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The Significance of the Euro: A Primer

Europe's monetary union is simply one of the most important experiments of our time. Can the countries whose wars against each other shaped to a large extent the past millennium, if not longer, form a sustainable monetary union without political union?

This experiment is being tested currently under conditions of dramatic imbalances among the participants of the union and three members have been effectively locked out of the capital markets, except for very short-term borrowing. Much has been said and written about these issues, but there are a few basic points that have tended to be overlooked.

Political Nature

Most basic is an understanding of what brought about this experiment. At its heart, it is an economic solution to a fundamental political problem. Under what terms Germany could be reunited after the Berlin Wall fell?

Like the Lilliputians in Gulliver's Travels, a number of countries often vexed by Germany historically, in effect, tied Germany's fate "once and for all" to the rest of Europe. It would share its uber-mark with the rest of Europe (now called the euro) and it would share the Bundesbank's anti-inflation credibility (under the auspices of the European Central Bank headquartered in Frankfurt), which means low interest rates.

That the euro zone is not some optimal currency zone or does not satisfactorily address some economic problem is quite frankly beside the point. Its first master is political and it did not arise as Athena did, popping out of Zeus' head, fully grown and armored.

Since the 1950s and the Coal and Steel Community, European countries have been cooperating on an increasing, though not without fits and starts, range of political, social and economic areas. It required increased coordination and cooperation (which lends compromises and exchanging favors) and often some erosion of sovereignty.

Monetary union is evolving. Europe is evolving. It is being forged in crisis in a way that should be vaguely familiar to Americans. The thirteen colonies fought the first war for national independence under a governing document called the Articles of Confederation and beat the most powerful empire of the day. Despite the success, it was clear that the Articles were not sufficient to govern the new independent country. Rather than offer reform, as they were instructed, the founders introduced an entire new federal system embodied in a Constitution.

European institutional capacity has grown during the crisis and this includes the European Central Bank. The ECB bought covered bonds and sovereign bonds, something most would have thought unimaginable five years ago. The European Financial Stabilization Facility and its successor the European Stabilization Mechanism are products of innovation, which is possible when politically expedient.

Role

The monetary union that emerges on the other side of the crisis will be different than the one that entered, in the same way that Heraclitus, the ancient Greek philosopher, said one can't step in the same river twice. However, many observers confuse this evolution with the demise of the experiment itself. It is not and the explanation can be seen on two levels. First is the role of Europe in the 21st century and the second is a function of a cost-benefit analysis.

For a couple of centuries until the early 1980s, the locus of the world economy was the northern Atlantic. However, around 30 years ago this shifted. More trade goes over the Pacific than the Atlantic. Surely the elites in Europe recognize that the 21st century is likely to be a Pacific Century.

How is the relatively small western peninsula of the Eurasian landmass going to be relevant in a Pacific Century? The US is a Pacific power. Europe is not. Moreover, Europe is incidentally on the edge of a significant demographic shock that will push it further in the diminutive direction.

The European elite have no alternative vision of a future than one of integration. There is no Plan B. Lawyers are debating the issue as one can imagine, but it appears that to leave the monetary union one would have to leave the European Union. This has never happened. A failure of monetary union could weaken the larger integration efforts, which Denmark's recent decision to unilaterally impose border controls illustrate the already fragile conditions. In one direction lies integration, and in the other, marginalization and irrelevance.

Cost/Benefit Analysis

Most claims that Greece or Germany should exit monetary union do not appear to be the product of a serious cost/benefit analysis.

Begin with Greece. The argument is that if Greece were to drop out, it could devalue its currency, thereby reducing its debt burden and making its exports more competitive. This is the alpha and omega of much commentary: Greece simply needs to devalue. Full stop.

Look a bit closer as to what happens. Greece's debt is in euros. It would still have to service that debt, and a devaluation of a new drachma would lead to a sovereign default. It would produce a banking crisis in Greece and profound economic and financial crisis in Greece. There would be a much deeper economic contraction. There would also be very high inflation. Social dislocation and political instability would likely result. The elite would be discredited and in ruins.

There have not been many successful examples of a sovereign reintroducing a currency for the sole purpose of devaluing it. In Ecuador, when something similar was tried, even the shopkeepers rejected the new currency. Moreover, any competitive gain that devaluation would garner for Greece would quickly be eroded from the higher inflation.

There would be severe knock-on effects outside of Greece. Most commentary has focused on the sovereign exposures as the main channel of contagion, yet foreign exposure to Greek banks is greater than to Greece itself. Greek banks would largely be wiped out. The ECB itself would have to be recapitalized.

Most arguments appear to focus only on the first order of impact. While this may be fine of editorial writers, policy makers cannot stop there. A second order impact of the failure of Greece and its banking system, which its exit would entail, aggravate concerns that Ireland and Portugal would follow suit. These forces could jeopardize the firewall that has thus far protected Spain, and some would add, Italy. Ironically the risk premium for the remainder of the euro zone would likely increase, not diminish if Greece were to quit the union.

Even if Greece's debt were to disappear overnight, what is the future of Greece outside of the EU and EMU? How will it compete in the world economy? The debt problem in the periphery of Europe reflects a competitive problem, which is not getting the attention it deserves. It is not a solution for Greece's or Europe's woes.

What about Germany? Maybe it should leave the union before its taxpayers have to be tapped again. Germany could not and did not have a referendum to give up the mark in exchange for the euro. It never would have won, judging by opinion polls. Recall it passed in France by only the smallest of margins.

Yet, Germany has been the single biggest beneficiary of the euro zone. Monetary union has effectively denied its members the ability to devalue, which is what from time to time they, not just the periphery, would do to regain competitiveness lost though inflation and rising relative unit labor costs. While diversifying a growing part of its exports to China, Germany also was quite willing to finance peripheral European countries purchases of German goods. For example, German exposure to Greece is roughly the equivalent of 50% of German exports to Greece over the past decade.

As Sun Tzu instructs us, "keep your friends close and your enemies closer". Germany has done well as the first among equals in Europe, keeping what may appear as Lilliputians from eroding German competitiveness. The challenge presented by the crisis for the periphery is clear, but the challenge to Germany is just as stark if not more so: Should it exert political leadership commensurate with its financial prowess and to what end and at what cost? Germany's elite knows its future is in Europe even if some of the commentariat class don't.

Greece or Germany leaving monetary union would be a failure of the European project. With no clear alternative, European elites are loath to jump into the abyss. Nor will they be pushed. The scar tissue from Lehman is still to raw for them to accept the risk of an attempt for an orderly restructuring of Greek debt. Officials will have to revisit these issues again when they acknowledge that Ireland can no more re-enter the capital markets next year than Greece.

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