Problems arising from a common currency

Dr. Barbara Kolm
b.kolm@austriancenter.com
Austrian Economics Center
Vienna - Austria

Expectations

Milton Friedman was the key figure of Monetarism, of the Chicago School of Economics, and a receiver of the Nobel Prize. In 1997, before the euro was even launched, Friedman predicted many of the features of the current currency crisis the euro is going through. He believed that a common currency could be either good or bad, depending the circumstances. These circumstances were basically the adjustments mechanisms available in any given economy. "Flexible rates," said Friedman (1997:1), "are a powerful adjustment mechanism for shocks that affect the entities differently."

The United States can be seen as a positive example for a common currency. Common language, common cultural life (its inhabitants watch the same tv shows, the same movies, etc.), good and capital are able to move freely across the US, wages and prices are moderately flexible, and there is a common national fiscal policy – with very mild variations depending on the individual states.

Shocks affect the US economy from time to time. An example of those can be the 1970s oil crisis. And it is true that certain regions of the US can be more affected by shocks than others. For instance, the net oil-importing Midwest was much more affected by the oil crisis than Texas. However, these immediate effects of the shock were rapidly mitigated by the movement of people and capital, by the financial help of the federal government to the local and state governments, and by the adjustment of wages and prices.

Unlike the US, Friedman thought that the European common market was an example of an area unfavorable to a common currency. By contrast, Europe is comprised of different nations which do not share a common language or similar customs. Moreover, the loyalty of the citizenship was not to Europe but to their own countries. This can even be further even to regions or local communities. What is more, in spite of the free European free trade area, goods and capital move less freely than in the United States.

National governments, and not the European Commission based in Brussels, are the main political actors. Thus regulation of industry and labor stems from these different local entities and greatly varies from country to country. Wages and prices, indeed as Friedman believed, tend to be more rigid in Europe than in the US.

Confronted with a negative shock which calls for lower wages relative to other country or countries, there two ways to achieve this. One would be just to change one price within the economy – the exchange rate. But as we all know, the country members of the euro cannot do

that, which requires a myriad of changes in their economies. Naturally, this presupposes a large degree of flexibility, a rare commodity in European economies.

Therefore, Friedman concluded that the euro was a political project, not an economic one. He claimed that its aim was to make war between France and Germany impossible, and to pave the way for the United States of Europe. Friedman warned nonetheless that the opposite would happen: "[The euro] would exacerbate political tensions by converting divergent shocks that could have been readily accommodated by exchange rate changes into divisive political issues," and he denounced the ill-conceived way of the euro, "political unity can pave the way for monetary unity. Monetary unity imposed under unfavorable conditions will prove a barrier to the achievement of political unity" (Friedman, 1997:3).

In the year 2000 Ottmar Issing made one of the most eloquent defenses of the euro project. Mr. Isssing is currently President of Center for Financial Studies (Goethe University) and former member of the Executive Board of the European Central Bank and of the Deutsche Bundesbank. Launched the previous year, Issing was so optimistic about the common currency that he did not hesitate in relating it with Friedrich von Hayek's proposals. Issing acknowledged nonetheless that the euro was a governmental top-down initiative far from the private money issuers Hayek envisioned. However, for Issing there is a level in which the euro has caused the *denationalization* of money. The independent nature of European Central Bank (ECB) and the fact that national central banks members of the Eurosystem cannot take instructions from their national governments made this *denationalization* happened. So, with the introduction of the euro, the separation between public finance and monetary policy has been finally achieved.

Indeed, Hayek himself wrote in *The constitution of liberty* that

> It may still be true that, if there were full agreement as to what monetary policy ought to aim for, an independent authority fully protected against political pressure and free to decide on the means to be employed in order to achieve the ends it has been assigned might be the best arrangement. The old argument in favor of independent central banks still has great merit (Hayek, 1960:334)

What is more, Hayek also emphasized on the dangers of monetary financing:

> If we are to preserve a functioning market economy, *nothing can be more urgent than that we dissolve the unholy marriage between monetary and fiscal policy*, long clandestine, but formally consecrated with the victory of Keynesian economics (Hayek, 1976:117)

Issing claimed in 2000 that Hayek's ultimate objective –monetary independence from political interference and price stability– has been achieved by the creation of the euro, however different the path of the euro was from Hayek's free banking ideas. The creation of the European Central Bank and the euro might have been an act of "constructivism" but it may also represent the greatest contemporary attempt of denationalization of money.

Different views

Philipp Bagus (2010) believes that at t base of the European Union lies a conflict of visions between two groups. One tends to favor classical liberal ideas. The other is openly in favor of a more socialist Union.

Robert Schuman, Konrad Adenauer, and Alcide de Gasperi, all devote Catholics and members of Christian democratic parties, were in favor of a European Union more inclined to the classical liberal values. Individual liberty played a key role in their vision of a united and peaceful Europe. Private property, the free market, and open borders between European nations will insure the free exchange of goods, services, and ideas.

The 1957 Treaty of Rome delivered the four freedoms these leaders envisioned: free circulation of goods, free offering of services, free movement of financial capital, and free immigration. In a sense, the treaty restored the liberties Europeans enjoyed in the 19th century and sadly lost in the fratricidal period between 1914 and 1945. Thanks to the treaty, Western Europe moved away from socialism and nationalism and rediscovered its own liberal tradition.

According to the classical liberal vision of Europe, the idea of a centralized European mega-state is detrimental and dangerous. Due to their Catholic background, the "founding fathers" of the European Union strongly adhere to the subsidiarity principle. Problems must be solved in the lowest level, the one which is closer to the individual citizen. This would allow political institutions to compete and find the best solutions. The same should said about money and taxes. Different currencies and different tax systems which provide Europeans with options.

By contrast, the socialist vision of Europe is more inclined to see the EU as a system to fortify Europe. Protectionism is the way to deal with trade with the non-EU world and economic and political interventionism for the member states. The goal of the socialists is to create a European mega-state with all the present capabilities of the current existing national states and more. Many claim that this centralizing vision is a way to stifle inter-state competition and secure the enlarged welfare states of countries like France to the detriment of the poorer members. Thus, a "harmonized" VAT of 25% across Europe or the social entitlements French citizens enjoy would be unaffordable for poorer Poland or Slovakia. French politicians have even coined the phrase "fiscal dumping" to refer to Ireland's less extractive tax system. According to Bagus, "the socialist vision of Europe is the ideal of the political class, the bureaucrats, the interest groups, the privileged, and the subsidized sectors who want to create a powerful central state for their own enrichment" (2010:4).

Why the euro failed

A single currency like the euro implies that all the countries within the union have the same monetary policy and the same basic interest rate. Countries therefore are left unable to respond to negative external shocks lowering interest rates and devaluating their local currencies. An entity such as the European Central Bank naturally has to make monetary policy for all the country members and based upon the general state of their economies. This can

easily lead to a situation in which interest rates can be too low for some countries and too high for others.

Thus, countries such as Greece and Italy, to name a few, with traditionally high inflation and currency devaluation faced very low interest rates for the first time in decades. This proved to be a temptation impossible to avoid both for their governments as for their citizenry. Politicians launched massive projects and extended social welfare programs. One of the most pathetic examples of this was José Luis Rodríguez Zapatero, a former prime minister of Spain, who is responsible for the construction of many airports which count one or two flights a year. Households also took advantage of the interest rate drop and home building exploded in many countries. Consequently, the ratios of public and private debt to GDP skyrocketed.

For a very long time, a powerful opiate acted over the markets. Although there were explicit clauses forbidding bailouts, markets believed that they would not play any role in case one of the euro countries were in deep financial difficulties. The mechanism which used to be activated when countries borrowed too much, higher interest rates and national currency devaluation, was no longer functioning in the Eurozone. When eventually markets started distrusting Greek bonds and thought that perhaps they were not as reliable as Austrian or German bonds, interest rates did rise for countries like Italy, Greece or Spain. The spiral of lack of confidence affected these countries so much that they were by 2010 at the brink of default.

What is more, banks had in their portfolio large quantities of government bonds and were severly hit when those bonds lost value and private citizens started defaulting on their mortgages. Failing Spanish *cajas* or Irish banks turned to their respective national governments for rescue in the face of insolvency. In some cases government could not avoid guaranteeing the deposits themselves, which added to their already bloated national debts.

The presumption that irresponsible governments would be bailout one way or another for the sake of the common currency added a particular European flavor to the global financial meltdown. Everybody thought that, in the end, Germany would come to the rescue if needed. Easy money acted like a drug over the brain and both governments and citizens became addicted to it. The latter went in a shopping spree, the former expanded their "generosity" to previously unknown levels. Philipp Bagus claims that the current crisis was in the very nature of the euro project: "When the euro was created, it was implicitly assumed among member nations that no nation would leave the euro after joining it. If things went from bad to worse, a nation could be rescued by the rest of the rest of the EMU. A severe sovereign debt problem was preprogrammed with this implicit bailout guarantee" (2010:123).

This sort of incentives proved to be extremely dangerous. No Southern European politician seemed to be able to resist. Housing bubbles, financial bubbles, debt, malinvestments, huge public sectors were some of the consequences. Although some people benefitted from all this, the general population suffered (and still suffers) for the crisis the euro produced.

Another key aspect of the euro crisis has to do with the way governments can monetize their deficits under the ECB regime (Bagus 2012). Governments which spend largely can finance

deficits with the help of the banking system. This is because banks can purchase government bonds and then use them as collateral for ECB loans. This influx of money monetizes the national deficits indirectly. This monetization produces costs which, unlike in the pre-ECB era, are *paid* by all the Eurozone countries and not exclusively by the particular country which overspends. Thus, counties running deficits can externalize at least part of them to the rest on the union members. This transfer mechanism was embedded in the euro from the beginning. Transfers and "solidarity" among member states started long before the bailouts for Greece.

This enhanced the capacity of irresponsible governments to take the responsible ones (or the less indebted ones) as hostages (Selgin 2013). Since the ECB held Greek bonds and other sovereign bonds a potential default of those could very well hit the private banks and eventually the ECB itself. When everybody starts to think that bailouts will happen no matter what, moral hazard is around the corner. Irresponsible governments have now the title of "too big to default." The unspoken rule that no country will fall nor leave the euro certainly posed grave systemic threats.

This fire was fed also by the fact that France and Germany violated the Maastricht criteria and went unpunished. In addition, fiscal sovereignty by member states and the lack of an institutional framework to avoid debt monetization and bailouts created a high risk combination of incentives.

Once the crisis exploded European banks were truly affected and their solvency was put into question. Of course, free market solutions could have been applied to handle the problem. Private injections of money could have come from investors looking for the sustainable banks in the long run. Creditors should have been turned into equity holders of the troubled banks. This would capitalized the financial institutions and dramatically reduced their debts. Finally, as John Charalambakis said in Vienna a few years ago: "We should have left the banks die." At least some of them.

Unfortunately free market solutions were completely ignored. The EU leaders reacted in a rather hysterical way and just decided to throw money at the problem. National governments injected amazingly large sums of money to their banks and guaranteed the whole financial system. Courageous European politicians did not want to raise taxes to save bankers so they took the easy way of raising the national debt instead.

On top of this, in 2015 Mario Draghi started with a quantitative easing of his own. The ECB has committed 1.1 trillion euros to buy financial assets in possession of the banks. The full effects on the value of the euro and whether or not this policy will inflate an asset bubble remain to be seen. The results of the QE policy in the US are certainly not encouraging. More debt and even more malinvestments are in the European horizon.

Alternatives

If the euro, as it seems, has failed, what to do now? Brussels elites, the ECB, and Angela Merkel have chosen to save the euro whatever it takes. This differs real reforms and is in fact nothing

else than kicking the can down the road. Besides, Merkel's strategy of equating the European project to the euro is very dangerous to the survival of the good aspects of the integration project.

There are, however, other alternatives that we would like to discuss in what follows.

Parallel Currencies

The first possible alternative would be to allow troubled nations such as Greece to restart issuing their national currencies *without* leaving the euro. Pedro Schwartz, Francisco Cabrillo and Juan Castañeda (2013) have recently proposed such a thing. Their inspiration comes from John Major's proposal of a hard ecu instead of a common currency. They would like countries like Greece to be temporarily suspended from EMU membership and be allowed to print their national currency again. The new drachma would freely float and would be fully convertible to the euro at the exchange rate markets dictate. This possibility can facilitate recovery for the Greek economy while at the same time does not mean complete abandonment of the euro project. What is more, the Spanish authors propose that bank deposits in euros should be guaranteed so there is no bank run.

Schwartz, Cabrillo and Castañeda claim that

> The main advantage for Greece would be that pricing wages, taxes, social benefits and domestic assets in drachmas would help make the Greek economy competitive again in foreign markets and achieve the necessary price adjustments (2013:124).

An additional advantage for Greece would be that

> By not forsaking the euro totally, balance of payments deficits would continue to be financed for the time being as at present by Target 2. Greek banks could have recourse in moments of need to both the ECB and the Greek central bank. The drachma need not disappear if the Greek central bank applied a conservative monetary policy – indeed, the central bank would have an incentive not to misbehave if it wished to maintain its seigniorage income. A full return to the euro could be contemplated at a later stage, if Greece wanted this (2013:124).

Neither the euro nor the new drachma would be legal tender under the scheme proposed by Schwartz, Cabrillo and Castañeda. The key idea for these authors that residents and banks be let free to choose the currency they like best. Morover, commercial banks will have two lenders of last resort: the Greek central bank and the European Central Bank.

Monetary competition would make the convergence towards better currencies easier. And competition between the euro and the new drachma most likely push the Greek monetary authority towards prudence. The fact that savers will be allowed to save in euros adds to this.

Finally, the authors realize that this alternative would force Greece to default its debt. However, they trust that the “well-tried lines” of the Club de Paris and of the London Club can alleviate the sovereign and private debts respectively.

Germany out

A second proposal, put forward by George Soros and others, is that it is in fact Germany who has to leave the euro.

If Germany returned to the Deutsche Mark the euro would automatically devalue against the new German currency and the dollar. This would make the remaining European countries – particularly the troubled Southern economies– more competitive immediately. Growth would have the boost it needs in these countries. On the other hand, countries such as Austria and the Netherlands may perhaps follow Germany and form a new currency bloc. This was the d*e facto* situation prior to the euro for the Benelux, the Netherlands and Austria. Needless to say, this would further depreciate the euro – bringing more competitiveness to the Eurozone countries.

Of the European nations, it is perhaps Germany the one fittest to coexist with a strong currency. The role that the Bundesbank played before the introduction of the euro points in that direction. German companies can adapt to that again and it would definitely be a boost for productivity in the country. The huge German current account surplus would probably fall but German citizens will have more purchase power for imported goods and foreign debt would be less costly to repay.

Finally, German exit will spare the country of the current disciplinarian role it is playing. Intra-European relationships have suffered much since the euro crisis and the international image of Germany is one the victims. The fact that Greece is asking for war reparations for the World War II is a clear example of how much tensions have escalated.

National Currencies

Many voices, some of them even classical liberal, have repeatedly call for the complete abolition of the euro and the return of national currencies to Europe. If this happens, they expect that only the EMU will disappear but the European project as a free trade and free movement zone will continue to exist. They claim that this would not be a catastrophic end to the integration dream but its salvation.

If such a strategy was put in place, gradualism is not recommended (Record 2013). A hypothetical exit should be secretly planned in advanced and announced when put into practice.

All Eurozone countries would have to redenominate all the existing contracts in the economy. Bank accounts would be redenominated according in the new national currency of the country. This would happen regardless of the nationality and address of the costumers. The same would

apply to contracts, labor agreements, pensions, bond prices, etc. – they would be redenominated in the new national currency.

Free Banking

The above mentioned proposals leave us with central banks. They could be European or national in their nature, but they will still exist. A much more radical solution to Europe's monetary problems would be the complete abolition of the central bank and its replacement with competitive money supply.

All state support to the financial sector should disappear. The same should happen with all the state regulations for finance and money. There would not be a lender of last resort anymore and no deposit guarantees, let alone bailouts. Free banking would mean the end of monetary policy by the state.

Competitive private money issuers would replace the euro. They would only be disciplined by market forces. In the absence of legal tender, people would be free to use any private currency they wish.

Conclusion

There are powerful reasons to conclude that the euro has been a step towards the centralization and the bureaucratization of Europe. As Bagus (2012) points out the crisis has been used to give more authority and new powers to the supranational institutions. Tax harmonization, a "federal Europe" and fiscal union all call for a European centralized economic government. Ireland was one of the first victims of the supranational bullies. French politicians in particular tried to tie bailouts with a promise of Irish tax increases. Irish leaders were able to resists the assault. However, this example shows that the central institutions can very well be used to impose measures very far from "German austerity."

Competition has been also a victim of the euro. European citizens have now less monetary options than in 1998. The role played by the Bundesbank was supposed to be mimicked by the Frankfurt based ECB. But a completely different set of premises have led the actions of the European Central Bank.

National monopolies have been replaced by a supranational monopoly of monetary central planning. Central banking it is indeed a form of central planning. The ECB has the exact same faculties traditional central banks used to have and the same pretense of knowledge.

European diplomatic relations have suffered because of the euro too. Accusations of laziness and overspending are replied with war reparations requests and tasteless historical comparisons. Escalation can happen in any time.

A euro exit for the whole of Europe seems to be the only way forward.

Bibliography

Bagus, P.
(2010) The tragedy of the euro, Ludwig von Mises Institute, Auburn, 2012
(2012) “The Eurozone: A moral-hazard morass” in *Mises Daily*, online publication: https://mises.org/library/eurozone-moral-hazard-morass

Charalambakis, John
(2013) "We should have left the banks die" in Austrian Economic Center’s Blog, online publication: http://www.austriancenter.com/2013/10/11/charalambakis-we-should-have-left-the-banks-die/

Feldstein, M.
(2012) “The failure of the euro” in *The foreign affairs January/February 2012 issue*, online publication: https://www.foreignaffairs.com/articles/europe/2011-12-13/failure-euro

Hayek, F. von
(1960) The constitution of liberty, The Univesity of Chicago Press, Chicago, 1978
(1976) Denationalisation of money: the argument refined, The Institute of Economic Affairs, London, 1990

Record, N.
(2013) "Managing the transition - A practical exit strategy" in *The euro: the beginning, the middle and… the end?*, Institute of Economic Affairs, London

Schwartz, P.
(2004) The euro as politics, Institute of Economic Affairs, London

Schwartz, P.; Cabrillo, F.; Castañeda, J.
(2013) "Saving monetary union? A market solution for the orderly suspension of Greece” in *The euro: the beginning, the middle and… the end?*, Institute of Economic Affairs, London

Selgin, G.
(2013) “Incredible commitments: Why the EMU is destroying both Europe and itself” in *Cato Journal, Vol. 33, No. 1 (Winter 2013)*, online publication: http://object.cato.org/sites/cato.org/files/serials/files/cato-journal/2013/1/cj33n1-8.pdf

Soros, G.
(2013) “Germany has to accept Eurobonds or leave euro” in *Der Speigel*, online publication: http://www.spiegel.de/international/europe/george-soros-says-germany-must-accept-eurobonds-or-leave-euro-zone-a-893630.html