Five minutes with Jacques Melitz: “The discontented members of the Eurozone should consider very seriously the creation of a second euro”

blogs.lse.ac.uk/europpblog/2014/09/04/five-minutes-with-jacques-melitz-the-discontented-members-of-the-eurozone-should-consider-very-seriously-the-creation-of-a-second-euro/

04/09/2014

Since the height of the Eurozone crisis, a number of reforms have been pursued to stabilise the economic situation in states using the single currency. In an interview with EUROPP’s editor Stuart Brown, **Jacques Melitz** *outlines why the Eurozone is still suffering from two key problems – the European Central Bank’s inability to engage in proper open market operations and the lack of joint-responsibility for the banking system. He argues that, given the inflexibility of Germany, the discontented Eurozone members should give serious consideration to the possibility of creating a ‘second euro’ as an alternative.*

Although the initial crisis has been alleviated to some extent, there are still substantial difficulties within the Eurozone. Do we require more radical reforms of the single currency than have already been implemented?

There are two major problems. The first problem is the European Central Bank’s inability to engage in proper open market operations: the kind of open market operations which are discussed in textbooks, where the central bank just buys or sells at its own initiative. This power does not exist under the Maastricht Treaty – there are so-called open market operations, but they refer to refinancing operations of banks that depend on the banks’ willingness to lend to their customers, and in some special cases they refer to purchases of securities of particular governments in difficulty andwhich then have to be sterilised. So basically we have a European Central Bank which can’t engage in ordinary open market operations. This is a very great defect.

The other problem is that there’s no joint-responsibility for the solvency of the banking system. It’s true that some movement has been made in this direction with respect to the proposed Banking Union, however this has not gone nearly far enough. It simply involves the introduction of common rules and common supervision, but there has been no establishment yet of the essential Single Bank Resolution Fund under discussion to prop up insolvent banks. So on these two counts we certainly still require some important reforms.

You have argued that one such reform might be the creation of a ‘second euro’. How would this system work and what are some of the key advantages?

My argument is that the discontented members of the Eurozone should consider very seriously the creation of a second euro. Very simply, this would mean that there would be an additional central bank. Alongside the European Central Bank, there are already a number of different central banks in the European Union including the Bank of England, the Danish central bank and the Swedish central bank. So there would be still another one and this central bank would issue a second euro for the dissatisfied members, different from the euros issued by the European Central Bank. This currency would fluctuate in value and there would be an exchange rate between one euro and the other euro.

The basic advantage of this system is that the second euro could be constructed in a better manner than the previous euro from the discontented members’ point of view. This new central bank would be empowered to engage in proper open market operations and could therefore engage in expansionary monetary policy in order to increase aggregate demand in its own zone. And there would be a single resolution fund which would cover the insolvency of any particular section of the banking system.

In addition, of course, this would give the opportunity for an adjustment of the price of goods in the Southern periphery states. German goods are currently exceptionally under-priced and the second euro would allow for some form of price adjustment to take place. Moreover, while Germany would still carry enormous weight in determining monetary policy in its area governed by the European Central Bank, it would have no power over the other central bank so the monetary policy of the discontented members could be determined independently of Germany.

Would getting agreement from EU states to pursue such a system be feasible?

Well my argument is that if the discontented members of the Eurozone look ahead there is every indication that they are not going to get any German accommodation in the long-run. This is a long-run problem. Their problems are pretty serious right now and if the prospects are poor for the long-run future, then it would be better to bear the cost of a divorce. True it would be messy – divorces are messy – but there are times when it is better to simply bite the bullet.

One quite significant element is that the willingness to head in this direction would represent a very important turning point in negotiations with Germany. It would confirm to Germany the implications of its current inflexibility and it would be confronted with the fact that the result may be the monetary union splitting into two with an inevitable depreciation of its goods relative to the other members.

For more information on this subject, Jacques Melitz has also written an article on the topic here

Please read our comments policy before commenting.

Note: This article gives the views of the interviewee, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics. Feature image credit: European Parliament (CC-BY-SA-ND-NC-3.0)

Shortened URL for this post: **http://bit.ly/1t3zjqK**

About the interviewee

Jacques Melitz
Jacques Melitz is Professor emeritus at Heriot-Watt University in Edinburgh, where he had been Professor of economics from 2006 to 2013. He is also a Research Fellow at the Centre for Economic Policy Research and located in Paris at the Centre de Recherche en Économie et Statistique.

-