What will happen to the euro?

by Bernard Connolly and John Whittaker

Abstract

The Stability Pact – intended to make EMU governments run prudent budgets – is losing its credibility. This essay asks the question: what will happen if national debts start to rise again and some governments then have difficulty borrowing? It suggests that there will be calls for bailout, that the EU's political structures will not cope well with the resulting arguments over which countries will pay, and that the eventual and painful result will be the re-establishment of national currencies.

Introduction

When a country commits to a fixed exchange rate regime, the commitment is only credible if there is confidence that the country's debtors, both public and private, will generally be able to meet their obligations. When doubts arise about the ability to service and repay foreign debts, lenders become hesitant to continue lending and demand greater default premia. When there are doubts about the returns on capital, capital is withdrawn. These events lead to further erosion of confidence in the country's ability to pay and, unchecked, they inevitably lead to the fixed rate being abandoned.

There are various devices for enhancing commitment. Under a currency board, for instance, the central bank is supposed to carry larger foreign reserves to support the fixed rate. This may prolong the life of the fixed regime, but it may also allow more time for unsustainable debts to accumulate. There is then the risk that, when the devaluation finally occurs, it will cause more distress.

Economic and Monetary Union (EMU) is a form of fixed exchange rate regime, but member countries have raised the stakes much further by giving up their national currencies in favour of the euro. Technically, a member country could withdraw from EMU simply by reissuing its old currency. However, EMU has cemented financial claims into a 'foreign' currency, the euro. Given the absence of agreed exit procedures, the redenomination of these claims into a re-established national currency would cause severe difficulties, as is discussed below. It is this feature, above all, that makes the commitment to EMU credible: countries will tend to stick with EMU even if it hurts, but only so long as leaving would hurt more.

EMU has not eliminated the forces that undermine fixed exchange rate regimes, however, particularly excessive government borrowing. Indeed, membership of EMU reduces the perceived penalties for overspending. First, a government may validly assume that its 'partners' would be uncomfortable with the financial disruption that would accompany a debt default and would therefore be prepared to provide assistance. This assumption gains support from the understanding in the EU that richer 'regions' help poorer ones, via the structural and cohesion funds, for instance.

Secondly, for governments that used to have a reputation for inflation and loose fiscal control, borrowing is cheaper. This is because default premia on eurozone government debts have remained low,[1] while inflation premia have been brought down by the success (so far) in holding down inflation expectations. In effect, the euro has enabled fiscally-lax governments to gain from Germany's reputation for fiscal and monetary prudence. All governments face continual pressure to tax less and spend more. Membership of the EMU 'club' dilutes the financial discipline that would be faced by an independent government and makes it more likely that some governments will succumb to this pressure.[2]

The natural reaction to this moral hazard is to deny that any such assistance would be forthcoming, as set out in the no-bailout clauses of the Maastricht treaty (article 104, original numbering), although this denial is qualified by the let-out (article 103a.2) that "Community financial assistance" may be granted when a country is in difficulties "caused by exceptional occurrences beyond its control".

The other response has been to try to force governments to run prudent finances by means of the 'Stability Pact'. This prescribes fines for countries whose budget deficit exceeds 3% of GDP, and governments are also supposed to aim for budget balance, averaged over the business cycle. The European Commission has the job of demanding tighter budgets if it judges that this principle is not being respected.

The weakness of the Stability Pact

It is now clear that the Stability Pact is not being observed. Several eurozone governments, including all three of the larger economies – representing 70% of eurozone GDP, have now incurred deficits that have exceeded 3% of GDP or are becoming dangerously close to doing so. The immediate cause of these higher deficits is the general slowdown in GDP growth, which has made deficits worse via the 'automatic stabilisers' of lower tax revenues and higher welfare spending. Hence, while the Commission has been at pains to persuade governments to reduce their deficits, it will be hard for any of them to pay swift attention to the Commission's instructions unless growth unexpectedly improves. Indeed, In France and Italy there is talk of deliberately raising government spending and reducing taxes, with the

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[1] One might have expected EMU to cause a rise in default premia on government debts because the debts are no longer 'sovereign', i.e. implicitly backed by national central banks (See C.A.E.Goodhart: 1997, 'Two concepts of money, and the Future of Europe', special paper no.96, Financial Markets Group, London School of Economics). The reason why default premia remain low is presumably that lenders see eurozone government debts as collectively underwritten by the EU.

[2] Paul De Grauwe ('Europe's Instability Pact', Financial Times, 24 July 2002) takes the opposite position, arguing that the democratic politics of eurozone countries would prevent government debt default. Any government that allowed its debts to become unsustainable would be voted from office.

excuse that this is necessary at present to stimulate growth so that future budgets will be easier to balance.

Faced with these responses, the Commission has had no alternative but to back away. No longer is it asking countries for budget balance by 2004, a goal that was agreed in March 2002 but is now seen as impossible to reach. However, when Portugal admitted that its 2001 deficit/GDP had been 4.1%, the Commission followed its treaty obligations and threatened to invoke an 'excessive deficit procedure', implying interference in the decisions of the Portuguese treasury and a fine if the deficit does not fall fast enough. But it is most unlikely that a fine will ever be imposed on the Portuguese government or any other government. Besides being awkward to enforce, any fine would add directly to the deficit making it even harder for the government to reduce it.

When fines turn out to be an empty threat, this will expose the essential weakness of the Pact: there are no credible mechanisms to enforce it. Neither persuasion nor the threat of hard penalties carries much weight. Indeed, instead of a concerted effort to respect the rules, the unsurprising result has been a call to make them more 'flexible'. First, it has become undeniable that the 3% deficit/GDP limit is too low because the amplitude of swings in this ratio over the business cycle is often much larger than 3%. For example, Britain's budget surplus in 1988-9 turned into a deficit/GDP of 7.7% in 1993 after the (ERM-assisted) recession of 1990-1993. Similarly, in Sweden's recession of 1989-1992, its budget balance worsened by a massive 18% of GDP. There are many such examples, and there is no reason to believe that the propensity for swings that are larger than 3% has somehow been removed for eurozone countries.

Secondly, assuming that what really matters is the sustainability of a country's national debt, attention should be focused on how fast that debt is falling or rising. This implies that any deficit/GDP target or limit should rise with inflation. For instance, if a 0% deficit/GDP target (budget balance) is deemed appropriate when inflation is 2%, this target becomes unnecessarily harsh for a country that is suffering from 4% inflation, and it should be raised.[3] Extensions to this kind of reasoning imply that if deficit targets are to be applied, each country should have its own unique target depending not only on its inflation rate but also its growth rate, its existing debt, and the term structure of the debt.[4]

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[3] If a country has a debt/GDP ratio of 60%, real growth of 3%, inflation of 2% and zero deficit, its debt/GDP will be falling by 0.6(3+2)= 3% per year. If its inflation rate then rises to 4%, its deficit/GDP should rise to 1.2% if the rate of debt/GDP reduction is to remain unchanged. In fact, when inflation is taken into account, the primary deficit (before interest payments) is a more useful indicator of solvency and sustainability than the deficit after interest. See "Assessing Sustainability", by the Policy Development and Review Department of the IMF, May 2002

[4] The other well known shortcoming of a numerical limit to deficits is that it promotes practices that make figures appear more favourable. Some common devices are opaque swaps transactions, the creation of special purpose vehicles to hide government liabilities off-balance-sheet (as in Enron), re-classifying current spending as capital investment (as in WorldCom) and using private finance supported by government guarantees for current

The trouble is that, if some formula is devised for taking these adjustments into account, it will allow more scope for judgement. If the rule on deficits or debts is qualified to take account of growth rates, inflation rates and other variables, this will give any government the opportunity to plead that its case is special and its particular economic conditions warrant favourable treatment. If the Stability Pact is made 'flexible' in this way, it will become easy for a government to find plausible reasons for arguing that its higher deficits should be condoned. Then it will not take long for the special case to become the general case in which collective fiscal discipline is not achieved.

The consequences of rising budget deficits

While there is still agreement that constraints on EMU government budgets are desirable, it is hard to avoid the suspicion that some governments will incur rising deficits and debt. Let us therefore explore the consequences when the government of country X has found that the posturing and threats of fines from the Commission and other governments are empty, and has returned to its habit of deficit spending.[5] To add to the misery, let us suppose realistically that X's overspending has caused its inflation rate to be higher than the eurozone average, making its exports uncompetitive, reducing growth further and adding to the government's financial problems. Lower interest rates and devaluation would have been the solution in the old days, but this cannot happen under the euro.

The first result of X's rising national debt will be that lenders demand larger default premia,[6] adding to the debt and raising the probability of default. At some point, far from threatening fines for fiscal misbehaviour, there will be calls for financial assistance to prevent actual default, accompanied by increased monitoring of the country's budgetary processes by the European Commission and the Council. However, the funds that could be found within the existing EU budget are very small (the total EU budget is only 1.3% of national GDPs).[7] So

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expenditure (Britain's 'private finance initiatives'). See Gustavo Piga, "Derivatives and Public Debt Management", International Securities Market Association in co-operation with the Council on Foreign Relations, Zurich, 2001.

[5] A similar scenario has been considered by Martin Howe in 'The Shaky Legal Foundations of European Monetary Union', *Economic Affairs*, 18.2, June 1998

[6] The differences between interest rates for the long-term debts of the various eurozone countries have never been completely removed. 10-year Italian government debt still commands a 0.25% interest premium over German government debt, and Greek government debt a 0.3% premium. Since these are all obligations to repay euros, this implies that lenders feel safer with debts of the German government than the others. In other words they attach a non-zero probability either to the default of the other governments or to the exit of these countries from EMU.

[7] It has often been argued that, for monetary union to endure, the scope for fiscal transfers should be much larger. The classic reference is the MacDougall report, "Report of the Study

the richer EU countries, not excluding Britain, would come under pressure to provide handouts or cheap loans, or to act as guarantors to the government of X to see it over the 'temporary' downturn.

Without financial assistance, if X's financial distress reaches the point, for instance, when it is cannot pay its public sector workers, leaving the monetary union and re-establishing its own floating currency must arise as a possible option. Then X's government could resume paying its bills using its own national money and it would avoid the irksome interference from Brussels officials that would accompany any bailout. All X's central bank needs to do is resume issuing its own currency in exchange for euros at some declared initial rate, and thereafter to lend its currency against eligible collateral at its own chosen rate of interest as it did before joining EMU. The government of X would then designate its re-created national currency as legal tender instead of euros, and change the denomination of its existing debt back into its own currency.

Presumably, the new currency would be expected to inflate faster than the euro, and any default premium on government debt would then be replaced by a higher inflation premium, causing a fall in the value of bonds. But given the supposed state of X's national finances, there would be nothing that its bondholders could do to improve their positions: they would have to accept what would be, in effect, a partial repudiation of their claims. Thereafter it would be up to X's government to show its ability to return to sound budgeting, having regained control over its own monetary policy.

So far, this seems reasonably straightforward. Indeed, the reissue of national currency would be in accordance with the principle of *lex monetae* that is generally accepted in public international law. There are many examples of countries re-establishing their own fiat currencies, for example, the Eastern European members of the former Soviet Union. But in these countries, the changeover occurred in circumstances of political discontinuity – a total regime change. Eurozone countries are subject to a complicated and often ambiguous relationship between national law, international law and Community law, which would make leaving the single currency much more problematic. Another relevant difference is that the former Soviet countries did not have developed systems of private-sector financial claims. In contrast, the debt market inside the eurozone is well-established and ownership is becoming more dispersed as a result of the regulatory effort to promote the 'single market' in financial services.

The most recent example of the sort of intractable financial, legal, social and political problems that can arise when a country abandons a fixed rate regime is that of Argentina in December 2001. Having no control over its own monetary conditions, Argentina was subject to a one-size-fits-all interest rate and exchange rate that inevitably produced boom-bust. In the bust, deflation set in, causing very high real interest rates and threatening government and private-sector solvency. Repeated IMF loan-cum-austerity packages merely postponed the unavoidable break with the fixed peso-dollar peg. When that finally occurred, it brought

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Group on the Role of Public Finance in European Integration", Commission of the European Communities, 1977.

major problems of its own because most private-sector debts, and nearly all private debts to foreigners, were denominated in dollars. Released from its dollar peg, the relative value of the peso halved and the burden of these debts, *measured in pesos*, rose in proportion.

In EMU countries, nearly all government and private debts are obligations to pay euros. This, above all, is what would make departure from EMU a costly and uncertain undertaking. If a country were to leave EMU, its government might be able to get away with rewriting its debts into the new national currency, but firms with earnings in 'soft' national currency and debts in 'hard' euros would be in an impossible situation. This would also make banks vulnerable and further weaken the government's fiscal position. Moreover, if corporate debtors tried to convert their obligations back into the national currency, foreign holders would undoubtedly seek redress.[8] It is difficult to foresee the outcome of the legal arguments that would ensue but, given that there are no agreed provisions for withdrawal from EMU, there would undoubtedly be conflict between the national government (and perhaps national courts) and the European Court of Justice, and indeed between Community law and international law. The financial crisis would provoke a constitutional crisis.

It is beyond our scope to pursue these constitutional implications further. However, they must make departure from EMU appear unattractive both for X and the remainder of the EU. With the certainty of legal wrangling and the probability that the financial disruption in X would spread beyond its borders, other EU countries might well be persuaded to find some cash to bail out X in attempt to arrest its debt default. And X might well be inclined to swallow the discomfort of bureaucratic interference in its fiscal decisions, and to accept the cash.

But any bailout will just perpetuate the moral hazard, making it even harder to maintain the pretence that overspending carries penalties. Moreover, there is a limit to the extent that EU members will be able and willing to provide finance to an ailing partner, particularly if that partner is one of the larger eurozone economies. In the end, there must come a point at which, in spite of the acrimonious legal arguments that would be involved, leaving EMU appears less costly than staying in.

The ECB to the rescue?

There is one safety valve. Individual countries cannot reduce their interest rates, but the European central bank can reduce rates for all EMU countries together, at least at the short end of the yield curve. This would bring relief both by stimulating demand and reducing

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[8] In the planning stages of EMU it seemed that the euro notes issued by each national central bank might be distinguished by national symbols. This would have made exit much easier, as the national central bank of X would only need to suspend convertibility of its euro notes into other national euro notes, while the government of X would declare that its debts were only payable in the national euros. It might also have been possible for private debtors to claim that the understood currency of their debts was national euros. Though not officially discussed, this is surely the main reason why the notes issued by each national central bank are made indistinguishable.

government debt interest. Of course, the ECB's job is to choose the repo rate for the euro so as to maintain low inflation, averaged over the eurozone, and it is unlikely to be persuaded to deviate from this objective by the government of a small member country that cannot pay its bills. But if the governments of one or more large eurozone countries were in budgetary straits with the possible results described above, there would be overwhelming pressure on the ECB to set the repo rate for the euro a little lower than is consistent with the inflation objective.

The ECB would also be tempted towards lower interest rates if banks were facing difficulties. In addition to controlling inflation, the ECB also has the responsibility, "to promote the smooth operation of payments systems" (Maastricht treaty, article 105). Even without this specific mandate, the ECB would be keen to avoid banking crises because, as euro currency issuer, it is the ultimate supplier of liquidity and it would necessarily be involved in any rescue of troubled banks.[9] A sure way to make it easier for banks is to hold down interest rates or to postpone raising them. The desire to prevent a financial crisis in the eurozone is surely stronger than the concern about a little inflation. [10]

At present, thanks to the downturn, there appears to be little threat of euro inflation. Indeed, there are fears of a liquidity-trap: that, in the current climate, no amount of monetary stimulus would succeed in raising demand. Hence, there is limited scope, at present, for the ECB to ease any financial crisis by means of inflationary finance. But if some governments disregard the Pact and resort to deficit spending, it is not clear that the ECB will raise rates high enough to forestall inflation. If inflation were to take hold, as always, this would provide temporary relief at the expense of greater pain later. There would be the familiar detrimental effects on the balance of trade and/or weakening of the foreign exchange value of the euro.[11] At some point the ECB would be forced to react by raising euro rates higher than they would have been without the inflation, bringing back the very conditions that motivated the softer interest rate policy in the first place.

Conclusion

We have argued that, despite the Stability Pact, eurozone members will not be able to display

[9] The ECB's concern about financial crises gains little relief from the official understanding that the primary responsibility for prudential regulation lies with national authorities, and the fact that official literature has been silent on provisions for handling a financial crisis. Further discussion appears in J.Whittaker 'Fiscal Constraints and Financial Regulation in Economic and Monetary Union' *Economic Affairs*, 18.1, March 1998.

[10] C.W.Calomiris, *Cato Journal*, 18.3 (1999) goes as far as arguing that the force driving euro inflation will be the threat by weaker EMU members to leave the union, rather than the ECB's concerns to avoid fiscal and financial crises.

[11] The worrying prospect that the EU might see fit to impose controls on capital outflows has also been raised. See Bernard Connolly, 'Returning Declines', *AIG Trading Group World Markets Advisory*, February 2002.

sufficient collective discipline over fiscal policy to prevent financial crises. The EU's solution will be for the richer countries to find cash to help those in difficulties, with the attached strings of 'surveillance' of national budgets by EU institutions or, in plain words, more centralised economic control. Indeed, it has been claimed that, in some minds, this was the motive for EMU[12]: the crises that EMU is bound to cause will force greater economic integration.

The resources available for such support are limited, however. If several EMU governments are simultaneously finding it hard to borrow, it is unlikely that the others will be content to make enduring commitments to finance them or to provide funds to the Commission for this purpose. To the extent that bailout does take place, whatever the imposed conditions, this also allows the offending governments to continue overspending.

The shortcomings of the Stability Pact have been exposed quite suddenly by the increasingly poor growth performances of the eurozone economies, and the inevitable adverse effect that this has had on government budgets. For this, one may blame Al-Qaeda, US protectionism, poor eurozone productivity growth, falling stock markets, the much-lamented absence of EU structural reform, and any number of other causes.

Whatever the cause, the inescapable fact is that resources now have to be found to shore up government budgets. This means that expectations of incomes, returns on investment, pensions and prosperity now need to be revised downwards before economic health is restored. The sectors and countries that lose have to be selected by the political process. Because of the interdependence of EU states, partly a consequence of EMU itself, this process has to be EU-wide, and it is not at all clear that the EU's political structures are up to the task. When the dust settles, the monetary architecture of the EU will most likely look more familiar: independent currencies will more or less coincide with independent governments.

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12 See, for instance, Pedro Schwartz, 'Back from the Brink: An Appeal to Fellow Europeans over Monetary Union', IEA Occasional Paper 101, January 1997.