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The Euro in 2084

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The Eurosystem stumbles from crisis to crisis as politicians seek to rescue bankrupt countries from their financial distress with huge sums and little success. At the same time economists have proposed constructive solutions and mechanisms for exiting the crisis (EEAG 2011; Plenum der Ökonomen 2011). Yet there is no foreseeable progress in this direction and an end of the crisis is not in sight. Why? It will be shown in this article that the current political decisions are often constrained by decisions taken many years ago: history matters. This paper aims to shed some light on previous decisions that not only shaped the present form of the euro but also constrain today's political action.

An important starting point is the collapse of the system of Bretton Woods in 1973 and the institutions which subsequently emerged. In Europe some countries adopted an 'inflation regime' for their economies with the intention of using inflation as an extra stimulus for promoting economic growth, while others followed a 'stability regime' based on stable prices and a reliable economic framework. The result was that the former lagged in growth behind the latter, inducing the inflation regimes to exert a permanent political pressure towards fiscal equalization. Eventually, however, self-responsibility has proven to be the least common denominator. So the European Monetary System (EMS) has emerged as a viable framework of coexistence between the two antagonistic groups of countries. The succeeding 'euro' system from 1999 up to present, however, has resumed destructive elements of redistribution in its institutions. Therefore, the old struggle over fiscal equalization re-emerged in new forms. It will be shown why the self-correcting macroeconomic mechanisms were paralyzed and did not restore fiscal stability but instead produced huge public debts in some euro member states. This is why true reform is so difficult today. Those euro states that once pursued stability policies are in a minority today and unable to enforce sound rules of fiscal and monetary policy.

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The heirs of Bretton Woods: inflation regimes and stability regimes (1973–1991)

On 14 March 1973 the Bretton Woods currency system collapsed. European countries were no longer willing to finance the American balance of payments deficit and as in the case of Germany to pay 4.00 DM for 1 US dollar. The result was a system of flexible exchange rates among autonomous states. But how did the states utilize this newly won freedom? More precisely: which interest groups prevailed in this power vacuum? Over the course of time, two regimes emerged in Europe: inflation regimes and stability regimes.

Inflation regimes are marked by strong labour unions, weak governments and weak central banks. They may be characterised as follows.

Labour unions put pressure on public and private companies by wage demands as well as political, wildcat strikes. In the case of public companies, often state monopolies, the government is the employer. It usually has no other choice than to meet the wage and job demands and, if tax increases are not possible, to finance them by running a budget deficit. If higher unemployment is to be avoided, it also feels compelled to help private businesses suffering from wage pressure. In order to ensure the survival of the companies, it provides subsidies and public contracts that, if tax increases are precluded, are once more reflected in a rising public debt. To avoid debt-induced increases in interest rates, the government tells the central bank (often a department of the finance ministry) to expand the money supply and purchase government bonds.

As a consequence prices rise, import demand increases, international competitiveness declines and exports fall, the current account moves into deficit and finally

the government must devalue the national currency. The unions feel cheated out of the fought-over wage increases and start the process anew. There will be an up and down of inflation and devaluation, upsetting businesses and impairing long-term growth.

In *stability regimes* the unions like any other interest group are part of a constitutional framework. They may strike for wage demands but may not use strikes to push through political goals. Likewise, the government cannot ask the central bank to accommodate the inflated public debt. The central bank is independent. Therefore wages rise in line with labour productivity and prices remain comparably stable. Stability promotes business investment and economic growth.

After the collapse of Bretton Woods, Germans had the choice of an inflation or a stability regime. They opted for a stability regime. Many had lived through two hyper inflations and lost their savings twice, this was not to happen again. For them an inflation regime was not an option. The Bundesbank was to remain independent of the government budget and was not to be forced to finance it by money creation. This decision proved to be right and was copied in time by Austria and the Benelux countries. From then on, together they formed the so-called DM block. The governments of France and the Mediterranean countries of Spain, Italy, Greece including Portugal had a different view. They gave in to the demands of the labour unions, pursued an inflation regime and accepted the sequence of boom and devaluation that impaired long-term economic growth.[1]

The political process leading up to the euro (1992–1998)

The tensions and speculation caused by the co-existence of inflation and stability regimes were detrimental to European integration. In particular the fixed price system of EU agriculture suffered when individual countries with an inflation regime had to suddenly devalue. Some began to see a common currency as a cure for these problems. According to the so-called Werner Plan – named after the then Prime Minister of Luxembourg – the EU countries should pursue a common economic policy out of which a common currency would emerge.[2] To do this, France and the Mediterranean countries would have to adopt a German stability regime. But they refused and the plan soon collapsed due to dissimilar inflation rates and exchange rate adjustments.

A new attempt was made by French President Giscard d'Estaing, who in 1978 convinced German Chancellor Helmut Schmidt to set up a European Monetary System (EMS) that would have obligated the Bundesbank to buy up the other currencies of the member countries in order to maintain fixed exchange rates even if the member countries failed to pursue monetary policy discipline. But the Bundesbank recognized the manoeuvre and (then still a powerful institution) vetoed it.

Instead the European Monetary System was agreed under the principle of self-responsibility of each country. The D-mark formed the 'anchor' *vis-à-vis* the two (or more) countries and intervened when the limits of a fixed exchange-rate band were reached. In fact, however, the Bundesbank determined the policy to be followed by the other countries. For example, France had to raise its interest rates in the 1980s in order to keep the exchange rate to the D-mark constant. Understandably, France disliked the dominance of the Deutsche Bundesbank. In 1988 it made a move for taking economic and monetary policy out of the hands of one country – Germany – and putting it into the hands of all EU countries. But how was this to happen? As an answer, the German government together with the Bundesbank proposed the creation of a common currency (the future euro) with a common monetary policy in a common central bank. Membership, however, was to be limited to those member states that beforehand fulfilled the convergence criteria regarding price stability, budget equilibrium, exchange-rate stability and long-term interest rates. Furthermore, the national economic policies were to be harmonized. The Bundesbank wanted to establish the currency union only after a political union with uniform economic policies, i.e. in the distant future. German Chancellor Helmut Kohl initially shared this opinion. But he ultimately gave in and in the Maastricht Treaty of 10 December 1991 agreed, probably as compensation to France (for its support of reunification), to 1 January 1999 as the starting date of the currency union, without any preconditions (Art. 121 Section 4 EC). With this the solidity of the convergence criteria was abandoned. Either way, the currency union had to start on the agreed date and had to have a minimum number of member states in order to function. Concessions to the countries with

[1] Ireland, which is often mentioned in this context, is excluded here as it does not seem comparable to the Mediterranean countries due to its large banking sector.
[2] The Werner Plan had arisen as soon as 1970, however, i.e. before the collapse of the Bretton Woods System, but then disappeared in its wake.

inflation regimes were therefore inevitable. In this way Italy, Spain and Portugal succeeded in becoming part of the first round of euro countries.

In order to preserve the solidity nonetheless, two convergence criteria, the stock of debt and the deficit criterion, were determined as permanent criteria at the 1996 Dublin Summit upon the initiative of Theo Waigel, the then German finance minister. They were to be adhered to by each country even after its entry into the currency union and in 1997 were added to the Treaty of Amsterdam as the Stability and Growth Pact.

After the currency union had been irrevocably established, however, the Stability and Growth Pact was not able to effect much. It was a still birth. In fact, it was hardly ever seriously applied. When its rules were softened in 2005, the now more generously defined discipline hardly improved. This permitted the Mediterranean countries in fact to maintain inflation regimes. Instead of devaluing now and then and thereby making their economies competitive, they accumulated ever higher public debts, which of course was not sustainable. Although these debts were considered serious violations of the Maastricht rules, nobody really wanted to believe that they would eventually lead to payment defaults and sovereign bankruptcies.

The contribution of the twin-deficits theory

In the inflation regime of a nation state there is a succession of inflation and devaluation because the government cannot state credibly that it will withstand the demands of the unions. Here a system of fixed exchange rates can help. The government can no longer use the exchange rate as a way out. All that remains is the public debt as a possible buffer.

In that case the macroeconomic standard theories in the tradition of Ricardo-Barro and of Keynes apply, according to which in case of a budget deficit self-correcting mechanisms become effective so that the public debt does not grow without limit and the budget returns to equilibrium. For the United States, so-called twin deficits may be observed, i.e. a budget deficit occurring in parallel with a balance of payments deficit. Elmendorf and Mankiw (1998) characterize the relationship between the two deficits as follows:

The private households are subject to a budget constraint, given by the national income

(1) $Y = C + S + T,$

or GDP at market prices

(2) $Y = C + I + G + NX.$

where

Y = national income or GDP,
C = consumption,
S = savings of the private households,
T = taxes minus government transfers,
I = domestic investment,
G = government expenditures on goods and services,
NX= net exports = (exports – imports).

Combining the two equations (1) and (2) yields:

(3) $S + (T - G) = I + NX$

The sum of private savings (S) and public savings ($T - G$) on the left-hand side of equation (3) must equal the sum of investment and net exports on the right-hand side.

To net exports NX correspond net capital imports NKI. It comprises foreign investment at home minus domestic investment abroad. Here:

(4) $NX = NKI$

or

(5) $S + (T - G) = I + NKI$

following equation (3).

By reducing tax revenues paired with constant government expenditures, a budget deficit is created, i.e. government savings ($T - G$) decline. There are various ways to balance equation (5). According to Ricardian theory, individuals will increase their savings. According to the Keynesian approach, they may also cut back on investment or they may (*via* increased imports) try to reduce net capital imports NKI. The budget deficit is reflected in the balance of payments deficit and hence creates a twin-deficit problem. The ensuing decline in the capital stock will lead to a rise in the marginal product of capital and the interest rate and to a decline in the marginal product of labour and real wages, which will then trigger self-correcting measures in the area of investment.

A mixed model with a change from Keynesian to Ricardian behaviour is also conceivable. For euro countries Nickel and Vansteenkiste (2008) have shown that at a low level of debt, below 80 percent of GDP, individuals will behave in a Keynesian way when the budget deficit increases. The level of debt does not concern them. They utilize the scope created by the tax reduction and reduce their net capital imports, i.e. they increase their imports. Along with the budget deficit, the twin deficit of the balance of payments grows, initially delaying a self-correction. This parallel effect ebbs, however, at a higher public debt. People become concerned; the relationship of the budget deficit to the balance of payments deficit becomes insignificant in the estimates or in part even reverses. Therefore savings *S* must rise more in order to fulfil equation (5), i.e. individuals start behaving in a Ricardian fashion.

Greece already had an official public debt ratio of about 110 percent at the time of euro accession, i.e. an amount way above the level of 80 percent calculated by Nickel and Vansteenkiste. Therefore, one would have thought, the Greeks should have behaved in Ricardian fashion and should have increased their net capital imports through more savings or more exports. That they failed to do so seems to contradict the twin-deficits theory. What happened? Evidently the Greeks assumed from the time of entry into the euro area that in case of insolvency they would be rescued by the community of euro countries. For them the reference value was not the 110 percent debt to GDP ratio, but the then average of about 70 percent of the euro community. Greece therefore behaved in a Keynesian and not a Ricardian way.

Outwardly, Greece even behaved more virtuously than required by the theory. Its alleged debt ratio reported to Brussels fell from the above-mentioned 110 percent (2004) to 98.4 percent (2008). Therefore, the creditors assumed that Greece was on the right path. Without hesitation they could therefore grant the same interest rate on Greek government bonds as for other euro country bonds. This explains why interest rate spreads of close to zero between the government bonds of Greece and those of other euro countries were observed (as, for example, presented by Sinn 2010).

At this time, Spain and Portugal had government debt ratios that were also way below the 80 percent mentioned by Nickel and Vansteenkiste. They, too, behaved in a Keynesian fashion in conformity with the theory. With rising government deficits they increased their imports or reduced their own net capital imports.

Over time, however, according to the twin deficits theory, in the above-mentioned countries, but especially in Greece (independent of its ‘officially reported data’), self-correcting measures should have set in. With the decline in labour productivity and the rise in the return on capital, individuals there should have saved more. This was not necessary, however, as the high rates of return attracted a large volume of foreign capital. Especially German investors were caught up in the vortex.

At the same time, the actual Greek public debt kept rising. But even after the state bankruptcy had become obvious and the foreign investors stayed away, there was no reason for Greece to change from the inflation regime to the stability regime and to reduce its twin deficits in a Ricardian way. The explanation is that the foreign investors were replaced *quasi* automatically by the Target2 credits of the euro system. The latter were especially favourable for Greece, as the interest rate to be paid was only that of the main refinancing rate of 1 percent (Sinn and Wollmershäuser 2011).

In this way it was possible for Greece as for the other Mediterranean countries to continue living under the soft budget constraints of the inflation regime without having to accept the disagreeable side effects of inflation and loss of purchasing power that normally come in the wake of an inflation regime.

Who is not automatically reminded of the end phase of the Bretton Woods System mentioned at the beginning? At the time Germany refused to continue financing the US twin deficits by purchasing dollars at the fixed exchange rate. Germany exited the Bretton Woods Treaty, caused its collapse and forced the United States to adopt reform measures. In today‘s Germany, however, this idea is no longer opportune.[3]

Euro, what now?

Many economists argue for insolvency procedures to overcome the sovereign debt crisis. But politically this solution has no chance of being implemented at present. With the political forces in place today, the future is likely to lie in a transfer union under the

[3] Only ‘heretics’ such as Henkel (2010) dare to demand Germany’s exit from the euro system.

direction of a centralistic euro government *(gouvernement économique)*. Why is this the case?

1. *Loss of sovereignty:* the days of Bretton Woods, when Germany stood and refused to buy any more dollars, are past. In the EU Germany is no longer a sovereign state. In the council of the heads of state or government of the euro area, Germany has only one single vote. Although the body decides unanimously and Germany could veto every decision, this alone is not decisive. What is important is how decisions are formed in the process of 'decision shaping' preceding the vote which produces a draft that in the end no member can oppose. In this process the number of votes is often less important than the number of opinions. France evidently succeeded in using its standpoint on fiscal equalization to become the spokesman of the recipient states and hence had many opinions behind itself. On the other side there are only Germany and the Netherlands as safe payer states of any financial weight. The remaining countries stand in the middle. With the seriousness of the crisis, the weight of voters behind the heads of state and government is also shifting more and more toward those that need additional rescue programs and thus are in favour of a transfer union.
2. *The role of the banks in the preparation of decisions:* in addition, the decisions of the euro council are influenced by institutions that are independent of the voters: the EU Commission, the European Financial Stability Facility, the European Central Bank and the International Monetary Fund. In their considerations the burden on the taxpayer is not so important. They are dominated by bankers. A banker earns less by ending a crisis than on financing it. That is why he is possibly more interested in extending the crisis than in ending it. As to assessing what happens with the money, bankers are less knowledgeable. That is why bankers are more willing to put together rescue packages than to say how structural reforms are to be implemented on site. On the passage of the Greece-II package, it was typically remarked: what must we do to secure Greece's financing until 2020? Much less was said about how the money was to be used.

   A bright spot in the decisions of 22 July 2011 is the voluntary participation of banks. Can this procedure be repeated? I am sceptical. A bank executive can hardly step in front of his shareholders and say: I have made transactions at your expense. He is more in a position to communicate that a loss arising from a bankruptcy of Greece of say fifty billion euros must be accepted. After all, in the past the bank earned good money on Greek bonds.
3. *Transfer union via the European Central Bank:* politically the simplest is a financing of the transfer union *via* the European Central Bank. Since President Trichet has been ignoring Art. 123 of the Lisbon Treaty, there are no longer any limits here. The ECB can buy government bonds depending on the political pressure and political opportunity, i.e. support the budget of this or the other member state. Or in the words of Prime Minister Berlusconi: "and if today it's our turn, tomorrow it can be Paris's turn".[4] Today it is Italy and Spain, tomorrow perhaps France and other countries. The actions of the ECB may bring liquidity to the recipient countries, but the different risks and hence different interest rates remain. The inflationary effects will be modest as long as the economies of most euro states produce below their capacity limits. In Germany, however, which already produces more closely to the full employment limit, the inflationary pressure may be greater. In the same vein, the external value of the euro may decline when more euros are offered in the financial markets.
4. *Transfer union via Eurobonds:* Eurobonds are issued by each state in its own name and on its own account. But the repayment is guaranteed by all euro states as a common debtor. Whenever a debtor state declares that it is insolvent, the other euro countries stand in for it, initially according to a key of the euro states to be agreed, and eventually according to the one that is still solvent. If Germany wants to escape these burdens, it must declare that it will not participate in the Eurobond programme. Since the other countries do not want to lose their most solvent partner, it is more likely that Eurobonds will be issued via the European Financial Stability Facility (EFSF), of which Germany is a member.
5. *Economic Governance:* in order to maintain control of the Union's finances, the Brussels bureaucrats are already envisaging a strict economic government (a *gouvernement économique* according to the French model). At present an expenditure plan with a common industrial policy is foreseen. In the longer term, however, a harmonization of the major taxes in terms of tax base and rates is probably aimed for. Only with a strict mercantilistic exploitation of the tax substratum can the voluminous

[4] Open Europe, 10 August 2011.

expenditures of the transfer union be financed and at the same time indebtedness contained.

In this way everything will be nicely planned. Only our freedom will be lost. George Orwell's (1949) erstwhile projection for 1984 may perhaps become reality one hundred years later in 'Euro 2084'.

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