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Alternatives for Europe's Future*

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Joseph E. Stiglitz:
The Euro: How a Common Currency Threatens the Future of Europe
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Joseph Eugene Stiglitz is an American economist, a Nobel Prize-winning professor at Columbia University, and former chief economist and vice president of the World Bank. In 2001, he was awarded the Nobel Memorial Prize in Economic Sciences jointly with George A. Akerlof and A. Michael Spence for developing the basic theory for markets with asymmetric information. His research areas comprise income inequalities, management of financial risks, corporate governance and international trade. He is known for his critical views on the rise and regulation of globalisation, the "laissez-faire" economics approach, and international institutions (IMF, World Bank).

His book "The Euro: How a Common Currency Threatens the Future of Europe" describes the crisis of the euro area, and the extent of the recession and the slow pace of the recovery process. The author explains the economic, political and ideological reasons lying behind the debt crisis. He analyses the detrimental, often procyclical effects of the crisis management programmes of the so-called Troika (ECB – European Central Bank, EC – European Commission and IMF – International Monetary Fund) and comes up with several alternatives for the future of the euro area.

The 2008–2009 financial crisis which originated in the United States grew into a systemic debt crisis in the European Union, especially in the euro area. While the recession was followed by rapid growth in the Unites States, in the euro area the crisis developed into a systemic debt crisis which – in its most severe period – threatened to break up the euro zone. Stiglitz believes that the economic difficulties of the euro zone were primarily due to the incomplete institutional framework of the euro, or more exactly the euro zone. He points out that the establishment of the euro zone was primarily a political initiative, which was ahead of its time.

* The papers in this issue contain the views of the authors which are not necessarily the same as the official views of the Magyar Nemzeti Bank.

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Although monetary policymaking was centralised in the Economic and Monetary Union, the necessary crisis management mechanisms – that would have made it possible to effectively handle asymmetrical shocks affecting the euro zone – were not established. He attributes the problem on the one hand to a lack of European solidarity, on the other hand to the economics approach prevailing at the time of the establishment of the euro zone, the widespread dissemination of neo-liberalism. In a neo-liberal approach, assuming efficient markets, there is no likelihood that significant systematic risks will build up and thus no serious crises can be expected. Even in times of a potential crisis, efficient markets would automatically converge to a new equilibrium, and thus there is no need for significant state intervention or state regulations.

According to the expectations of its founders, the optimal functioning of the euro zone established along neo-liberal principals was supposed to be ensured by the fulfilment of the Maastricht convergence criteria which, however, only imposed restrictions on public over-indebtedness, and did not mitigate the often excessive risk-taking of the private sector. Thus, a centralised monetary policy was implemented within the agreed framework and, in parallel, the room for manoeuvre in fiscal policies left to the national competence of the Member States was also restricted. Due to a fixed exchange rate between the Member States' currencies, in the event of a shock inherent to the operation of a market economy, the correction of imbalances appearing in the balances of payments was not possible through a shift in the exchange rate. In the absence of the option of external devaluation, countries could only restore their competitiveness by reducing domestic price levels and primarily by cutting wages. The reduction in wages could increase exports at the price of reducing domestic demand and thereby by increasing unemployment.

The economic model of Germany also bears responsibility for the serious balance-of-payments deficits which developed in eurozone Member States before the crisis. In the 2000s, wages in Germany were only raised to a lesser extent than economic growth and, as a result, the unit cost of labour decreased. At the same time, the euro exchange rate favoured German industry, because the euro was weaker than a separate German mark would have been. As a result of these impacts, the competitiveness of German industry improved as compared to other countries in the euro zone, which led to an unprecedented balance-of-payments surplus for Germany and, in parallel, a significant balance-of-payments deficit for the southern Member States.

Due to the centralised monetary policy, a shift in the exchange rate could not be applied to correct imbalances in the balance of payments. In the southern Member States, a more rapid rise in wages as compared to Germany led to a higher demand and inflation, and thus to a lower real interest rate, which resulted in robust capital inflows. However, these capital inflows did not serve to finance the real economy and especially not to support SME lending, but rather led to the development of asset price bubbles. As a result of the 2008 crisis, these capital inflows dried up. Governments and banks of countries relying on these external funding sources were not able to renew their maturing debt, or only at excessive costs. The drying-up of capital inflows resulted first in Greece's insolvency. This case revealed, on the one hand, that use of euro did not automatically eliminate the country risk of Member States, and on the other hand, that the euro zone lacked mechanisms that could help Member States facing liquidity problems and their banking systems. Identification of these two facts started to produce extremely severe contagion effects on financial markets, not sparing even the returns on bonds in states that until then had been considered stable.

In federal states, it is usually the central bank that acts as a lender of last resort in such cases. In this function, the central bank may purchase government bonds or provide extra liquidity to support banks. In the EU, however, the ECB has no such powers, and thus Member States in trouble could not count on monetary policy support. Moreover, there was no fiscal transfer mechanism within the euro zone to mitigate the crisis. Finally, the Member States' own fiscal space was restricted due to the fiscal rules in place. These factors together resulted in a severe recession and extreme social tensions.

While the difficulties of Member States facing payment problems worsened due to the structure of the euro zone, more resilient countries that were less affected by the crisis even benefited from the debt crisis due to a decrease in interest expenditures. Thus, in contrast to the initial promises, the euro did not contribute to the harmonious development of the Member States. On the contrary, by centralising monetary policy and eliminating the possibility of exchange rate corrections, it amplified the differences among countries: it led to the unfolding of creditor and debtor countries within the zone, and thereby to conflicting national interests, a lack of confidence, an erosion of solidarity, and ultimately to a loss of support for the process of European integration, and to the strengthening of eurosceptical parties.

The third part of the book demonstrates that the crisis management programmes of the Troika mostly failed, and did not support the economic recovery of growth in the affected countries or the expansion of employment. The reforms of the Troika – mainly driven by neo-liberal ideology – wished to reinstate balance by improving the primary balance of those Member States that got into trouble. They wished to achieve these objectives mostly through steps which hit vulnerable social groups more severely, furthermore through so-called structural reforms, that fundamentally change the entire economic framework of Member States. According to the Troika, the temporarily painful reforms, if carried out, would have ultimately resulted in an improvement in Member States' competitiveness, growth in exports, and thereby an improvement in the balance of payments. However, export volumes only increased to a limited extent, while the implementation of reforms resulted in an extreme economic downturn, severe social tension and political cost. The Troika attributed the serious downturn to the inappropriate implementation of the programmes. However, based on the similar outcomes of several countries, it cannot be convincingly stated that the programmes would have efficiently supported the recovery of insolvent countries. Nonetheless, they were able to restore the primary balance, and in several cases there was even a significant surplus. Furthermore, they enabled governments to bail out their countries' banks, ensuring the settlement of outstanding amounts owed to creditors, often German or French financial institutions. It appears therefore that the aim of the Troika was not to restore the economies of the Member States in trouble, but rather to help creditors, considering that any hypothetical but in fact absolutely necessary debt-restructuring was consistently and categorically rejected by creditors, mostly Germany.

The structural reforms urged by the Troika did not treat the underlying problem of Member States facing payment difficulties and the lack of possible corrective mechanisms. In the absence of an easing of monetary or fiscal policy and the function of ECB as a lender of last resort, governments with liquidity problems implemented – in vain – extremely costly structural reforms to improve the flexibility of their labour markets. This had no significant impact, except that it substantially increased unemployment. The programmes undermined social security, in addition to increasing income inequalities between the Member States, which impaired the efficient functioning of the economy. Finally, they also contributed to dividing the euro zone into creditor and debtor states, where the equality of the Member States is undermined, and creditor countries dictate the directions to be followed, often against the expectations and preferences of the debtor countries.

Yet, as Stiglitz argues, the functioning of the euro zone can be restored, and if there is sufficient political will, it is possible to set up a monetary union that is beneficial for all Member States, and promotes growth and full employment. The author sets out three possible approaches. A potential option is to deepen European integration and to *complete* the eurozone institutional system, including the missing crisis management mechanisms. Another option is a *smooth divorce* whereby through the exit of one or more Member States, the euro zone would be divided into smaller currency zones. Finally, a *flexible euro zone* could be created where the exchange rates of the Member States' currencies would fluctuate against each other in a pre-determined band, abandoning the rigid policy of pegged currencies.

To complete the institutional system of the euro zone, Stiglitz recommends the following structural reforms:

1) Creating a banking union with a single deposit insurance scheme. The resulting banking systems with a uniform level of resilience would remove the burden imposed on Member States to bail out their banks, and at the same time, would leave considerable fiscal space for offsetting the negative effects of potential crises.

2) Similarly to the banking union aimed at preventing capital outflows from the countries' banking systems, it is necessary to mutualise European debts to prevent labour migration. As long as the issues of government debt belong to administrative units, more mobile, mostly younger social groups may move to member states with lower government debt levels, thus with lower tax levels and better living conditions, further deepening the divisiveness between creditor and debtor countries in the EU. By contrast, issuing mutually guaranteed debts would allow for the sharing of debts, since the repayment burdens of debtor countries could be reduced, which would leave more scope for applying demand stimulation economy policy tools.

3) A stabilisation fund, that is, an EU solidarity fund for stabilisation purposes. This could be used to offset the effects of asymmetric shocks. In addition to a common budget for stabilisation purposes, there would be automatic stabilisers financed at EU level, for example to finance a common unemployment benefit scheme.

4) Coordination of economy policies, that is, the avoidance of excessive macroeconomic imbalances, including the elimination of both the excessive deficit and surplus of the balance of payments. The author proposes to pursue an expansive wage policy in countries with a balance-of-payments surplus in order to terminate imbalances. The above reforms would efficiently support the functioning of the euro zone, while at the same time, they require a significant step towards deepening the European integration. Moreover, they would lead to higher burdens on creditor countries, which presumably would not gain support from these countries. Germany explicitly stated several times that the EU is not a transfer union; however, without the reforms outlined above, this "muddling through" the crisis will only continue. Even a smooth divorce may be better than that.

In the case of a *smooth divorce*, the euro zone could be divided into one or more sub-areas. These sub-areas would constitute a more homogeneous currency area where a centralised monetary policy can set an interest rate level appropriate for the Member States. Under this scenario, the establishment of 2–3 country groups could be sufficient for the operation of the system. If Southern countries exited form the euro zone, their exchange rates would be lower, and their balances of payments could reach equilibrium. The simplest case, however, could be the exit of Germany, because then the German currency to be introduced would strengthen, and Germany's balance-of-payments surplus as well as balance-of-payments deficits of the euro zone countries would be mitigated without any shock. However, a smooth divorce can widely be considered as politically unacceptable, and may restrain the already scant support for the European integration efforts for decades to come.

In the case of establishing a *flexible euro zone*, Member States could maintain their exchanges rates within a narrow band, and in parallel with the deepening of integration, these bands could be narrowed. In this approach, it would be reasonable to introduce export coupons in order to regulate the export quotas of companies. In this way, the development of the balances of payments could be directly regulated, which would not result in a much stronger limiting factor than pegged exchanges rates. On the whole, a system like this could efficiently combine the advantages arising from the more stable exchange rates, while it would open the door to the still required shifts in exchange rates. As a result, capital flows between Member States could be prevented, and it would be possible to set up an institutional framework that promotes the harmonious development of the euro zone.

Finally, Stiglitz emphasises that the EU is more than a monetary union: hence, whichever alternative is adopted, it will be better than an approach that paralyses the continent and entrenches an approach of "muddling through". To succeed, it should be made possible for each Member State to achieve harmonious growth and full employment, while working to reduce inequalities and improve social justice. At the same time, Member States should avoid establishing economic integration without prior political agreements, which would only result in inoperable structures and painful corrections.