CRITICAL EVALUATION OF THE EURO-BASED CURRENCY UNION

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Abstract

In light of the recent clamour surrounding the Eurozone crisis, this article aims to go deeper into the theory, history and the real options facing the member nations today. Starting with a brief outline of the theory of currency unions, it examines the intent with which the Eurozone was conceived in 1999, and goes into analysing the trends of a few indicators of health of the Eurozone as a currency union. Taking into special consideration a few main players like Germany, Spain and Greece, it ends with a viewpoint on the outlook and expectations of how the current crisis will pan out for the Eurozone.

1. Introduction

Economic and Monetary Union of the European Union refers to the economic and monetary integration of 17 of the 28 European Union (EU) Member States. Both the 17 Eurozone members and 11 non-members states are EMU members. What differentiates them is the convergence criteria, or the Maastricht criteria, which are conditions that states must fulfil to join the economic and monetary union and to use the euro as their official currency. Starting with 11 participating nations on January 1, 1999, six more since then have adopted the euro. The rest 11 EU members continue to use their own currencies. The European Central bank (ECB) was established on June 1, 1998 to run the monetary policy of the "euro-nation" countries.

The three pillars for formation of a successful currency union are 1) Economic integration 2) Political integration and 3) Institutional integration. Whether the European countries were ready for a single currency union in the 1990s is a topic discussed innumerable times. In this paper, we discuss that while there was political willingness for the formation of the EMU, and certain economic commonalities existed, institutional maturity was not present. Hence, the most critical lesson for the future is to rely less on hope for future convergence amongst joining and existing nations, and rather analyse them in the present context when including newer nations to the single currency union.

2. The Optimum Currency Area - Importance of Factor Mobility

According to Mundell (1961), an Optimum Currency Area is a geographical region such that it would maximize economic efficiency to have the entire region share a single currency. The optimum currency area is the region within which there is factor mobility and outside of which (relative to other regions) there is factor immobility. This region should have a separate currency, which fluctuates relative to all other currencies (i.e. flexible external exchange rate). McKinnon (1963) in his paper defines an optimum currency area very specifically as one within which monetary policy, fiscal policy and exchange rates are used to give the best resolution of three objectives:

1. The maintenance of full employment
2. The maintenance of balanced international payments
3. The maintenance of a stable internal average price level

3. The European Monetary Union - Facts and Figures

Many Member States back in 1992 were not ready before they joined the European Union. The general plan was that the Member States would converge towards fulfilment of the criteria and the Council of the European Union, along with the European Commission would monitor and issue recommendations every year until that happened. However, even superficial analysis brings out the fact that many countries were in violation of several of the key criteria specified in the Treaty in terms of debt-to-GDP ratio, central government deficit, HICP inflation and long-term interest rates. In many cases, the central banks were not in alignment with the Treaty’s expected standards. Many countries stepped out of line at times but were let off because of a weak global economic outlook or expectation of the violation to be temporary. In the case of Greece, it never once fulfilled the criteria, yet managed to survive in the EMU.

3.1. Unemployment

As Exhibit 1 shows, from 2004 to 2011 the unemployment rate has been increasing for most countries except Germany, which has shown a decrease. The steep increase in Greece and Spain’s rates shows that they will have to work uphill to stick to the repayment plan they have promised in return for their bailout packages.

In Greece, Italy, Luxembourg, Portugal, Slovenia and Turkey, both the “income effect” from a high level of pension wealth and the “substitution effect” from reductions in pension wealth from working until age 65 are likely factors that drove people to leave the labour market well before age 65 (OECD,2011).

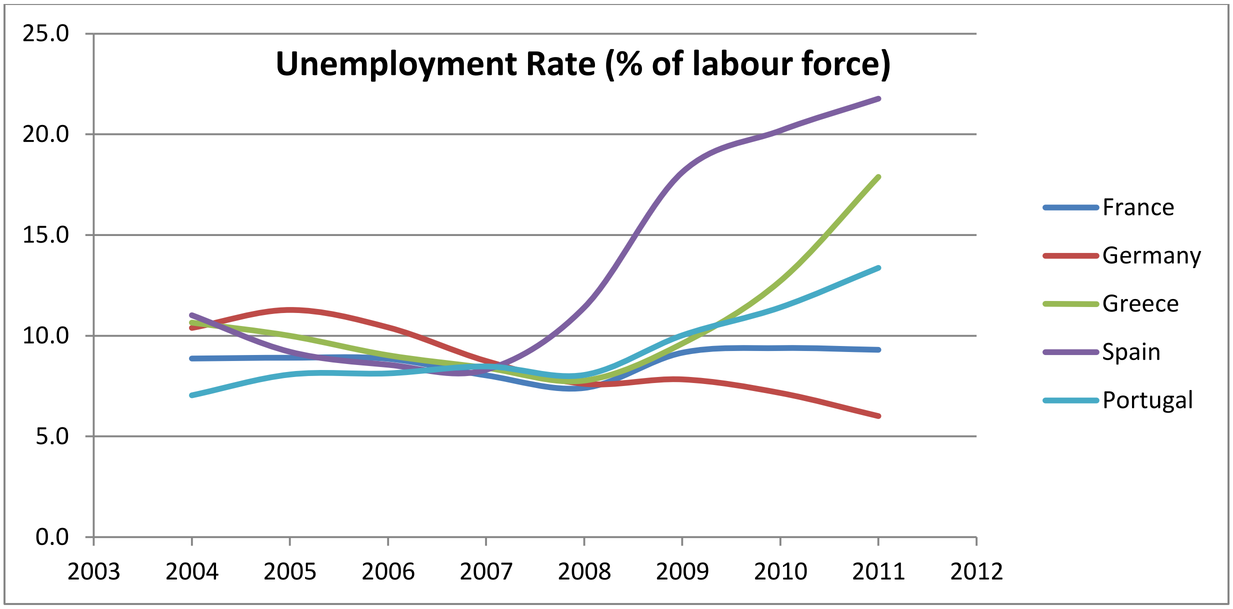


Exhibit 1: Unemployment Rate as a percentage of labour force (2004-2011)

Source: Employment and labour markets: Key tables from OECD - ISSN 2075-2342. Last updated: 11 July 2012

3.2.Taxes

Based on Exhibit 2 that uses an unconventional approach to measuring average income tax rate for a single person at 100% of average earnings (see note below chart), it is clear that Greece has been grossly underpaying taxes. This would have led to little revenue collected by the government. The years after 2008 when Greece went into recession, got a fiscal bailout and started implementing austerity measures have better rates.

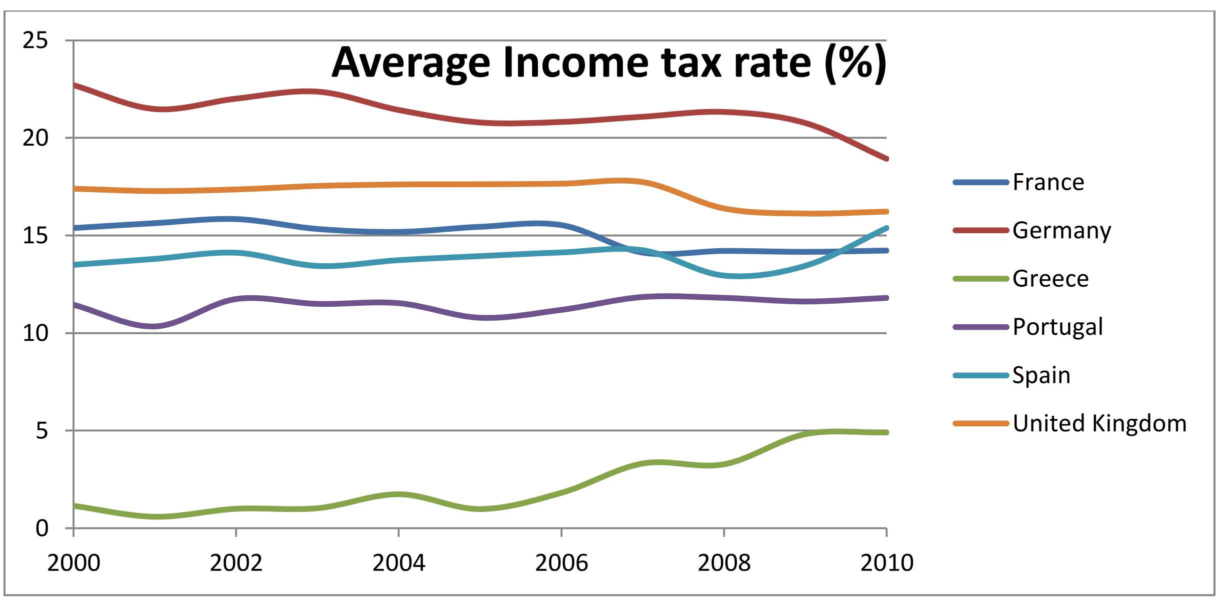
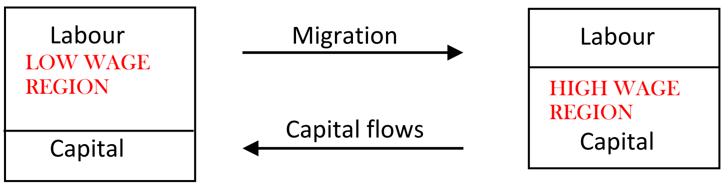


Exhibit 2: Average Income Tax Rate (%)

Note: Data extracted on 21 Aug 2012 17:51 UTC (GMT) from OECD iLibrary. Based on calculations for the Average Worker (AW) in the private sector (see http://stats.oecd.org/index.aspx?r=756933#), and the results are shown for 8 household types covering one- and two-earner families of varying size and different fractions of average gross wage earnings.

3.3.Mobility of Labour and Capital

The theory of optimum currency areas points out that one of the fundamental criteria for a successful monetary union is labour mobility across the currency area (intra-regional labour transfer). It is important as a real adjustment mechanism in case of asymmetric shocks, and for the efficient allocation of resources. The same holds for capital adjustment mechanisms.



If there is an asymmetric shock, then the adversely affected region experiences increased unemployment. Assuming that wages are reasonably flexible, wages revise downward, automatically attracting more capital inflows from other countries in the region. This should happen in the ideal case and GDP recovery will be a natural consequence.

The above scenario is utopist and has never worked in Europe because the wages are downward sticky and once depressed enough to attract capital, they may not be incentive enough for the people to work when unemployment benefits are comparable.

Labour mobility has suffered in the EU because of differences in languages, cultures, social security systems, etc. and government regulations that discourage transfer of superannuation etc.

The dispersion or standard deviation of national unemployment rates across the euro-zone countries is now far higher than what it was in 1991 (data). This speaks volumes about the success (or rather the lack of success) of the Euro as a currency union.

3.4. Product Market regulation

Since the formation of the monetary union, countries like France, Greece etc. have shown a marked improvement in their regulations. However, for Greece, it starts with a high score on restrictiveness in the 'Domestic economic regulation' (see Exhibit 3)

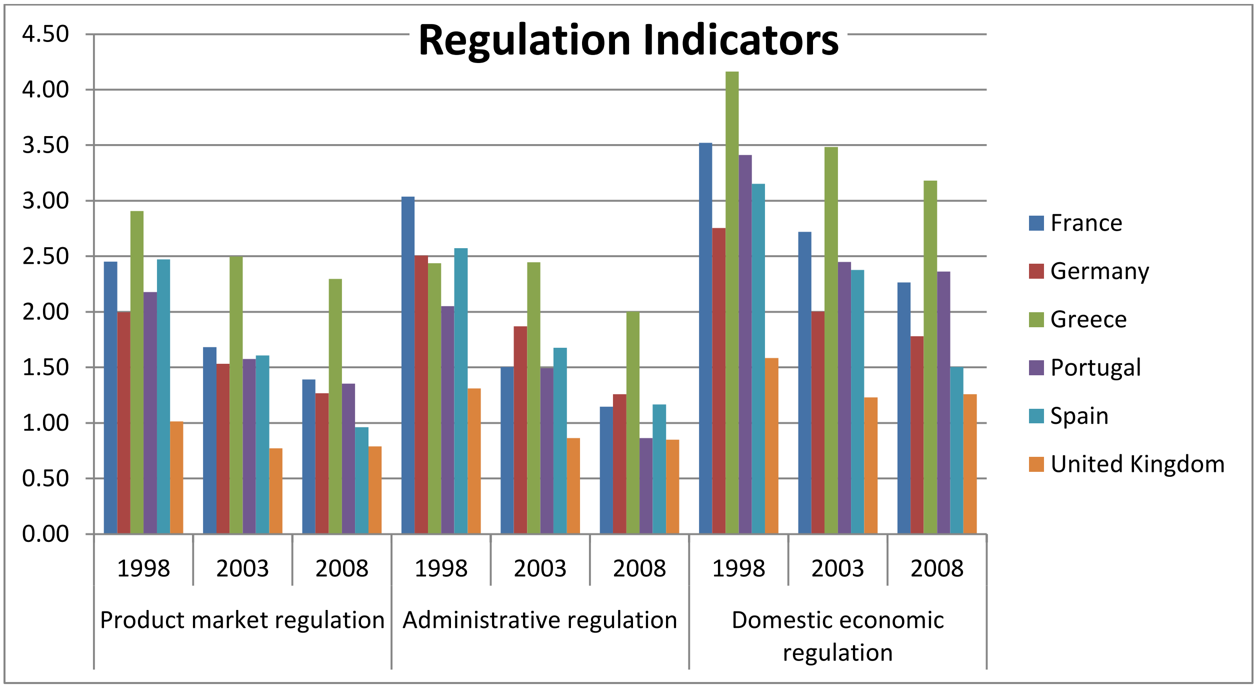


Exhibit 3: Regulation levels in France, Germany, Greece, Portugal, Spain and the United Kingdom

Data extracted on 17 Aug 2012 19:17 UTC (GMT) from OECD.Stat

Such tight regulations lead to:

- Reduced entrepreneurship, by not only creating higher barriers to entry but also with the prospect of tighter controls going forward.
- Reduced competition and lower incentives to enhance efficiency through investing in innovation.
- Increased costs when expanding productive capacity due to regulatory burdens and red-tapism, thus reducing productivity.
- Reduced flexibility in the labour market. So, from a politico-economic perspective, deregulation of product markets would result in employment gains, and hence introducing flexibility in the labour market should become easier.

4. Key Takeaways

It can be observed from the data that the improvement in regulations from 1998-2003 had been far more significant than the changes in the period 2003-2008 for most of the EMU countries under consideration. While there has been some progress towards opening up of economies by reducing domestic restrictions in the EMU member nations, it still leaves a lot to be desired to achieve greater convergence. Cross border trading of goods has achieved significant progress. But integration of the services industries still has a lot of scope for improvement – for example: 'recognition of qualifications across the countries'.

Another critical factor in which the PIGS (Portuguese, Ireland, Greece, and Spain) nations languish is the investment in education and research & development. Poor policy-making has resulted in poor networks between the government machinery, the education system and the corporates, as well as lack of incentives to corporates for carrying out R&D. This eventually breeds to poor economic development and reduced competitiveness.

Even though, since entering the EMU, Greece has enjoyed good levels of GDP growth it is clear from the indicators that it has continued to suffer from low international competitiveness as their economy is constrained by various market entry barriers. In terms of openness of economy, State control is still high, there still exist significant Barriers to Competition and the Barriers to Trade and Investment (as measured by the OECD indicators) are still way above fellow EMU countries. While intra-EU barriers have reduced as a result of the formation of the European Monetary Union, countries like Greece seem to have lacked the political will to bring about policy changes to keep itself abreast with fellow EMU nations.

5. Outlook for the Eurozone

How the current crisis will pan out and whether the Eurozone will further unify or divide is a topic that has been discussed extensively in the past year. While the crisis has abated over the past few months, an unintended consequence of the recent measures has been the surge in value of the Euro. This hampers the competitiveness of exporting European nations and poses significant risks to growth prospects. Despite the flurry of measures undertaken in 2012 and assurances by the ECB, Greece remains as keenly watched as ever, and the epicentre of the crisis.

Breakup v/s Rescue

The possibility of the breakup of the Eurozone is providing a lot of fodder for speculation to economists and investors alike. Greece's exit from the Eurozone would mean that it could delink itself from the euro, and devalue its currency to bring the deficit to manageable levels. Moreover, it would mean that Germany saves itself from an open-ended commitment of financing the bottomless pit of Greece's debt. However, the ECB owns Greek bonds worth €40 billion, which would in the process also get devalued. The bailouts would have to be written off. Market sentiment will nosedive, as the exit will be proof of the reversibility of the euro. Countries with huge number of foreign investors, like Ireland, Portugal, Cyprus and Spain would feel the pressure of rising bond yields. A section of economists are also arguing that the Eurozone's basis is flawed – it has to break up sooner or later, and a breakup now would be expensive but a breakup later would be disastrous. The argument for a unified Eurozone is the stronger one as of today. A banking union with shared debt management and more empowered Eurozone-wide authorities is the optimistic future of the euro.

6. Current proposals

After the humongous amount of funds doled out as bailout for Greece, Ireland, Portugal and Spain, there is a common consensus that the system to be reformed in terms of defining implementable mechanisms in the event of a crisis. This is precisely the kind of thinking that was needed in 1999, and which the Maastricht Treaty failed to include, because nobody had imagined such a scenario at that time. Towards that end, the EFSF (European Financial Stability Facility) and the EFSM (European Financial Stability Mechanism) were established as temporary funding programs. These are intended to be replaced (once due ratification is completed) by the ESM (European Stability Mechanism), an organization for the disbursement of emergency funds, subject to strict reform targets.

To stop the banking crisis – debt crisis cycle, consensus has been reached and work has started to implement a banking union, by setting up a single banking supervisor as a pre-condition to allowing the EFSF (and later the ESM) to directly inject funds into lenders, instead of lending to a government first. On the table is the proposal to facilitate supervision by the ECB of all banks irrespective of nationality.

The European Union, the European Central Bank and the International Monetary Fund ("the troika"), as administrative institutions, have taken on the role of creditors who facilitate direct fiscal transfers to the countries that are undergoing debt crises, in particular Greece. The three are also the enforcers in the sense that they are monitoring the commitment of Greece to undergo the painful process of austerity and high unemployment.

Over and above everything else, as opposed to the spirit of including the convergence criteria as mere guidelines for inclusion of members into the EMU back in 1992, the spirit today is of arming Eurozone-wide institutions with the power to intervene in national budgets if need be, in case of divergence from promised reform. This idea of common monitoring, shared responsibility and solidarity seems apt in today's scenario, but it needs also to be analyzed from the point of view of potential for infringement of the sovereignty of the countries and the fairness of the decisions of budgetary allocations.

The flurry of activity in mid-2012, intended to pacify markets and save the euro, is indicative of the commitment of the administrators (influenced mainly by Germany and France) to keeping Greece within the ambit of the Eurozone. This would ensure that peace is maintained in the face of the threat of bailout fatigue in the core and austerity fatigue in the peripheral countries for the coming few years. Meanwhile, the responsibilities of European institutions needs to be redefined and enhanced in ways that take the EMU closer to a federal-like structure.

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