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The Future of the Euro Still Lies in its Past

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Abstract The true problem for the future of the Euro is to get a wider statute for the European Central Bank (ECB) similar to those of other central banks, notably the Fed, to permit better monetary policy. This means the power to act as a lender of last resort or "whatever it takes" (Draghi 2012). People consider this possibility tied to the political will of the main member states (Germany and the Netherlands, partly France). However, two other problems would remain unresolved if the Euro is to have full legitimacy as a paper money: a state behind it and a common Eurozone fiscal policy. This means a move to a political union, which is less possible than the approval of a new ECB statute. The existence of these problems does not mean that the Euro cannot survive, but that it depends on the will of both the market and the owner of official reserve denominated in Euro. It also depends on acceptance by member countries affected by the negative effects of not having a true and free lender of last resort and a targeted policy to resolve the weakness of the non-optimal currency area of the Eurosystem which preexisted the birth of the Euro. This is why the future of the Euro still lies in its past, not having found a consensus on what to do or leaders capable of filling the gap. Collapse is always possible.

Keywords Monetary policy · Central banking · Non-OCA · Fiscal policy · Supply policy

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Introduction

The topic of this paper is the future of the Euro. Let me begin with an almost trite statement: the future of the Euro still lies in its past and can be changed only by rewriting the institutional architecture that supports it.

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Of the two pillars, a common currency and a new supernational state, the first was implemented with the Maastricht Treaty (Treaty on the European Union 1992) and the entry into circulation of the Euro in 2001. The second was postponed under the consideration that a single currency without a state, known in the literature as “coronation theory,” could be managed (as indicated by the slogan “money first” used colloquially by two former European Commission Presidents Jenkins and Delors) since it would have forced European Union (EU) member countries toward political union in the form of a new state among already known and available options. The real situation is far from favorable. The European monetary area is not “optimal” as productivity differs structurally among regions, sectors and firms of varying sizes. Without a targeted policy to remedy this weakness, the richest zones become richer and the poorest ones poorer, creating social and political tensions inside the union.

The idea that the Eurozone was “not optimal” was not even taken into consideration by the EU Treaties. Instead for expediency, the adoption of the Euro was only allowed in those countries able to fulfill the four Euro convergence parameters stated in art. 121 of the Maastricht Treaty. However, these parameters did not define the growth rate in productivity as the most important variable for comparison purposes, but instead focused on the comparison among the rate of growth in prices, government budget deficits, government debt/gross domestic product (GDP) ratio and interest rates. There also were those who denied that the Eurozone was a non-optimal currency area (OCA). The ECB itself has published papers (Mongelli 2008) arguing that the system was likely to move spontaneously towards the same growth rate in real GDP. The Stability and Growth Pact (Treaty of Amsterdam 1997) amended the Maastricht Treaty, setting a greater emphasis on citizenship and the rights of individuals, and attempted to achieve more democracy in the form of increased powers for the European Parliament, a new title on employment, a Community area of freedom, security and justice, the beginnings of a common foreign and security policy and institutional reform in the run-up to enlargement, without any suggestion of policies for absorbing non-optimality.

To overcome the problem of a “non-optimal” Eurozone, the choice that was made, and later reaffirmed, was to give competitive markets responsibility for stimulating productivity. The member states, under the pressure and supervision of the EU institutions, have the responsibility for implementing micro and macro “reforms” necessary to pursue the objectives of high growth (at the beginning officially estimated at about 4 to 6 % in real terms) and peace, as stated in article 3 of the “Single European Act” (Single European Act 1987). This act set for the European Community an objective of establishing a single market by Dec. 31, 1992, and codified European Political Cooperation, the forerunner of the European Union’s Common Foreign and Security Policy. The objectives of the Treaties have been reiterated constantly up to article 2 of the Treaty of Lisbon (Treaty of Lisbon 2007) which amends the two constitutional bases of the European Union, the Maastricht Treaty and the Treaty of Rome, renamed as the “Treaty on the Functioning of the European Union.” A limited consideration to the OCA problem was given by approving the EU “cohesion policy” to contribute to the achievement of social and political goals. The annual amount of financial resources to implement this policy was and is modest in size, given that it is a small fraction of the EU budget, equal to 1 % of European GDP, and could be activated under several constraints. They are not meant to achieve productivity rate convergence but to ease the social effects, pursuing substantially “meta-economic” goals.

By signing the Maastricht Treaty, two national sovereign powers were transferred by the member states to the EU: the right to regulate their own markets and the right to manage their own currency. Today, the first power is exercised by the Commission playing a *de facto* role which is more important than that of the heads of state or government European Council and of marginal influence to the European Parliament. The second power is exercised by the European System of Central Banks (ESCB) of member states, named “the Eurosystem” as not all states have adopted or are eligible to adopt the Euro (now 19 out of 28), which includes the European Central Bank (ECB), the monetary authority with deliberative and operative powers.

The institutional architecture realized to manage both sovereign power acts, according to a very complex procedure, has a deep influence on production, exchange and money at the national level and outside the union. The regulations relating to the functioning of markets have expanded up to a point that now they set the standards for items such as zucchini, bottle caps and cheeses, as well as deciding the rules of competition between producers and the way consumer and environmental safety should be guaranteed. The rules emerge out of preparatory meetings with member states, as well as with national and industry lobbies and, more recently, with the Parliament (in the course of meetings called “trialogues”). The process of their definition can last for years. The regulations are approved by the European Council, following a proposal from the Commission bureaucracy discussed with the national bureaucracies of each member state, which prepare the choices to be made by their governments, often in a very limited time.

The complex governance of sovereign powers to regulate the market is worth recalling to focus attention on the environment within which the ECB and the Euro operate. Strictly monetary decisions are made independently, but if they concern interpretation of the ECB statute, political influence is inevitable. If there is suspicion that the decisions go beyond the statute so as to modify it, they must go through a preliminary stage in which they are examined by the council of the states participating in the Eurosystem before being discussed by the European Council. The major flaws in the governance of monetary policy can be summarized in giving the ECB a primary statutory single goal, which is to maintain price stability, seen as a crucial pre-condition for further growth, while considering as a secondary goal the achievement of the broader objectives of the treaties. To pursue these goals, the ECB was given very limited tools, which are inappropriate when facing the difficulties created by global as well as EU-wide economic shocks. The ECB proposed inflation target was set at “close but not below” a 2 % annual rate over the medium term. The decision was initially made by the ECB Governing Council as a target “close to 2 %,” restated many times and reinterpreted on Jan. 22, 2015 announcing the decision to start European quantitative easing (QE). This primary goal of the Eurosystem has now become the inflation target value to be achieved, because of the current deflation, resulting in a double paradox: the ECB must create inflation in order to reach the target rate and consider monetary stability as standing alone with no links to any other aspect of the European economy (wage levels, aggregate demand, supply constraints, etc.).

Initial readings of the Eurosystem mandate were that the money supply could only flow through bank lending channels while the acquisition of government bonds (financing government budget deficits) and foreign exchange operations (influencing exchange rates) were impeded. Having rejected for a long period the possibility of

using treasury and foreign channels, they have become an essential part of the current monetary policy used to tackle deflation. The acquisition of government bonds was activated in an "unconventional way" (ECB terminology used by President Draghi in many speeches and press conferences) through outright monetary transactions (OMT) which are interventions in the secondary markets for government bonds with a maximum maturity of three years. Recently, QE was used to enlarge the length of maturity but not exceed a certain quantitative amount (88 % of 60 billion Euros for each month until September 2016, except for a rise in inflation) (ECB Press Release 2015). This statutory reading was unofficially confirmed by the European Court of Justice following a reference made by Germany's Federal Constitutional Court that was appealed by a large number of citizens of Germany and the parliamentary group Die Linke, to which the federal government of Angela Merkel decided to associate (Federal Constitutional Court 2014). The ECB's President, Mr. Draghi, has gone even further by stating that an intervention of this type is a "statutory obligation" (Draghi's Press Conference 2015) because of the subordinate mandate to cooperate with the other European institutions to achieve the general objectives of the EU assigned to the ECB by the treaties.

To gain the consent of the Governing Council of the Eurosystem, the majority was forced to introduce restrictions on the purchase of government bonds by imposing certain risk-sharing conditions in the event of a default: 20 % will be borne by the ECB and the remaining 80 % by the National Central Banks (NCB) (ECB Press Release 2015). According to the rules regulating the Eurosystem, the creation of 8 % of the monetary base is accounted for in the ECB's balance sheet while the remaining 92 % is in the balance sheet of the NCB member who proposed it. However, the entire risk of default is borne by the Eurosystem. The new regulation imposes a transfer of 80 % of the risk of default to each of the NCBs, thus fragmenting the responsibility of the Eurosystem (the so-called "mutualisation"). Anyway, QE is an important step forward as it enlarges the number of available instruments, but it is also a step backwards in the process of creating a single state that wears the crown of the Euro.

We know very little about the ECB's foreign exchange rate policy apart from the fact that the dollar is well below its initial parity of 1.16 against the Euro, after varying from about 0.80 to almost 1.60 in the 15 years of its life [ECB statistics on exchange rates Euro/U.S. dollar, daily]. Since we have not been informed of any possible purchase of dollars, the current exchange rate value reflects improved growth conditions in the United States and an increase in the supply of Euro-denominated monetary base.

I firmly believe that in order to achieve an effective and stable monetary policy, the ECB needs a new statute rather than a mere reinterpretation of the existing one. At present, it cannot play directly, independently and adequately in quantitative terms, the role of "lender of last resort" which is well known to be essential for the stability of the financial system and the real economy not only of the Eurozone.

The size of bond-buying operations has been quite modest so far, but in line with the logic of the instrument, and it is likely to increase after QE despite current market conditions suggesting this intervention is not needed. The ECB announced that it will buy public bonds using a "whatever it takes" approach (Draghi 2012), locking in private portfolios. The decision taken on January 22, 2015 that NCBs will participate in the purchase of these bonds in coordination with the ECB, will push up any stock prices that cannot hold up in the long term if not supported by stable and significant

growth in the real economy and profits. The American style of QE, which continues until unemployment falls back to desired levels, compared to European-style QE, which continues as long as inflation rises to the target level, presents a different degree of effectiveness and different perspectives. To be effective, the above described policy must be implemented within a system willing to expand rather than downsizing in terms of employment and public spending, which is not exactly the case of the EU. The decline of the Euro in the currency market, even if backed by an active ECB policy and a precise strategy of leader European countries playing in the global markets, will not have the same effects that a similar trend has in the U.S. or Japan, being exposed to a slack in aggregate demand and sudden political changes. The current conditions prevent firms in the Eurozone from making long-term production plans or cause firms to be extremely cautious in doing so.

The Link between the Economic Architecture and the European Policies

Our main argument revolves around the behavior of the institutional architecture created in Maastricht and reiterated in subsequent treaties. On one side is the EU Commission with large powers in exercising sovereignty to regulate the market but not fiscal policy. On the other side is the ECB with limited powers in exercising monetary sovereignty.

A well-known Italian jurist, Giuseppe Guarino, refers to institutions as "biolegal creatures," that create policies of a certain type and preclude others according to the legal structure that was given to them (Guarino 2014). The idea is more incisive than that advanced by Joseph Stiglitz (Stiglitz 2014). It implies that the European institutional architecture is not likely to generate welfare, recognized as a goal by the EU Treaties, whose main responsibility was implementation of "reforms" of labor markets, public administrations and competition (a kind of supply-side policy) but *de facto* left to the market (based on a mix of supply-side pressures and demand-side pushes). The responsibility for fiscal policy was left to member states subject to constraints on public budget deficit and debt ratios with respect to GDP. The result is a true confusion of political influences whose consequences are permanent deflationary tendencies.

The Italian government asks for more flexibility in the application of rules regarding government budget deficit criteria stated in the Maastricht Treaty. The French government openly violates the rules but not the institutional arrangements behind fiscal policy, keeping its budget deficit beyond 3 %. These actions are equivalent to not respecting the conditions freely agreed upon, thus giving reason to the German government. Draghi asks to change the policy but not the institutional arrangements behind monetary policy. This will drive the ECB towards a double contradiction. Dealing mostly with Germany to shape interventions as to satisfy Germany's needs violates the principle of the ECB's independence. Acting freely exposes the ECB to criticisms of having stretched the interpretation of its mandate and will cause the ECB to suffer impositions as the one fragmenting the risks taken up by the NCB members of the Eurosystem.

Instead of asking for a change in fiscal and monetary policies, we should request a change in the architecture to introduce discretionary use, at least for limited periods, of fiscal criteria at the national level while maintaining a certain degree of coordination at

the European level. Alternatively, give the EU Parliament, following a proposal from the EU Commission, the opportunity to intervene at least in infrastructure projects of common interest, as suggested by the Juncker Commission (Juncker 2015) creating the European Fund for Strategic Investments, and assign to the ECB objectives and instruments typical of other major central banks, making it responsible for pursuing the objectives stated in the treaties and choosing freely the most appropriate tools to be used. Only then can the Eurozone compete globally and contribute to the growth of Europe and other regions, instead of impeding growth, as it is rightly accused of. As we learn from the Bretton Woods Agreement, whose aim was to regulate the international monetary and financial order after the conclusion of World War II, an architecture with serious weaknesses, as was the dollar's convertibility into gold at a fixed price (called the "Triffin paradox") (Triffin 1960), cannot survive for long and collapses if authorities with greater governance responsibility within the system form an alliance with the market to determine the event. At present, the described outcome does not seem to be among the possible choices of the European leaders and of the majority of member states. They just want to keep functioning as a mechanism inappropriate to foster growth using mitigating measures, without trying to eliminate weaknesses (which can be called the "European paradox"). Since the outbreak of the global financial crisis, we experienced many of those measures such as the bank rescue fund, the state rescue fund, the six-pack, the OMT, long-term refinancing operations (LTRO), targeted long-term refinancing operations (TLTRO), etc. At the same time, by approving the so called Fiscal Compact, a new stricter version of the Stability and Growth Pact (Fiscal Stability Treaty 2012), they have worsened the ongoing deflationary process.

From Diagnosis to Treatment

The logic behind the creation of the Euro rested on two pillars: a single market needs a single currency and this latter needs a single state to give it legitimacy. The first was partially implemented as the central bank was created with limited instruments as compared to those normally granted to central banks of major foreign countries (Federal Reserve Bank, Bank of England, Bank of Japan, People's Bank of China, etc.). The second was just a hope, never seriously pursued. The result is that the Euro is lamed.

National governments and the ECB are working on two fronts to prevent the Euro from collapse. The first is by spreading terror about what that would happen after dropping the Euro. The EU architecture is conceived as irreversible and the legal and economic consequences would indeed be severe for all countries if they were not able to handle the end of the institutional arrangements. The second is by announcing growth-enhancing measures to boost positive expectations (such as the recently mentioned Juncker Plan costing 315 billion Euros (Juncker 2015) and the 1.140 billion Euros QE operation (ECB Press Release 2015) by the Eurosystem), but still leaving the architecture unchanged.

The so called "austerity" policies as a group are the product of biolegal creatures specifically conceived to address dualisms through reforms and not through targeted public spending to push aggregate demand exogenously. The resulting picture is very

tangled. It widens the welfare gap among member states and growth between the EU and the rest of the OECD countries as implied by Robert Mundell's interpretation of non-OCA (Mundell 1961). The inconsistency between the EU objectives of peace and welfare and the agreed upon instruments (what we call "institutional architecture") permit Germany and the Netherlands to reject the principle of symmetric responsibility for adjusting their huge surplus of balance of payments on current account (of around 7 to 10 % of GDP, about three times higher than China's highly criticized balance of payments surplus) (Economist 2015) and refuse to push their domestic demand.

The consequence is that the European system teeters on social issues and enlarges its undemocratic features. One of the two pillars on which the Euro rests, the birth of a state filling the gap of its legitimacy, has made steps backwards (France has formally expressed its adverse opinion with a referendum held on May 29, 2005 and Germany has taken substantial actions against it (Federal Constitutional Court 2014)). The EU still lack a policy that seeks to remedy the "non-optimal" monetary nature of the area. As a result, the situation will become unsustainable in the long run and, if it is to be remedied, it will be through a loss of fiscal sovereignty of the most vulnerable states, the denial of the nation-state Westfalian physiognomy, and the absence of a new supranational one. If a member country asks for financial assistance, it accepts economic colony status.

Since the leverage on ECB and Eurosystem capital is high, the guarantee on their liabilities, namely the Euro in circulation, lies in the solidity of the asset side of their balance sheets, so far determined by the solvency of the banks and, after QE, of the states which were financed and therefore exposed to the risk of deflation and production recession. However, if the ECB had the same powers granted to other major central banks all over the world, government bonds denominated in Euro would not represent a risk for the sole reason that being denominated in Euro and thus always redeemable creates new monetary base. Sovereign bond risk would become inflation risk. Therefore, the request made by Germany, and then accepted, that NCBs would be responsible for 80 % of any losses they might incur if the government bonds purchased were not repaid in whole or in part, is valid only if the ECB is not provided lender powers of last resort as properly defined. Thus if the institutional architecture that supports the ECB remains unchanged, this is proof that there is no intention to reform the ECB as indicated.

If the above discussed reform of the ECB statute is implemented, not only would the risk on sovereign debt disappear, but also exchange rate risk would be brought back under control. The power to activate all three channels of monetary base creation (banks, treasuries and foreign) is fundamental for any well-built central bank. Today the Euro has a semi-private nature, as did the currencies of the private issuance banks before the birth of the central banks at the turn of the 19th to 20th century. In this limbo, the ECB is free from any obligation to ensure the convertibility of the Euro either into gold or into other currencies, or to guarantee its "liabilities" in circulation (i.e., the Euros) for amounts exceeding the capital conferred by Eurozone states. Today, the Euro has a status similar to that of the dollar, when used to carry out international transactions. It is a "fiat money" that, if refused as a means of payment, is not backed by any sort of coercive power to overcome the refusal, if the state where the refusal occurred does not intervene to ensure respect of the signed international treaty. The speculation against countries in difficulty, or the fear that it will happen, performs as a good

substitute for a military attack. Since monetary treaties can be revoked unilaterally at any time, as proven by the refusal of the United States to fulfill the Bretton Woods agreement (Nixon Executive Order 1971), the international market keeps a suspicious and cautious attitude regarding the future of the Euro.

Whenever the Eurosystem improves its institutional arrangements and decision-making procedures in the form of a change in policy, this attitude is attenuated, but the doubts do not disappear. The conclusion remains as expressed in the title of this article with a relevant codicil: The future of the Euro lies in its past if the EU institutional architecture will not change.

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