

# Economic and Monetary Union in an Historical Perspective

## Will the Euro Survive?

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It is a great pleasure to be in Prague. I am very grateful for the invitation. This is the city that has given us the Prague Spring, then the Velvet Revolution of 1989 and then the Velvet Divorce on 1993. And, in the case of the last episode, who's to say that there will not be parallels in the future development of the European single currency? I must congratulate Vladimir Dlouhy and all the organisers of this series of seminars, testament to the restoration of democracy in the Czech Republic.

My task today is to relate the story of economic and monetary union, in a historical context. It is a story with ups and downs, about the dashing of illusions. It is a tortured tale, something like a mystery play. To the English, it bears resemblance to a "whodunit" of Agatha Christie. In the US, it would be a crime novel by Robert Ludlum. At the end of the drama, there will be bodies and blood on the stage, but mystery will surround who finally plunged in the dagger. In the saga of the euro, particularly the early years when developments were relatively benevolent, there are parallels with the celebrated Grimms Tale of "Der süsse Brei". A young boy lives with his mother in conditions of abject poverty, discovers a magic spell – *Töpfchen koche* - that enables him to cook porridge in unlimited quantities from a magic pot. But he has forgotten the incantation to stop the pot from boiling. So all sate themselves to begin with, but, as the pot keeps boiling, the porridge spills over into the whole house, then the street, then the village, then the forest and soon the whole world. This comes to an end only when the spell to stop the pot from boiling – *Töpfchen stehe* - has been found. We have been in a similar situation with the euro.

To answer the question of the seminar right at the beginning: Yes, I think the euro will survive, but it will be in slimmed-down, more compact and durable form. And the euro may well be stronger than it is today. One reason for its survival is because the great reserve holders and investors of this world seek alternatives to the dollar; they do not want to be left facing the Americans with a monopoly of reserve currency issuance, pursuing enjoyment of the “exorbitant privilege”.

I presume that Europe will muddle through the debt crisis and that the burdens of looking after the debtors will fall increasingly on the “triple A” countries, led by Germany. But resistance in Germany is rising and there will be upsets. The Germans foresaw some of these developments, but they failed to spot the symbiotic character of EMU, in particular how the debts of the peripheral countries would reverberate back to the core. We have a situation like in 1971, only in reverse. Then, John Connally, President Nixon’s famously irascible Treasury Secretary, lectured the Europeans by saying: “The dollar is our currency, but your problem.” Since the euro is now the currency for the whole of the EMU area, Chancellor Merkel of Germany can justifiably say to the Greeks: “It’s your problem, but our currency.”

Since we are holding our meeting today in a Mathematical Institute, let me be quite mathematical about this speech. It contains a list of five fundamental errors of judgment occurring within EMU; a description of four prime objectives behind monetary union and a brief analysis of how successfully these have been accomplished; and 10 lessons that have been learned.

What have been the main elements of what has gone wrong?

First, there was a classic misunderstanding of the way markets behave. In the initial years of EMU, when capital markets moved to price Greek debt at more or less the same level as German debt, a self-feeding loop was set up. Politicians believed that, because the markets appeared to price in convergence in Europe, they no longer needed to carry out any more economic reform efforts. Even those perennial sceptics on the markets appeared to believe that convergence was for real!

Earlier this year, I shared a platform in the Far East with a European central bank governor. He said, of the earlier EMU developments: "The markets appeared to be on our side." Yet this was always a misunderstanding. The markets are never on anyone's side. They are there to make money. The same people who speculated and made money by buying Greek bonds in the initial years of EMU are the ones who made money by selling bonds thereafter. It's a mistake to think the markets make friends with anyone. I said this to the Governor and reminded him of the words of Harry Truman after the Second World War. "If you want a friend in Washington, get a dog."

Second, we have to blame the politicians for monumental incompetence and negligence. As has been often said, this was primarily a political project. You would have thought the politicians would have been rather better at safeguarding it. There was monumental complacency about the problems that were undoubtedly building up in EMU in the early years. They were apparent to many, but not, seemingly, to the politicians who were in charge. To take just one example, look at the almost incredibly lax treatment of the phenomenon of the rising currency account imbalances within EMU in the description of the euro in the European Commission's publications on the 10<sup>th</sup> anniversary of the foundation of the European Central Bank in May 2008. This contained an astonishingly glowing foreword by Joaquín Almunia, the then commissioner for monetary affairs. In the book's 328 pages, on only two was there any mention of the rising current account disequilibria within EMU that demonstrated the rising foreign debts of the system's faster-growing, higher-inflation members, losing competitiveness as the inexorable result of the "one size fits all" monetary policy.

The third element was the miscalculation of the way that these current account deficits represented the counter-balance to the surpluses building up in the northern states that had on the whole preserved or improved their competitiveness. German economic policy-makers and analysts certainly foresaw that there would be retribution among the deficit states. But this, of course, had nothing to do with Germany! The Germans failed to see that retribution would spread to the surplus countries too. Europe's monetary union has represented a relatively closed system where the debts of the deficit states feed through into

the claims of the surplus members. When these debts demonstrably cannot be paid, the surplus states share in the pain. Theo Waigel, Helmut Kohl's finance minister, liked to say that Germany was exporting its D-Mark into Europe. In the symbiosis of monetary union, this was a two-way street: Germany failed to see that, simultaneously, it was importing the drachma into Berlin.

The fourth failure was the inability to think consistently in the matter of banking supervision and regulation. A system that was almost certainly prone to asset bubbles would clearly cause banks to lose money on bad debts that would not be repaid; because of the nature of monetary union, a lot of these loans would be cross-border in nature, and so debt impairments applied to the borrowing of sovereigns or corporate would be international in nature. Why, then, was no system of cross-border banking surveillance and resolution put into place to cope with the repercussions of such an inevitable set of circumstances? Why has Europe been universally behind the curve in coming up with a system to rectify shortcomings that were bound to occur?

Fifth, I must mention the overall inability to prepare governments, parliaments and electorates for the almost-inevitable calls on solidarity among the better-off and better-run states for the good of the errant countries which eventually would need largesse from elsewhere. Before monetary union was established, a lot was spoken in Germany (particularly by the Bundesbank) about the need for a genuine "solidarity union" where the members would be bound together "*auf Gedeih und Verderb*" – for better or for worse. Why, when the need for solidarity eventually manifested itself, was nearly everybody so singularly ill-prepared?

Let us go now into the four principal objectives for monetary union and ask whether they have been met.

The first was to overcome 150 years of Franco-German animosity and rivalry witnessed in three epochal wars, to continue the highly successful path of post-Second World War European rapprochement and eventually forge a political union in Europe. Well, deep-seated divergences in Franco-German attitudes and behaviour have been demonstrated by monetary union. And while there's little doubt that France and Germany will patch up their quarrels, as they usually do,

we are further away from a genuine political union for the European Union than we have been for generations.

The second great motivation was to complete the single market, under the Delors programme of the 1980s – started well before the Berlin Wall fell. The slogan was “a single currency for the single market.” In fact, although stable, reliable exchange rates can certainly help cross-border trade, a totally fixed exchange rate is not necessary. Since the establishment of monetary union, the amount of foreign trade that the members of EMU carry out with each other has fallen, as a proportion of their overall trade, because of the rising share of trade being carried out with faster-growing economies outside the region, whether in non-EMU members in central and eastern Europe or in Asia. The idea that you need a single currency for a single market is plainly not true.

Third, we must recognise the long-held desire, put forward for different reasons by the French and the Germans, to provide an alternative to the dollar as a world currency. To a certain extent this has succeeded, witnessed by the No.2 spot staked out by the euro in world reserves. As already mentioned, the Chinese and other large reserve holders have a built-in desire to diversify in to the euro. This is one powerful reason why it will survive. However, despite their many mistakes and setbacks in many areas, the Americans incontestably maintain the world’s No 1 currency. This will be the case for many years to come.

The fourth reason was to keep the Germans in check as the country was reunified in 1990. Whether or not there was agreement on EMU, reunification would have happened anyway. President Mitterrand foresaw this happening (by the end of the century, as a result of Soviet weakness) nearly a decade before the seminal events of November 1989. The Delors committee mapped out a route to EMU (but with no timetable) more than six months before the fall of the Wall. As German unity beckoned, the German government thought it politic to enshrine EMU into a plan for a new Europe where the Germans would be every bit as *communautaire* as the old Federal Republic had been. The French, Italians, Dutch and others wished to see the looming power of united Germany contained through the act of emasculating the D-Mark and subsuming the Bundesbank into

the ECB. Whether this has been accomplished is a moot point. In many ways, Germany has now more political and economic clout than before. However, now the Bundesbank is being regularly outvoted in the ECB council. So in one way the stratagem of wily old President Mitterrand has been vindicated. It's still too early to say whether the apparent increase in German dominance in Europe since the beginning of EMU has proven durable.

What are the 10 lessons of EMU?

1. Money needs a state, particularly when things go wrong.
2. Balance of payments deficits matter, even – perhaps particularly – in a monetary union.
3. Low interest rates coinciding with high growth encourage reckless behaviour by banks and individuals that they - and their creditors - later regret. Countries with surpluses that have lent money to those with deficits often end up bailing them out.
4. Monetary union, designed to produce the opposite, has reinforced German strength and increased the probability of a “European Germany”.
5. The repercussions of the financial crisis on Europe – even though it started elsewhere – will prove longer-lasting and more pernicious than on America.
6. If the Euro is to hold together, the Germans will need to be in charge, but it is far from clear whether they want to be.
7. As the pivotal state in monetary union, Germany is becoming more self-centered but less sure-footed, more hectoring but more vulnerable. Berlin would like to stride to the forefront of the economic governance of Europe but lacks both the self-confidence to project a comprehensive message to its neighbours and the bargaining skills to assemble them into strategic allies.

8. I apologise for mentioning Stalin in Prague, but I am minded of his formulation in the 1920s that Socialism would work only in one country. It could be that “Bundesbankism” will only work in Germany (or countries like Germany).
9. A lesson for countries like the Czech Republic that are outside EMU: my advice is that, contrary to what the Germans are supposed to have done about reunification (“Speak about it never, think about it all the time”), the Czechs should talk about EMU membership all the time, but think about it never. There’s nothing wrong with trying to meet the Maastricht criteria, but it would not be wise to seek to implement the consequences of having fulfilled them. This is where Marx comes in (Groucho, not Karl). He said: “I wouldn’t want to join a club that would have me as a member.” That applies to creditor counties like the Czech Republic. The present EMU members would like to have more creditors among their midst; yet such a club is not one which the Czechs and others such as the Danes and the Swedes are enamoured about joining.
10. Politicians and technocrats alike say it is impossible for countries to leave the euro. This is a monetary house with an entrance through a grand front door but no exit. Yet economic history – particularly in the field of currencies – is littered with unthinkable events that actually happened, whether they be Britain’s departure from the Gold Standard in 1931, the ending of the dollar’s link to gold in 1971 or the fracturing of the Soviet monetary empire into sixteen separate currencies after 1991.

It may be that a country like Greece will have to leave the euro, even though we all know it would be messy, difficult and expensive. But it is wrong to presume that such a modest unravelling would mean the unravelling of European integration. The type of Europe embraced in the Velvet Revolution – an open society of open borders, a Europe built on democracy, self-responsibility, transparency and accountability – will continue. And this will be a Europe where the Czechs – who during the past 100 years have withstood many strains and overcome many challenges – will play a full part.

As far as the currency is concerned, there is no reason why the Czechs should not eventually be involved with the new euro that may eventually emerge. For it will be a new euro. The battle to maintain the euro as it was originally conceived has been lost. The new task will be to safeguard what is to come.

I thank you for your attention.