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The Future of the Euro

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The common model – a single currency backed by a single country and government for a single currency

- In the US and UK monetary unions, the elected government works with the Central Bank to determine monetary policy and targets
- Central Banks in single country single currency areas usually have full powers to buy bonds, to lend to banks and set rates
- The central government usually sets out the limits to the national deficit and borrowing requirement, and tells the authorities how much to borrow

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The common model – a single country and government for a single currency

- The elected government usually sets out the aims for inflation and growth, and informs the Central Bank and others of the targets
- The elected government is ultimately responsible for all the decisions, including those of the Central Bank when acting independently. It is the government's job to keep broad consent for the institutions and for the policies being followed. If trust breaks down the electorate can change the government and therefore the policy.
- The elected government may change the policy, operating framework and scope for independent action by the central bank.

The model for the euro

- The Central Bank decides on money growth, but is subject to conflicting pressures from member states over the approach
- The Central Bank has limited powers to buy bonds, which are queried by member states. It does now seem to have full powers to bail out or lend to distressed banks
- The Union imposed a 3% deficit limit for each year for every member state and a 60% debt ceiling.
- The Bank has an inflation target for the zone as a whole. There is no growth target.
- Disputes are resolved at EU and Euroland level in meetings between Finance Ministers and Heads of government

The weaknesses of the Euro model

- There is no agreed sovereign to decide how much money to create. The German influence encourages restraint, whilst others urge more expansive policies
- The ECB has been buying substantial holdings of bonds, but the German group are seeking to reduce or stop this. There is no agreed programme with published totals as in the US and UK
- The Bank is meant to sterilise its intervention, but there is argument over whether it does
- The controls over both deficits and debts have not been enforced. Now the Union is trying to enforce them more strongly, it is finding it difficult to do so in countries like Greece

The weaknesses of the Euro model

- The different countries of the zone have very different outcomes on inflation and growth. The southern countries have become very uncompetitive but cannot devalue. This has led to low growth or economic decline.

- Dispute resolution is difficult owing to gaps between meetings and absence of agreement between the main players. It is difficult gaining and holding consent to EU austerity policies in a country like Greece. Governments now regularly fall when having to face IMF/EU packages, but the incoming new government cannot change policy.

Unresolved problems of the Euro model

- How can the EU/Euro authorities control debt and deficits in member states?
- How can they decide on an appropriate level of money printing and inflation?
- What action can they take to ensure solvency of banks?
- Is debt default by states which have overborrowed an acceptable outcome? Does it lead to further default and instability?
- Should states have to cut wages and other costs to compete, in the absence of devaluation?
- What should be done about the size and cost of public sectors in the zone?
- What is the route to a growth policy?

How the Eurozone sees the answers

- Selected default by states and banks
- A large new lending fund, based on borrowings on the common credit ranking, to make subsidised loans to distressed states and banks
- New capital – or less lending – by weaker banks
- Public spending cuts
- Increases in tax and regulation

The Debt Problem

- Most countries on entry into the currency exceeded the 60% and / or 3% debt and deficit limits
- Italy and Greece had especially high debt to GDP ratios. Ireland and Spain have weak banks to support.
- Should the answer be:

a) Higher taxes?

b) Lower public spending?

c) Bigger grants, transfers of money from richer areas?

d) More borrowing at an EU or subsidised rate?

The Debt, Deficit and Growth Circle

- Some say higher taxes will:

a) Cut demand

b) Reduce entrepreneurship

c) Drive businesses to lower tax jurisdictions

- Some say lower public spending will:

a) Cut the number of public sector jobs

b) Reduce incomes and demand

c) Lead to strikes and disruption

The Debt, Deficit and Growth Circle

- Some say:

a) Growth cannot proceed unless the deficits are brought down, allowing lower interest rates

b) High borrowing by a state reduces confidence in an economy and leads to fears of default

c) Falling state bond prices weakens banks and cuts the flow of credit to the economy

Options to help weak Euro countries borrow

a) European Financial Stabilisation Fund

- Aims at €440bn, all borrowed
- Wants to create a total of €1 trillion by leverage
- Has raised €16bn so far at widening spreads over bunds

b) EFSM – smaller EU fund

c) ECB – bond buying programme. Secondary market only

d) IMF / EU subsidised loans with adjustment programmes

Lack of competitiveness

- Greece may need to improve competitiveness by 30% vis a vis Germany. Italy, Spain and Portugal may need to do so by at least 20%.
- This has to be achieved within the Euro by:

a) Wage cuts

b) Productivity gains

c) Better purchasing

How would you create a single economic government for Euroland?

- The European semester to become European budgets, controlling spending and revenue
- A unified indirectly elected Council of Ministers which meets weekly, or a directly elected Euroland financial government
- A more active Central Bank which aims to bring bond yields into line, around a common issue of bonds at an average and common credit rating
- Stronger Euroland banking regulation

What answers would work?

- Exit of weaker members from Eurozone, and devaluation through new currencies
- Exit of Germany and strong satellites from Euro, re-establishing the DM which would revalue

How easy it is to get out of a single currency?

- At least 87 countries have done so since 1945
- E.g. 16 members of the rouble block
- New Zealand, Ireland and others from the sterling area
- Algeria and others from the French franc area

a) Contracts

b) Bank accounts

c) Bank notes

Summary

- A single currency needs a single country to love it
- You need a sovereign to decide how much to print and how much to borrow
- You need a political system to ensure there is popular consent for the policy followed