

The Euro – A Challenged Project of Monetary Integration

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When the Euro was launched eleven years ago, the new money marked a further bold step in the ongoing processes of European integration. The successful completion of the Common Market with its liberalization of cross-border movements for capital, labor, finance, and goods and services was followed by an Economic and Monetary Union that was supposed to push economic integration further. Nowhere else in the developed world of market economies was such an ambitious project of economic integration in the plans. The creation of the Euro provided the Euro area, and Europe overall with a zone of monetary stability that helped push cross-border trade with goods and services and increased the interweavement of foreign direct investment across Europe. Abolishing any currency risk within the Euro zone and simultaneously providing an institutional framework for the conduct of monetary policy helped improve the reputation and trust in the processes of European integration. Only a couple of years of experiencing the benefits of this project were needed so that even skeptics were urged to revise their positions towards the common currency. Until a couple of months ago debates about a future globally dominant role of the Euro flourished, not only in scholarly circles. This has changed with the threat of sovereign default by Greece, one of the member states of the Euro zone. Today, the discussion focuses on the question of whether the Euro zone will break up.

Despite all fundamental problems, I would argue that this speculation is misleading, though. The common currency is no dead-end project. However, we will have to see fundamental changes in the governance structures of the Euro in order to prepare the Euro zone for the current and also future storms. The Euro has its flaws and they need to be repaired in order to restore the stability culture of the currency. Let's go back to the beginnings of the Euro to understand some of today's problems.

The introduction of the Euro in 1991 came with at least four implications. *First*, it meant the abolishment of formerly national currencies and the transformation of all financial stocks and flows from national denominated assets and debts to Euro-denominated assets and debts. Most importantly, the introduction of the Euro came with an entry exchange rate, and it seems from today's perspective that not all entry exchange rates properly reflected economic prowess of member economies. This mis-match of economic capabilities and entry exchange rate had an economic price that shows up today. *Second*, all national monetary sovereignty was transferred from national central banks to the newly founded European Central Bank (ECB). The European System of Central Banks made national central banks into regional sub-units that no longer had direct monetary power. This centralization of monetary policy created the so-called one-

size-fits-all problem, i.e. the problem created when the ECB sets a Euro zone-wide interest rate that does not necessarily reflect the economic needs of each member state. Differences in national inflation rates, for example, could no longer be dealt with on the national level. *Third*, no longer having a national currency led to the loss of a formerly often used economic policy tool, namely the exchange rate instrument. Member states of the Euro zone can no longer refer to depreciating their currency in order to increase international price competitiveness by making export for third parties relatively cheaper and simultaneously imports relatively more expensive. *Fourth*, in order to create financial stability, the Euro came with the so-called Stability and Growth Pact (SGP) that introduced a ceiling for public deficits of 3 % of GDP and a ceiling for public debt of 60 % of GDP. This rule restrained fiscal policy but did not touch at all on the authority of member states for taxing economic activities.

In particular, the SGP was under fire for quite some time and the European Union introduced a couple of changes to inject doses of flexibility into its rules. The financial and economic crisis of 2008 demonstrated that those changes came just in time as governments of the Euro zone, as well as governments around the globe, had to discover the virtues of fiscal demand management in order to stop the downward-spiral and kick-start their economies. All the changes, however, did not remove the 3% and 60 % targets of the SGP. Those targets were kept not least for the reason of keeping up the reputation and trust on the side of international financial market actors. The main changes made referred to the timelines and the conditions under which the targets could be legally violated. This added a component of politicization to the SGP, as governments now had the opportunity to make their cases and raise their voice in the EU organs that deal with the SGP. Political horse-trading in regards to the SGP was a long-standing practice, in particular on the side of 'big' economies like France and Germany. The changes in the rules of the Pact made this practice to a formal part of the Pact. When the Socialist Greek government, at the end of 2009, declared that the public deficit it had reported previously needs to be revised upwards due to misrepresentations of the former government, it might have hoped to follow this practice. Factually, the disclosure was a wake-up call for the financial markets. The run against Greek debt was open. The announced deficit close to 14% of GDP for 2009 obviously was far beyond the public expectations, but then again Greece was not alone in this range of public deficits.

The situation of Greece and to some extent of Spain, Portugal, and Ireland stresses, on the one side, the negative effects of the financial and economic crisis, which brought public finances around the world into, disarray; on the other side, it stresses the shortcomings of the governance of the Euro zone as all the sovereign debt default candidate economies currently are member states of the Euro zone. The US and the UK and also Japan show similar levels of disarray of financial finances but have not been listed as default candidates by financial markets. The rise in the price for Greek Credit Default Swaps (CDS) reflects the increase in risk level and mirrors the downgrading of Greek public debt by the rating agencies; it also indicates the speculative nature of many investors who bet either on 'bankruptcy' or the provision of a significantly large emergency umbrella by the EU and its national governments.

Changes of the economic governance of the Euro area are in the making. Proposals reach from the launch of a European Monetary Fund to the provision of conditional below-the market credit lines by individual member states. The role of the ECB as a supervisor may be strengthened and deepened. New transparency rules of public finances may be introduced. Whether all this leads to an economic government as the French have asked for years or it results in other new institutional settings, is currently an open political question. Changes will come, not least in order to save the Euro. Changes will also have to happen on the side of member economies. The severe austerity plans of the Greek government mirrors similar efforts already started in Ireland and signals the direction we will see in Portugal and Spain. The turn towards deflationary fiscal policy will not stop the problems, though. What is needed are substantial efforts to modernize those economies and to drastically increase their international competitiveness.

All member states of the Euro area stressed in many occasions that the European project of monetary integration is too dear to let it go. This insight holds on the European but also on the global level. In a global economy that lacks the previous stabilizing role of the US-Dollar it is a necessary (but not sufficient) requirement to establish a stable multi-polar currency regime where the key poles show sufficient stability. In other words, in stormy times the global economy needs a re-stabilized Euro zone. In this respect, it is in the strong interest of the Canadian economy that the Euro troubles are solved sooner than later. It is now up to the Europeans to find solutions that are re-stabilizing the European economy but also provide the global economy with an anchor of stability.

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