told, is a different sort of leader.

Or so it is said. Recent events in fact suggest otherwise. Notwithstanding its political posturing, the Merkel government ultimately supported an EU-IMF rescue package for Greece. Despite political rhetoric associated with the regional elections, Germans remain committed Europeanists. The challenge now is to strengthen the institutions of the eurozone so that it can function more smoothly. This means strengthening national fiscal institutions so that they deliver better budgetary outcomes. It means making another attempt to strengthen the Stability and Growth Pact. It means strengthening financial regulatory and fiscal transparency so that no government can again use complex derivative instruments to disguise its actual fiscal position. It means building a European Monetary Fund, along the lines suggested by Daniel Gros and Thomas Mayer, to regularize emergency intervention, where needed, in national fiscal affairs.

Accomplishing this will require German cooperation. My forecast is that Germany will cooperate. This leaves me confident that the euro will be in existence five years from now.

The main forces leading to the common currency remain in place.

ALLAN H. MELTZER

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The Greek crisis brought forward latent fears that the fixed exchange rate system, based on the euro, cannot survive. Like much policy discussion, this concern reflects media bias toward the very near term. The euro solves an ever-present problem faced by principal European countries. Most of their trade is with each other, so they prefer fixed exchange rates. Further, exchange rate changes disrupt their common agricultural policy by requiring price adjustments that governments have difficulty resolving. Most ECB members are aware of these issues, so they will remain in the ECB system. Pundits who predict an end to the euro system forget why most European countries joined the system.

The main forces leading to the common currency remain in place. Those forces were Chancellor Helmut Kohl's belief that a common currency fostered political stability in Europe. Economics was not his major concern. But the 1980s and 1990s convinced the French that, like it or not, they were better off accepting Bundesbank policy than proceeding independently with exchange rate crises every few years. Their price for accepting Bundesbank rules was a seat at the policy table. For Germany, agreement on Bundesbank rules over a wider area was a benefit, and for Chancellor Kohl a lasting political benefit for Europe.

The rules under which the European Central Bank operates cannot be altered except by unanimous agreement. Germany can veto changes. The Greek crisis, and problems in Portugal, Spain, and Italy, show that the fiscal rules that limit deficits to 3 percent of GDP are not observed. Bailing out the miscreants creates the European version of too-big-to-fail, creates moral hazard, and pushes the European Central Bank toward the mistakes that the United States has made: rescuing failed institutions is hard to limit once it becomes established. If banks are too-big-to-fail, why not General Motors and Chrysler? Good answers do not stop political pressures for poor policies.

The European Central Bank must strengthen its fiscal rule. If it enforces a tighter set of rules and continues its monetary discipline, its future will be bright. But some of its weaker members may decide to leave.

Greece, Portugal, and others understood when they joined the European Central Bank that a fixed exchange rate system eliminates one adjustment mechanism. That leaves only fiscal restriction and real wage reduction as the adjustment mechanisms. Borrowing from the International Monetary Fund or the European governments won't change that. Real wages, including pensions and other benefits, are above competitive equilibrium. Either productivity growth must increase or real wages must decline. Loans will not change that. The most they can do is to delay part of the fiscal adjustment and, by subsidizing interest rates, reduce some of the cost. But subsidized foreign loans invites governments to rely on such aid instead of making hard choices.