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Is the Euro Sustainable?

Yes, of course. To prolong the discussion, I shall instead ask the alternative question, under what conditions might the euro become unsustainable? Currency regime changes are essentially political issues, but economics influences politics. Pressures on euro membership would probably grow if asymmetric adjustment amongst the weaker euro members proves hard in the face of current adverse economic shocks. The costs of exit for such a weak exiting country would be huge, as Barry Eichengreen (2007) has already noted, but that does not necessarily mean that it would not happen, especially through some combination of market pressures and miscalculation. I consider, and try to guestimate probabilities for the following scenarios:-(i) A German exception; (ii) North/south divide; (iii) Miscalculation under pressure; (iv) Market pressures; (v) An interactive process.

1 Politics Trumps Economics

It is nice to be asked a question with a one-word answer: "Yes". The organisers of this Conference might, however, be mildly upset if I was to end there. So I shall turn the question around and ask a related question instead, which is under what circumstances might the euro become unsustainable?

Mike Mussa, when Chief Economist at the IMF, noted the regular pattern that each country had its own single currency.[1] When empires split, as occurred with the Soviet Union and Yugoslavia, the constituent separate states adopted separate currencies. When subsidiary states coalesce into a single union, as with Germany and Italy in the 19th century, they adopt a single currency. Optimal currency area theory has zero predictive power, apart from mini-States of the size of Luxembourg, or less, for whom an individual currency could be an unnecessary and expensive luxury.

The adoption of a single currency in the euro area was, of course, largely a political act, seen by most observers as a step along the road to greater political union. But it had the unusual feature of preceding, rather than succeeding, such union. Meanwhile the road to greater political union has proved quite rocky. The unfinished nature of both political and fiscal union in the euro area provides the basis for some continuing fragility.

In his excellent papers on "The Breakup of the Euro Area", reprised in part in his paper to the "Workshop EMU @ 10" (Brussels, 26 and 27 November 2007), Barry Eichengreen reminded his readers "that monetary union without political union is problematic. Since the latter is not likely to change anytime soon, collapse of the former cannot be dismissed", (also see De Grauwe, 2006). The decision of a Member State of the euro area to seek to pull out of the euro area, and to re-establish a national currency would be a major political step, with many serious repercussions; some of the economic consequences are discussed below. Since it would be primarily a massive political decision, there are many considerations beyond the bounds of economics that could come into play. I am not, however, competent to assess them, so I shall stick to the purely economic issues.

2 But Economics Influences Politics

The main economic question for national politicians is whether membership of the euro area continues to be seen to be in the best interests of the citizens of their own country. Besides the political and social effects, the sin-

[1] *Though Hong Kong within China, (two currencies in a single country) is a partial exception to this rule.*

gle currency generally brings efficiency gains, but at the expense of greater difficulties of adjusting to country-specific, asymmetric shocks. This latter is, of course, worse when the specific shocks are severe, as may well be the case in 2008/09.

When monetary and exchange rate policies cannot be used, and fiscal policies are somewhat restrained, on which more below, the main channel of adjustment is labour market flexibility, both in wages and labour mobility. A problem is that the first of these, relative wage flexibility has not, so far, been working well. Chart 1 shows the change in percent over the proceeding year of unit labour costs for the whole euro area, and for the main constituent countries, Germany, France, Italy and Spain.

In most years the differences have not been huge but they have been persistent. Initially these relative differences were quite benign, since they offset an original over-valuation of the

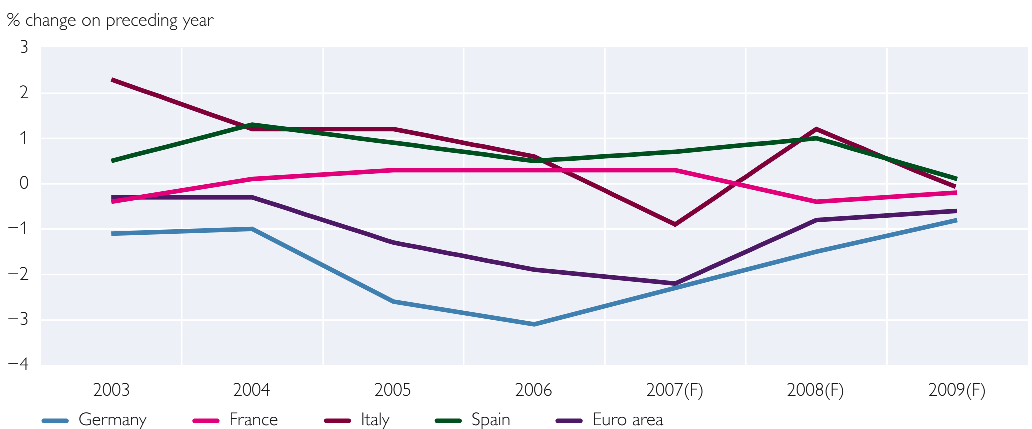
Chart 1

Unit Labour Costs – Whole Economy

Source: European Union Economic Forecasts, spring 2008.

Chart 2

Relative Unit Labour Costs to Rest of a Group of Industrialised Countries (National Currency)



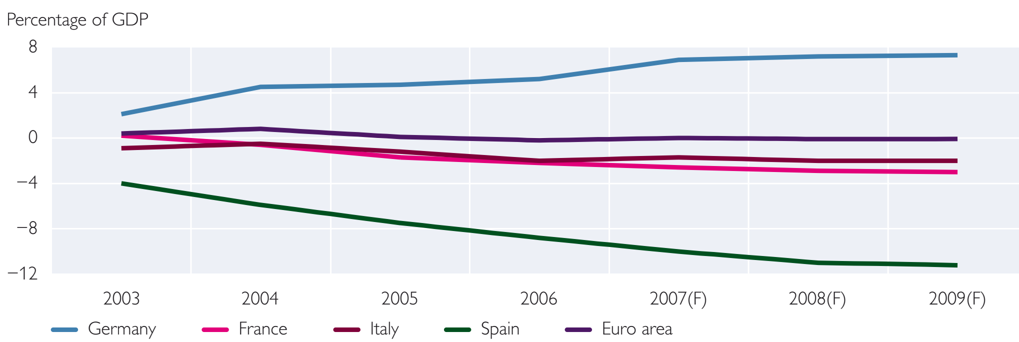
Source: European Union Economic Forecasts, spring 2008.

German Mark, post-unification, and capital inflows into Italy and particularly into Spain. Over time, however, they have led to some extreme movements in competitiveness, relative unit labour costs, and current account balances. Given the likely pattern of the effects of the current financial turmoil on Spain and Ireland, as contrasted with Germany and Austria, such trends will have to be reversed rapidly. The latest forecasts from a research study of the Centro Europa Ricerche in Rome are not optimistic on that score.

Moreover given the German and ECB aversion to inflation, this will have to be done by the peripheral countries reducing their unit labour costs. In those countries where productivity growth is quite high, Greece or Eastern Europe more generally, this can probably be done without wage cuts, but the pain will be greater in low productivity countries, like Italy.

Chart 3

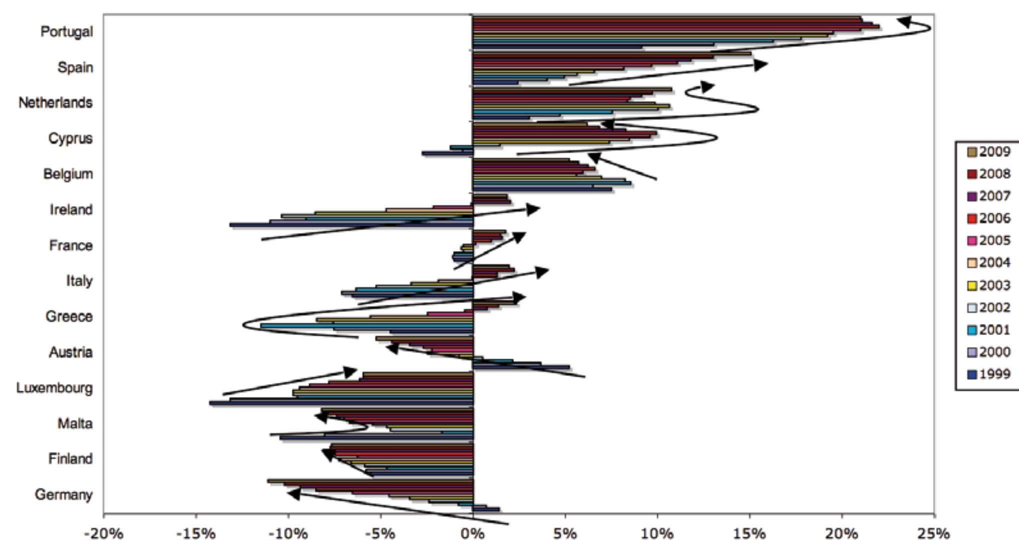
Current Account Balance



Source: *European Union Economic Forecasts, spring 2008.*

Chart 4

Unit Labour Cost Deviations from Euro Area Levels: 1999–2008



Source: Centro Europa Ricerche, Rome (2008).

It used to be said that there was low labour mobility within Europe, but that was prior to the unexpectedly large scale of migration from Eastern Europe, especially Poland, into the booming countries of Western Europe, notably Ireland, Spain and the UK. What will happen to the migrants when boom changes to downturn, or even recession? Many migrants are in the kind of job, e.g. in construction, most liable to lay-off in downturns, and some may go home. But inevitably many migrants will remain in jobs in their host country, while the indigenous unemployment numbers also rise sharply. During the boom the migrant inflow

from East Europe was apparently assimilated quite easily and generally welcomed. Will that survive a sharp downturn; could the previous migrant inflow come to be perceived as an increasingly serious social problem?

By most standards the fifteen years, 1992–2006, were a golden age of steady growth, stable prices and moderate unemployment. That has now temporarily ended. The stresses and strains arising from lack of adjustment mechanisms *could* now become more serious.

It is, at least, a possibility, to which I would give a probability ranking of 50% that the majority of voters in at least one euro area state will, during the next year or two, come to regard their membership of the euro area as a net liability. Put another way, if there was a tabula rasa, no past history, and a *fresh* choice to be made between entry, or not, into a newly constituted euro area, voters faced with this choice in one, or more, of the current euro area Member States would vote on balance against entry.

3 The Costs of Exit

But history is irreversible. The cost of exit from an existing system is not the same as whether, or not, to join in the first place. In Eichengreen's paper, to which I have already referred, he lists, and outlines, most of the costs of exit; the operational and transitional costs of reverting to a national currency, the costs of a probable loss of counter-inflationary credibility, the political costs of being seen as European backslider, etc. I agree with the points that he makes in a paper that can develop those at much greater length than I can here. So read his paper.

But I would like to extend and emphasize one issue, more than Barry does. This is that the debts, the IOUs, the deposits, notes, bills and bonds being issued by some hypothetically exiting country will have been issued in euros, whether by the public or the private sector. That hypothetical country may declare all its debts instantaneously redenominated in the restored, and presumably devalued, national currency. But the foreign creditors would not take that lying down. A contract is a contract. The creditors would go to their own national courts and then to the European court.

Why should a court, outside the country exiting, agree to a unilateral abrogation of contracts? Unlike Argentina, in almost all euro area countries private sector companies have sizeable

assets situated outside their own countries. Creditors from other countries could seize these, if their contracts were not honoured. A government has sovereign immunity, but if a European court ruled that it had to pay its euro debts according to the contractual terms, could an exiting country refuse to accept that ruling and still remain in the EU? Again unlike Argentina, the costs of unilateral partial default for a country exiting the euro could be huge.

Could an exiting country differentiate between domestic creditors (to be paid in the new currency) and foreign creditors (to be paid in euro)? The operational, logistical and legal problems would be massive. But if all, or even a large proportion, of pre-exit debts would have to continue to be paid in euro, while domestic assets were to be redenominated in national currency, a large segment of the private sector would, most likely, be forced into bankruptcy.

So, to my mind, unilateral exit would not be an optimal or rational policy for any country to make, both for the reasons set out above and those adumbrated at greater length by Eichengreen. Nevertheless, the course actually chosen is not always the best. So, in the next section, I shall set out some hypothetical scenarios that conceivably could lead to exit and/or break-up of the euro area.

4 Scenarios for Exit

(i) The German Exception

In the above, I have been implicitly assuming that the potential exiter was a weak state, planning to devalue. Barry Eichengreen uses some space to discuss the option of the other countries ganging up to push through a too inflationary policy, causing Germany to exit in disgust. I dismiss this as totally improbable. Inflation is a monetary phenomenon; the ECB is independent of politicians, protected by the Treaty and has a mandate for price stability; the members of the Governing Council are Central Bankers, required to maintain price stability for the euro area as a whole. Given this institutional set-up, the idea that Germany could be pressured into an inflationary policy strikes me as fanciful, unless the politicians use their powers on exchange rate regimes to require the ECB to peg the euro to some other more inflationary currency, presumably the U.S. dollar. That would, I believe, be institutionally and legally feasible, but hugely risky, not least because it *could* trigger a German exit and the break-up of the euro area.

(ii) A North/South Divide

Although the likelihood of getting a committee of Central Bankers to abandon their price stability mandate, and consciously embrace an inflationary policy, seems slim to me, the possibility that a large number, or even a majority, of euro group Ministers of Finance might do so is somewhat more likely. In particular, there is a possibility that all the main Mediterranean states, Greece, Italy and Spain, plus Portugal, Cyprus and Malta, could be pushed simultaneously into depression in the next few years. If they could reach a political understanding to press for an economic agenda with a united front, they might achieve a much better outcome for themselves than available by a unilateral exit. If they were to take such a political line, where that would leave France, Belgium, Ireland and the East European states would have to be seen.

Be that as it may, a Mediterranean political alliance could threaten to split the euro area unless policies were made more expansionary (and more assis-

tance was channelled in their direction). Might such a political alliance occur? It would probably require a combination of a severe recession and the election of relatively euro-sceptic parties in both Italy and Spain simultaneously. That looks improbable at present, but not impossible, perhaps a 2% chance, one in fifty?

(iii) Miscalculation or Pushed?

I have argued that exit could be less painful, and some of the potential costs negotiated, if done by a large group of countries rather than individually. But such political manoeuvring would probably become evident long before a common front could be hammered out. Indeed the election of a euro-sceptic government, pledged to do *something* to improve the economy, could act by itself as a warning signal to investors. There could easily develop a run out of claims on that country's fixed interest debt, whether it be issued by the public or private sector, corporates or banks, deposits, notes, bills or bonds; and there could be simultaneously a run to borrow from their banks. We have seen in recent months once again how, when confidence falters, runs can develop overnight.

The suspect country's, or countries', banks would become effectively stripped of liquidity in a flash. They would turn to the ECB who would have to accept piles of that country's debt as collateral for loans. The ECB, and the country's own banks would turn to an incoming euro-sceptic government for clarification of its future policies. Effectively, should a vocally euro-sceptic party win an election, it would probably be forced, by market pressures, either to abandon some of its election pledges and reconfirm membership of the euro, or to exit the euro within a day, or at best a week, of taking power. What would it choose? That would all depend. I would put the probability of exit under such a scenario, i.e. election of a euro-sceptic party subject to instantaneous market pressures, as about 4%, one in twenty five.

(iv) Market Pressures

Markets are forward looking. They will seek to assess the build up of economic and political pressures. For the weaker members of the euro area, there is a one way option. Either they stay as members, or they get forced into devaluation. Hence, investors would prefer the fixed interest debt of the stronger members, unless offset by a risk premium, or differential. So, the relative economic weakness, and political potential towards exit, will be marked by widening interest differentials, probably well before any specific choice of exit, or not, is put specifically on the table.

To the extent that such interest differentials should appear, it could lead to a vicious spiral. Widening interest differentials reduce the perceived benefits of euro membership, and worsen the economy affected. That exacerbates euro scepticism, which further increases the interest differential. Could such a market-driven process go so far as actually to drive a country out of the euro area without the prior election of a euro-sceptic government? Highly improbable, but not entirely impossible, perhaps a probability of one in a hundred.

(v) An Interactive Process

Perhaps the most probable scenario is a combination of most of the above. The Mediterranean countries weaken, and political grumbling about the constraints of the euro area membership increase. Interest rate differentials widen. Clarification of future policies,

with respect to future membership, is sought from the relevant (new) government(s). The statement does not reassure, and a financial crisis ensues. The government then reasserts control of the printing press, and issues a national currency, to support its financial system.

The market then turns to the next weakest country; contagion amongst member nation states ensues. The country, (or countries), that has (have) already exited seek to fan such contagion, since, as already noted, the more countries exit simultaneously, the higher their own bargaining position. How far, violently and viciously, could such contagion spread? Remember the ERM!

What probability would I attach to this? Perhaps 5%, one in twenty.

5 Conclusion

If you add up all my probabilities, which is not quite kosher since they are not all mutually exclusive, it comes to about 12%; perhaps overall between 10% and 20%. Slim, but not entirely negligible, and, as measured by government bond differentials, rising noticeably at this moment.

How might such probabilities be reduced? The obvious answers are by the achievement of further steps towards political and fiscal union, and/or through greater labour market flexibility. Whether any of that can be achieved, and on a time scale dictated by the prospective world-wide recession, is another question, which, perhaps fortunately, I do not have the time/place to answer.