The logic of the euro, its institutional architecture and the related implications

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Abstract: The Euro is the logical consequences of the European common market according to the principle ‘one market, one money’, to avoid unfair competition changing internal monetary parities. Anyhow it is a necessary but insufficient condition being the institutional architecture weak. The European Central Bank cannot perform as the other main central banks: cannot act as lender of last resort or intervene on the exchange market to counteract speculation; the risks on national exchange rates has been transferred to member-countries sovereign debts without a non-deflationary solution to reenter the excesses in the agreed ratio on GDP. The Eurozone is a non-optimal currency area without a policy Mundell’s type. The suggested solutions by the Europeans are to reform national labor markets and public bureaucracies, and by the idealists to create a political union.

Keywords: Euro; Market Competition; Central Banks’ Powers; Non-Optimal Currency Area; Rodrik Trilemma

1. Prologue

These notes are a synthesis of how the European Union and the Euro have been built, and of the main current dispute on how to keep a cohesion among member-countries, a necessary but not sufficient condition to advance in the process of European integration as a mean to push economic recovery and to protect welfare. Many consider this goal a mission impossible, because the deep cultural-political differences on the vision of how to manage a modern society (Greek politeia). Many others consider a mission impossible to go back from the Union and especially from the Euro. On the matter exist flows of writings, statements and academic papers that is impossible to synthetize. As many of them are in Internet, these notes don’t quote specifically some of them, either for sake of simplicity and being interested only to the logic of the Euro, its institutional architecture and the related implications.

2. The logic of the Euro

The discussion on the Euro is very often based on misjudgments and emotions instead of the logic of its creation. After the World War II the decision to move to a common market in Europe was the joined result of a persuasion that ‘moving goods does not move armies’ and the need of pushing a faster recovery of the Western European countries. The United States played an important role that was inspired by a double vision: to propose a liberal-democratic approach to global co-existence as expressed by Roosevelt in the famous 1941 speech on the four freedoms; and, to offer a political alternative to the communist approach to State organization as implemented by the Soviet Russia[1].

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The experience of the EEC-Economic European Community was highly positive, for its excellent implementation and the social-political base of the European people, tired by wars and desirous of welfare. After the drop of the Soviet block of countries and the start of the globalization process, the political ratio of the Community changed becoming to compete with big blocks of population well equipped with high technologies (like USA) or low salaries (like India and China). The first step of this new approach to European cooperation was the transformation of the EEC in the EC-European Community marking the change, at economic level, from an open market to a common market, and, at the political level, from a Community to a Union[2].

The natural consequence of the economic integration was that a common market needs a common currency, to avoid that a competition based on different national currencies and policies be influenced by ‘monetary parities’ (exchange rates), which distort the ‘terms of trade’, altering a competition based on real fundamentals (such as production factor’s behavior, inflation, ‘burden’ of the State). The Maastricht Treaty decided to move to a common money, the Euro, but not for all the signatories of the agreement. This is the first institutional limitation of the common market and, then, of the European Union. The confluence of the main national monetary sovereignties (Germany, France, Italy, Belgium etc.) was considered the viaticum of the political unification of Europe. The slogan advanced by two leaders of these European monetary ‘revolution’, Jacques Delors and Roy Jenkins, was ‘money first’ which indicates clearly what was the final goal of the monetary unification: to go to a political union. The failure of reaching this goal is the second, perhaps mainly institutional limitation of the Union and part of the difficult faced by the Euro after the Great Recession born in the United States on 2008.

The ratio to have a State behind a common money can be synthesized by the need to have an area with only one legal system that guarantee equal rights and obligations to all the citizens, a characteristic that is typical of a liberal-democratic system based on equal starting points. In the EU there are still 27 legislations + 1 to be negotiated (because of Brexit), with deep fiscal, welfare and productivity differences. The result is that the Euro area is not an optimal currency area where one monetary policy does not fit all, as explained by the Nobel Prize Robert Mundell[3]. Such a monetary area needs a policy to push convergence also in productivity; otherwise, an international agreement that creates socio-economic divergences instead of convergences remains intrinsically unstable, like the Euro area; to validate this statement we do not need sophisticated demonstration, but just to look the Euro-statistics. The instability can also express itself in various ways: a crisis of the public debt (Greece) or a spread to be paid on it (Italy), or the raise of nationalistic and populist political parties (everywhere) and a social demand for a closed society (as Brexit).

3. The institutional architecture of the Euro

The Euro is managed by the ECB Governing Council appointed by the Euro system, whose member are the national central banks of the countries who chose to join the monetary union and has been accepted by the Council of Heads of State or Government of the EU Countries. The ECB is the only European institution capable to take rapid decision and to implement them. But its powers of intervention are limited compared with those of the other main central banks (Fed, BoE, Bo J, etc.): it can finance European banks, but financing Member-States’ governments is forbidden; it cannot perform as a lender of last resort and intervene systematically on the foreign exchange markets. The ECB liabilities (the Euro) are equivalent to a ‘fiduciary money’ created by private bank before the nationalization of money creation between the XIX and the XX centuries, that gave a monopolistic sovereign power to the States. The Euro is also equivalent to a de facto irredeemable debt of the ECB, since the ‘shareholders’ (i.e. the central banks of the Euro system) consider the Euro “irreversible”[4]. The crypto currencies are potentially the way to bypass the institutional weakness of the Euro giving to the market the power to create money, removing the exercise of the monetary
sovereignty from the hands of the official authority. Today the Dollar and the other non-Euro currencies run the same risk.

Economists discuss how to reform the architecture of the Euro, but the problem is wider and deeper being linked to the behavior of the international monetary system created by the end of the Bretton Woods era. We are living a monetary and financial revolution without any idea of how to approach it, pumping growing flows of money and talking of “normalization” in monetary policy as if were the road to come back to old time\(^5\). As many other global problems, the perception of what to do–cooperating–is missing because highly confused.

The lack of a State behind the Euro is filled up by the will of the Council of Heads of State or Government of the EU Countries, a decisional body with heavy and length procedures which express the needs of national sovereignties and related national interests (that change in accordance with the alternation at power of domestic parties with different views on how to manage their countries). It is the so called “intergovernmental management” of Europe, instead of a “Parliamentary” one. The EU Commission is substantially a control authority of the Member-States’ compliance with the European rules set in the Treaties, having a very modest influence on the ECB. The Parliament is mainly an advisory board whose influence depends either from being the only EU institution appointed directly by European citizens and the intellectual-political level of the appointed members.

The working of the Euro depends on the institutional architecture created by the European Treaties. To understand the tight links between institutions and policies I borrowed a concept from an eminent Italian professor of law, Giuseppe Guarino. He considers the institutions like ‘bio-juridical creature’ (or ‘bio-legal entity’) that behave as living beings\(^6\). If their structure is strong or weak, so are respectively their performances. One having only a leg cannot run; one having only an arm, cannot play basket.

The inability of the European policies to create growth and employment mainly results from the kind of institutions created by the Treaties and managed by the institutions. Policies come from them.

The Euro switched member countries risks on exchange rates to their sovereign debts, whose denomination changed from a national to an ‘outside’ currency, which is de facto a ‘foreign’ one for each member. In the pre-Euro era member countries had the possibility to print money to reimburse their debt denominated in their domestic currencies, obviously creating other problems, but avoiding this kind of default. They now are in a condition similar to that of Argentina, which used the US Dollar as the denomination currency of its debts and failed to reimburse them.

The Euro floats freely on foreign exchange markets and is rigid, i.e. the exchange parities are not reversible among the Euro system participating countries. The ECB is authorized to intervene to face short-term speculative attacks, but it cannot change the floating regime into a dirty or fixed one. To survive the Euro needs either a tight coordination of the national fiscal policies, which is now compelled to a tight parameter on public budget deficits and on public debt on GDP, and a specific policy to govern the impact of its non-optimal currency area which still lack. These is why the European Union needs to be transformed in a political union similar to that of the United States with the Federal Reserve System.

Last but not least, the Euro is exposed to the decision of the non-Euro countries that are free to decide to have a fixed or a dirty exchange rates regime to convert the accumulated official reserve freely on the market. The possibility comes from an unresolved problem since the Bretton Woods agreement: to regulate the use of official reserves. The impact of this lack of regulation is well known in literature; but it emerged when China, the number one owner of official reserves, decided to convert Dollars in Euro, pushing its exchange rate to 1.60 (now it is 1.20), damaging European export sensitive to prices and putting further downgrade pressures on the Euro system growth, already penalized by the American financial crisis. The ECB did not have the power to counter intervene, the IMF has no more moral influence on these conversion, and countries do not accept to pass outside the market and knock to the door of the
central banks to cooperate for a better behavior of the international monetary system. In addition, the reserve accumulated under a fixed or dirty exchange rates regime have been used to finance the Sovereign Wealth Fund, which investments are decided on a geopolitical strategy not on a cost-benefit analysis of the projects, even if countries deny that. Everybody is talking of a global free competition, but that is increasingly dominated by State intervention. The World needs a monetary reform as the European Union does.

4. The implication of the institutional architecture of the Euro

If the Euro remains as it is (in terms of institutions and policies), it has no future.

Should the dominant élites be able to keep the Euro without improving the present institutional set-up, as they are doing now, the negative impact would be switched on ‘buffer’ countries (i.e. ‘weaker member-States’), as already happened to Greece. If so the European Union would enter a crisis, inducing countries to intervene in assistance of disadvantageous people without finding a structural solution, producing a negative impact also on the functioning of the common market.

Literature suggests four possible solutions: 1. disband the Euro system keeping the common market; 2. reform the EU; 3. accept the negative impact on weaker countries doing nothing; 4. split the Euro system into two blocks of countries (a two-tier market).

Instead, the current official discussions on the future of the EU are,

A: a further reduction of national sovereignty reinforcing domestic reforms, (i) completing the creation of a European banking system and a common regime of bank deposit protection and resolution of banking crises, (ii) introducing a tight coordination of national fiscal policies, appointing a European Minister of Finance, and (iii) creating a European monetary fund as an alternative to national interventions in front of bank or sovereign bond crisis;

B: start with active European policies (iv) implementing European infrastructural investment (as in Juncker’s Plan), and (v) investing in security and defense (as solicited by Trump).

Without an overview of the legal framework (that is not yet in the European agenda) each intervention – assuming it will be implemented – cannot give a reply to the widening of national and populistic political reactions and to the survival of the Euro without a deterioration of the weaker member-countries.

The impact of the four solutions under discussion are shortly as follow; 1. It is impossible to disband the Euro system keeping the common market or, better, keeping it as a place of fair competition; the rationale of the Euro comes from the existence of a unified market, as we explained at the beginning of this notes. 2. It is possible to reform the European Union, but member-countries disagree; the most influential, like Germany, consider the current architecture be the best we can have. 3. The so-called “France-Germany axis” and other EU countries accept the negative impact on weaker countries in line with protestant ethics that the bests reflect the will of God and the worst are responsible for their status and should “reform” themselves; this is a philosophy contrary to modern social conquests of “positive freedom” (as analyzed by Isahia Berlin). 4. The tentative to split the Euro system into two blocks of countries (a two-tier market) is highly difficult to implement and it leads the risk of a split of the common market; Europe would lose its power with respect to competitors with big blocks of population, creating an area of potential conflicts inside Europe, that the old European divisions were and are not in condition to prevent or manage.

There is a third level, that of what should be the reform of the EU institutions to relaunch the ideal of a democratic functioning of the European Union: (a) create a European school at any level to generate a common culture without cancelling national identities; (b) define the tasks of the EU and those of member-countries as in a confederation of States; (c) equate le ECB powers to the main central banks in the world; (d) give the European Parliament the power to
The impact of the reforms proposed by the EU authority or single member-countries are the following.

New proposed institutions. A further reduction of national sovereignty reinforcing domestic reforms cannot be obtained in a democratic national contest without worsening the European cohesion (as showed by both Brexit and the growing nationalistic and populistic movements). This would happen if the EU tries to: (i) complete the creation of a European banking system with tight rules and a common regime of bank deposit protection and resolution of banking crises, that Germany first dislikes; (ii) introduce a tight coordination of national fiscal policies, appointing a European Minister of Finance; many member-countries refuse the reform because it would be dominated by the Franc-German axis, increasing constraint without generating different policies; (iii) create a European monetary fund as an alternative to national interventions in case of a bank or sovereign bond crisis.

New proposed policies. The impact would be positive if the EU starts with active policies to: (iv) implement European infrastructural investment (as in the Juncker’s Plan) in order to activate the until now unused national policy instrument at European level, selling EU bonds and spend the proceeds to push real growth and employment, and to face dualisms in productivity originated by a divergent infrastructural endowment; (v) invest in security and common defense, enlarging the traditional social function containing the strategic variable of growth and security instead of stability, the current dominant factor of the EU behavior.

New institutional architecture. The goal should be to open the possibility to: (a) reach a common culture through a common school; and, (b) decide a specialization of tasks between the center and the periphery in order to govern the problems arising domestically or at the geopolitical level; (c) monetary policy should be the task of the ECB, keeping it free to autonomously manage all the known instruments of intervention; (d) instead, fiscal policy should be jointly decided by the EU Parliament and the EU Commission, and implemented by the Commission under the control of the Parliament. The New institutional architecture is similar to the structure of the United States of America. Any divergence from this new institutional organization of Europe would keep a permanent instability as that where we are living in

5. Epilogue

If they look to the EU agenda, European citizens are not in condition to understand what will be the future of Europe. If they look to the current conditions they are not satisfied and the usual reaction is to go back to a national “organization of the public welfare” (the Greek politeia) without distinguishing if the votes go to political Parties with a good or bad program: they demand a change to regain national sovereignty (as Brexit did and Macron’s En Marche!). The political wind blows on the two side of the Atlantic (Trump’s American First), but not on the rest of the world, which is cautious or rejects the international cooperation necessary to a satisfactory performance of the global market. I disagree with Dani Rodrik on the irreconcilability between democracy and global market which is not innate in the system, but the result of a cultural-political choice decided by the dominant ruling class and accepted by people[7]. If people want to benefit of a democracy should accept a global market governed by good rules; the opposite is not true.

The European Union and the Euro are the training ground to check this approach to world cooperation: common education, a better institutional architecture with the four proposed features, and a policy oriented to growth and employment under the ECB surveillance on inflation. This implies a reform of the international monetary system to avoid exchange rates unfair competition and a joint engagement of advanced countries to help social and economic development of the less advanced, mainly carrying out public goods (material and immaterial infrastructure). To do that is necessary to operate to increase mutual understanding, a true revolutionary innovative international policy. If the
leaders are not in condition to reach this goal, it does not mean that the proposal is useless

References

1. In the State of the Union Address on January 6, 1941, before United States declare war on Japan, Franklin Delano Roosevelt indicates that people «everywhere in the world» ought to enjoy freedom of speech, of workshop, from want and from fear.
2. The main steps of this process were: ECSC-European Coal and Still Community (1951); EEC-European Economic Community (1957); EC-European Community merges existing treaties (1965); establishment of the EMS-European Monetary System (1978); first election of the European Parliament (1979); SEA-Single European Act and Schengen Agreement (1985); EU-European Union (1992 Maastricht Treaty); establishment of the ECB-European Central Bank (1998); euro in circulation (2002); Charter of Fundamental Rights of the European Union (Treaty of Lisbon 2007).
4. On November 17, 2014, the ECB Chairman Mario Draghi said that the Euro was “irreversible” during a Parliamentary hearing. The definition was repeated by many others EU politicians and academicians.
5. The “normalization” started on Dec 16, 2015, when the Fed raised by 0.25% the official rate for the first time since 2006, announcing that it was the beginning of a cautious increase of the rate in accordance with the behavior of inflation and without putting a handicap on growth and employment developments. The Chairwoman Janet Yellen explained many times what means a “normal” monetary policy: a re-enter from the QE-Quantitative Easing, an accommodating policy to face the financial and real crisis which began in 2008. Some Fed Board Member, academicians and columnists consider the target of normalization to reach 3% in the official rate.
7. I have already stressed that the irreconcilability is institutional-set notin rebus. See“How to reconcile Democracy, the State and the Global Market”, with Giovanni Farese, in World Economics, Vol. 18, No. 2, April-June 2017, pp. 123-137.
9. Draghi, Mario (2014), Introductory Statement, Hearingbefore the Committee on Economic and Monetary Affairs of the EuropeanParliament, November 17
13. Roosevelt, Franklin Delano (1941), State of the Union Address, January 6.