EUROPEAN CENTRAL BANK

EUROSYSTEM

The Future of the Euro at 15:
Rounding the Corners of the Holy Trinity?

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A continuum of views on political integration after the euro crisis:

- Abolish the euro, return to national currencies and make a new start?
- Put in place the minimum requirements for a more perfect eurozone?
- Make a quantum leap to a single currency with a unitary state?

Most politicians prefer a half-way integration to preserve sovereignty. The question is whether this choice is economically sustainable:

- How did the euro arise as a currency without a unitary state?
- What where the design failures and how are they being repaired?
- How can countries (re)gain room for national policy manoeuvre?
- What are the implications of an incomplete and fragmented eurozone?

Key message:

- Countries may still have too much leeway to encroach on markets
- The eurozone may need more market-preserving fiscal federalism

The euro – a currency beyond the state

The euro was created as a currency without a unitary state:

- Since the Treaty of Rome of 1957, European economic integration was used to reach the political objective of an "ever-closer union"
- Economic and Monetary Union (EMU) was seen as intermediate goal
- Founding members gave up their monetary sovereignty to the ECB …
- … but kept their sovereign powers for all non-monetary policies (other than trade and competition), even financial regulation and supervision remained under national responsibility (within a common framework)

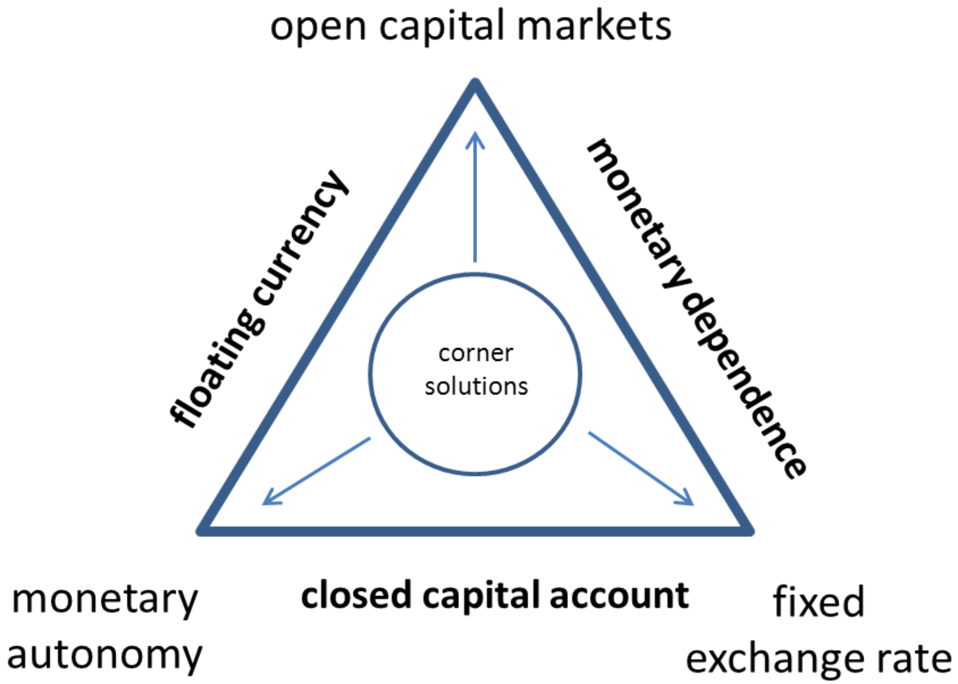
This left the long-term political vision of the eurozone ambiguous:

- Was the euro a currency without a state *yet* … or without a state *ever* (Spolaore, 2013)?
- Constitution for Europe was rejected in 2005, so no federal state
- The Lisbon Treaty of 2009 sees the European Union (EU) and the eurozone members as the joint sovereign behind the euro, turning it into a currency beyond the state (Hoeksma and Schoenmaker, 2011)

The monetary policy trilemma

The monetary policy framework of an open economy is characterised by an impossible "holy trinity" (Rose, 1996), two of the three corners can be selected, one has to be given up:

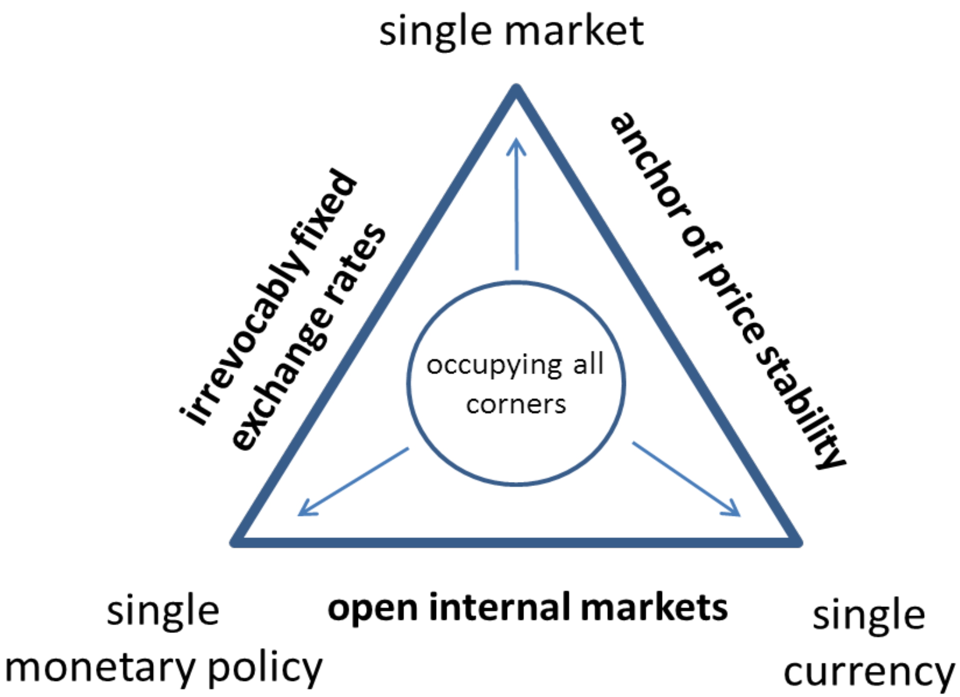
- Free cross-border capital movements (or close capital account)
- A fixed exchange rate (or let the currency float freely)
- Autonomous monetary policy (or import monetary stance from abroad)



The 'holy trinity' of the eurozone

Europe's response to the monetary policy trilemma was the 'holy trinity' of EMU, allowing countries together to occupy all three corners:

- Single market with open internal borders and free capital mobility
- Single currency with irrevocably fixed bilateral exchange rates
- Single monetary policy offering a common anchor of price stability



The role of market discipline in the eurozone

Member countries in principle faced a ‘hard’ budget constraint:

- No scope anymore to support the economy through a devaluation
- No scope anymore to reduce the real value of debt by inflation
- No scope anymore to secure privileged funding by financial institutions
- No scope anymore for excessive budget deficits or too high public debt
- No bailout by others in times of stress, as EMU was no transfer union

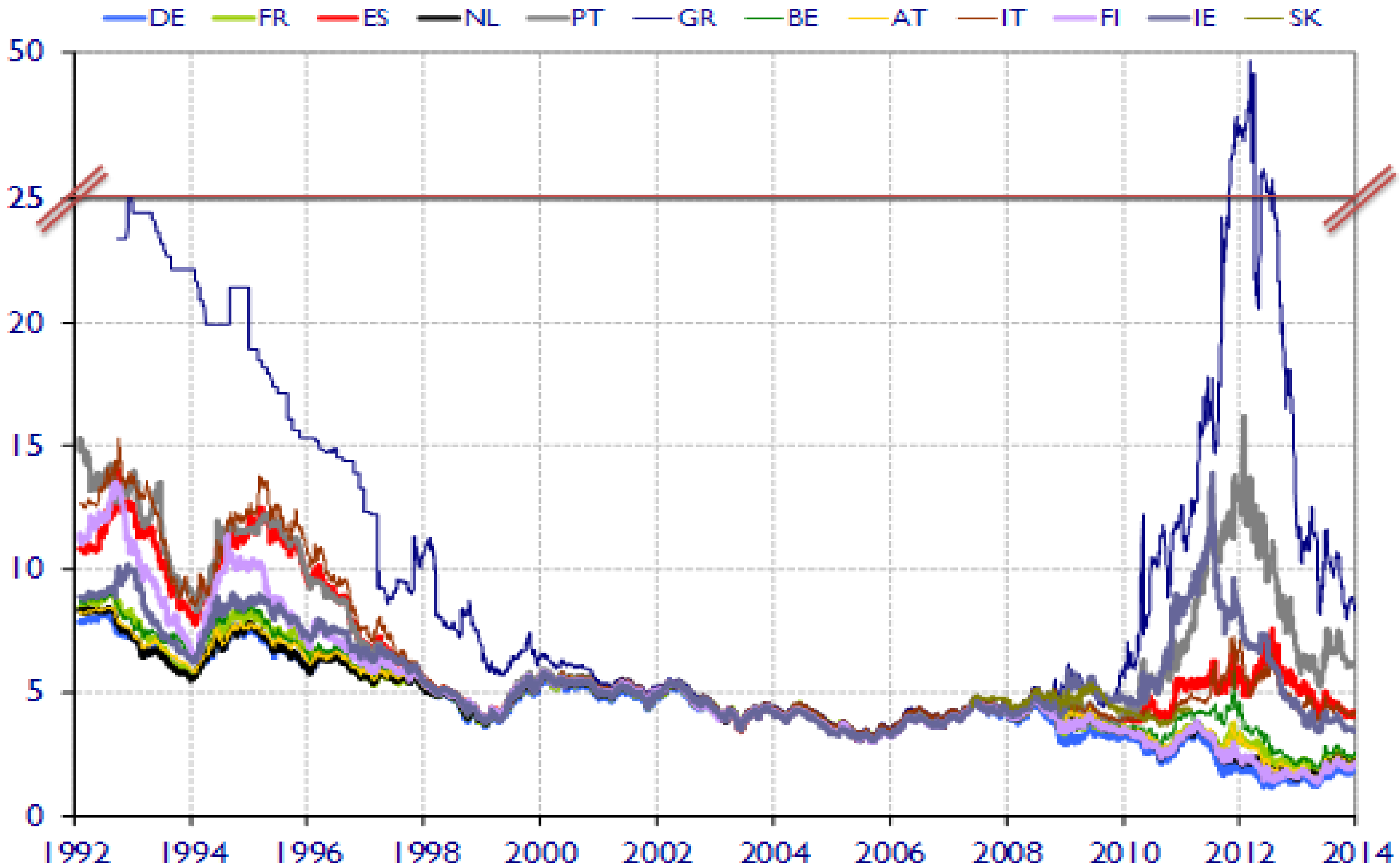
This made governments dependent on the capital market, subjecting them to market discipline as they had to compete for savings. But:

- EU banking rules deemed all euro-denominated sovereign debt issued by all member countries as risk-free, without large exposure limit
- EU fiscal rules were reassuring, but no-bailout rule was not credible
- Opportunity to diversify euro country risk without exchange rate risk

The pre-crisis ‘hunt for yield’ fuelled capital inflows, leading to cheap credit and an underpricing of sovereign risk

Government bond yields of euro area countries

Compression of long-term sovereign bond yields (in %) during 1999-2008, despite differences in fiscal fundamentals; sovereign risk premia jumped in 2009-2012.



Sources: Thomson Reuters and ECB. Chart excludes Cyprus, Estonia, Luxembourg, Malta and Slovenia.

Three fault lines and three remedies for EMU

The euro crisis revealed three fault lines in the design of the euro:

- No effective peer pressure on national economic policies
- No banking union to supervise and resolve systemic banks
- No common fiscal backstop for countries losing market access

Three remedies to improve crisis prevention, management , resolution:

- Strengthening of EU economic governance
- Steps towards a banking union, but no common fiscal backstop
- New eurozone rescue fund for countries facing liquidity stress

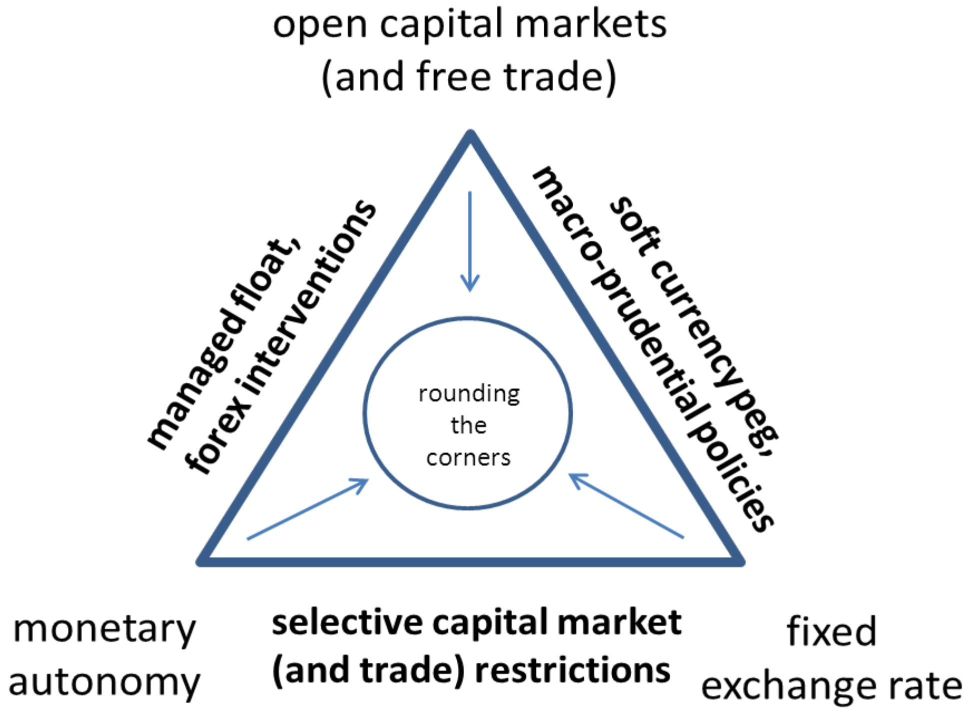
The EU and euro area leaders were ready to “do whatever is required” for ensuring financial stability. The ECB was committed to “do whatever it takes to preserve the euro”.

Missing: transfer of fiscal sovereignty to eurozone level, needed for banking union and to prevent countries from curtailing free markets.

Rounding the corners of monetary policy trilemma

Some emerging market economies restore space for national policies by trying to "round the corners" of their monetary policy trilemma (Klein and Shambaugh, 2013):

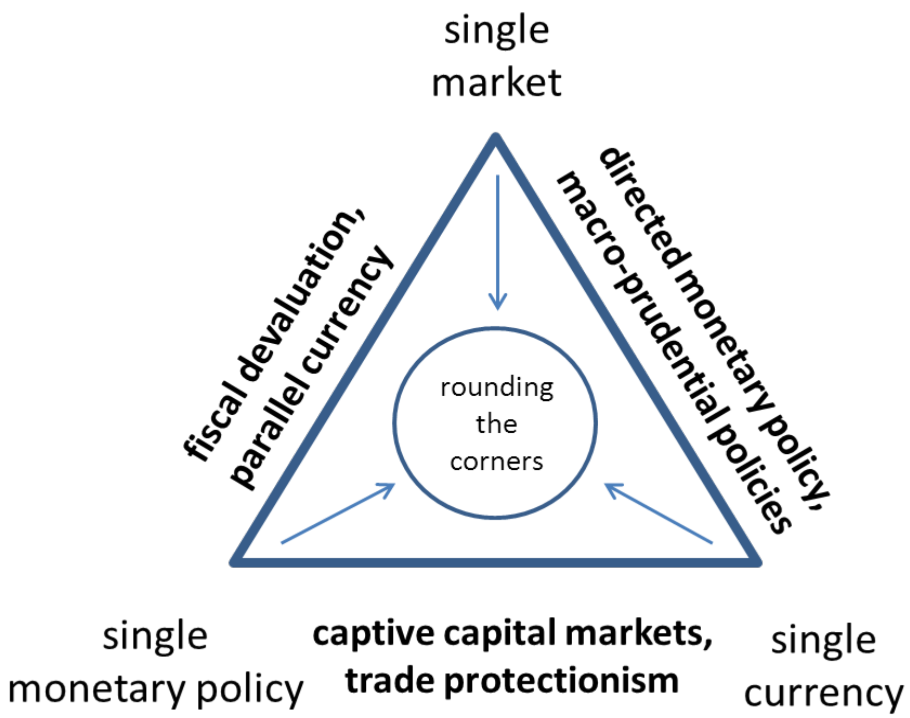
- Selective capital controls (and trade restrictions) to shield local market
- Managing the exchange rate to maintain cost/price competitiveness
- Macro- or micro-prudential policies to control domestic credit growth



Rounding the corners of the eurozone's holy trinity

Eurozone countries may also seek to restore space for national policies and try to "round the corners" of the holy trinity of EMU:

- Captive domestic sovereign debt markets (and trade protectionism)
- Fiscal devaluation to maintain cost/price competitiveness
- Macro- or micro-prudential policies to control domestic credit growth



Benefits of market-preserving fiscal federalism

A welfare-enhancing monetary union needs market-preserving fiscal federalism (McKinnon, 1994, Weingast, 1995, Montinola et al., 1995):

- To secure a durable federal vs. subsidiary governance structure
- To promote efficient competition between union members
- To place credible restrictions on discretionary national policies

Key elements of market-preserving fiscal federalism in monetary union:

- Hierarchy between area-wide authority and subsidiary governments, each autonomous in its own jurisdiction, durably institutionalised
- Area-wide institutions provide common public goods and services that are essential for the efficacy and stability of the monetary union
- The area-wide authority has a moderate budget backed by revenues and a common fiscal backstop for last resort support to banks/members
- Each subsidiary government is responsible for its own economy and is subject to a hard budget constraint; it can draw on the common fiscal backstop only under strict conditions, no bailouts to restore solvency

EMU needs more market-preserving fiscal federalism

Which elements of market-preserving fiscal federalism in eurozone?

- Hierarchy between European institutions and subsidiary governments, each autonomous in its own jurisdiction, durably anchored in Treaties
- Common provision of monetary policy, steps towards banking union, capacity for centralised macro-prudential policy, judiciary to police the EU internal market, eurozone rescue fund
- Small EU budget backed by shared revenues, the European Stability Mechanism (ESM) is capitalised by all euro area governments
- Fiscal compact demands national structural balanced budgets, scope for more intrusive policy surveillance, use of eurozone rescue fund is subject to policy conditions, CACs for orderly public debt restructuring

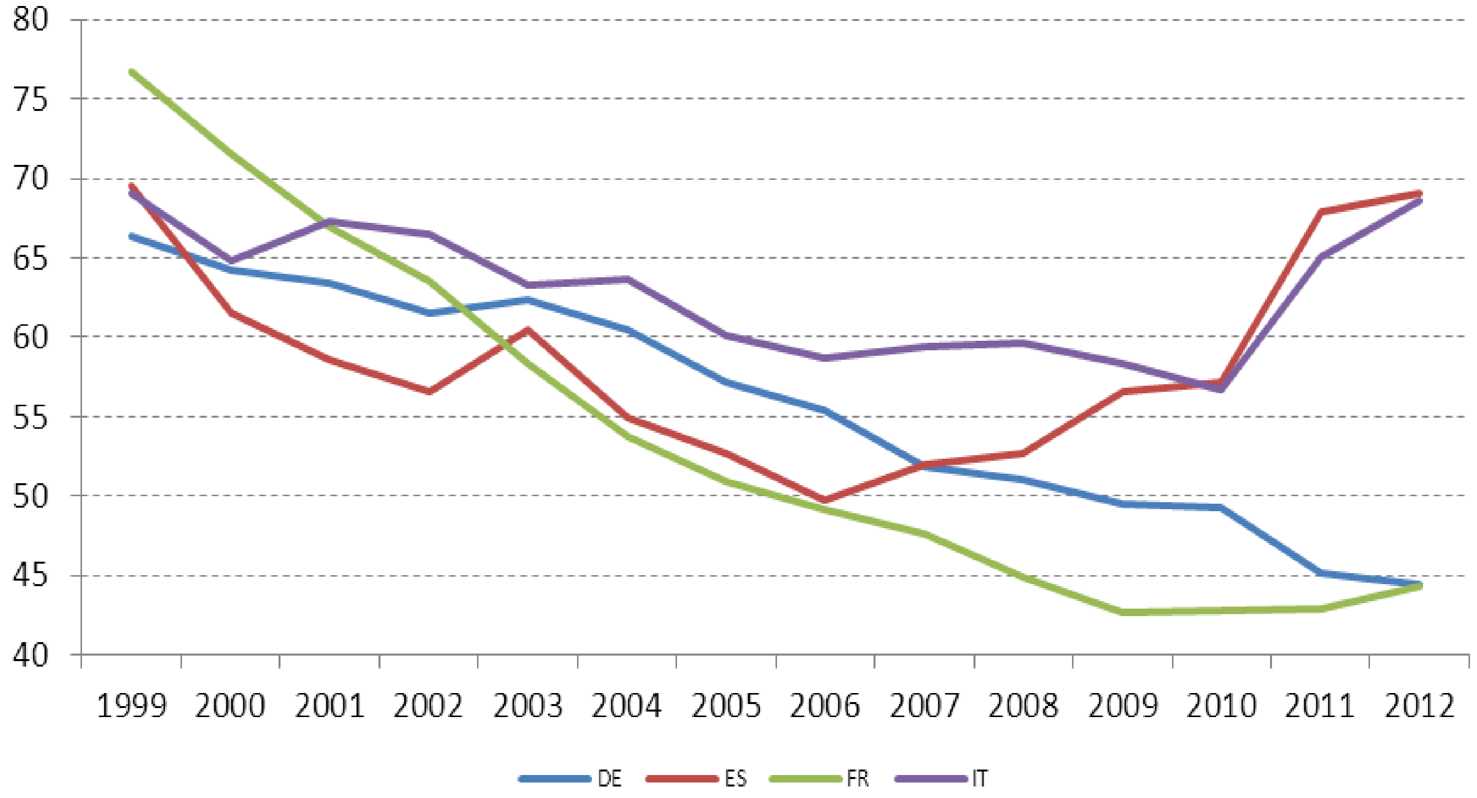
Yet, euro crisis triggered market repression and fiscal protectionism:

- Governments kept their fiscal sovereignty and created more captive sovereign debt markets to circumvent their hard budget constraint.
- Euro scepticism constitutes further risk of renationalisation of markets

More government debt held by residents

A rising share of residents in total government debt of Spain (ES) and Italy (IT), in contrast to Germany (DE) and France (FR). Signals flight-to-safety of foreign investors and captive domestic buyers?

Shares in percentages



Source: European System of Central Banks, van Riet (2014). Total government debt in 2010-12 excludes the loans received from EU/IMF and the bonds purchased by the ECB under its Securities Markets Programme.

Conclusion

- Responding to the euro crisis, European leaders have put in place a reinforced governance framework for a more perfect monetary union.
- But: is the political preference for half-way integration an economically sustainable status quo, sufficient to secure stability and integrity of EMU?
- Governments have kept their national fiscal sovereignty and may try to round the corners of the eurozone's holy trinity, i.e. to circumvent the hard budget constraint that should subject them to market discipline.
- The euro crisis triggered fiscal protectionism and a renationalisation of markets. Such fragmentation frustrates the single monetary policy and the functioning of EMU.
- A higher level of market-preserving fiscal federalism – i.e. a transfer of fiscal sovereignty to the eurozone level – may be needed to limit the ability of member countries to encroach on markets.
- This in turn requires a social consensus about the limits of the state and the economic and political reforms to underpin the viability of the euro.

Thanks for your attention!

Selected literature

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