EURO CRISIS OR EUROPEAN GOVERNANCE CRISIS?

Olga Marzovilla, Marco Mele

Introduction

The European Monetary Union is an unprecedented event in economic history: it is based on an institutional model characterized by a combination of a single monetary policy, mandated by sovereign states to an independent supranational institution, the European Central Bank, and decentralized fiscal policies, subject to the fulfillment of constraints.

This model has raised doubts and misgivings, the most relevant of which have focused on the costs of a single monetary policy address for countries that are different in terms of growth rates, inflationary pressures, public finance situations, labor market flexibility and balance of payments imbalances. The present difficulties of the EMU countries seem to confirm these doubts, fueling the conviction of a failure of the single currency and suggesting a return to national currencies.

This article rejects the aforementioned conviction, arguing that the current crisis is not yet a euro crisis, but it is a crisis of the European *governance*, which has not been able to cope with the limits of the EMU construction. This conclusion is reached through the review of the international functions that the euro has carried out since its introduction to the present.

1. The euro in the pre-crisis period: the euro emergence as an international currency

Economists agree that the emergence of a currency as an international currency depends on the market choices. These are affected by the economic strength of the country that issues them and its key role in the international exchange. Indeed, there is a clear advantage to use the currencies that are most widely employed as transaction currencies in the international private market also in international official roles. In fact, the currencies chosen as intervention currency are the most demanded in the foreign exchange market and, therefore, those mainly used in

private transactions. Moreover, the choice of a currency as intervention currency also favors its use as a reserve currency, i.e. an instrument able to form a stock of official means of international liquidity from which to draw quickly to intervene on exchange markets. Similarly, the choices of the private market may also affect the function of a currency as an official anchor for pegging. In fact, may be useful to tie national currencies to the most widely used in international transactions, in order to reduce exchange rate volatility and the risks connected with it.

In the 2002-2008 period the European currency had emerged in all the roles of an international currency as a result of the ECB and EMU stability policies. These seemed to have made the EMU a great area of stability in a global context in which the imbalance in the dollar area was worsening (Marzovilla, 2009).

The euro international role in the private market – With regard to the private market, the affirmation of euro international roles was particularly evident on the foreign exchange market. In April 2007, the European currency was second, after the dollar, in the ranking of most traded currencies. Indeed, 37% of all transactions in the foreign exchange market was in euros, compared to 86,3% in dollars, 16.5% in yen and 15% in the pound (BIS, 2007).This result is largely due to the growing euro role as a transaction currency, closely related to the positive effects of economic integration and EU enlargement processes.

In the capital market, in particular, the European financial market integration was the most important result arising from the euro introduction (Forbes, 2005; Bertuch-Samuels, 2006; Jappelli, Pagano, 2008; Lane, Wälti, 2007).

The EMU financial system, as measured by the sum of the value of stock and bond markets and of commercial bank assets (53 trillion dollars) has been similar to that of the U.S. (57 trillion), and significantly higher than that of Japan (20 trillion) (EC, 2008, p. 219) since the end of 2006.

Integration effects were particularly visible in the international debt market. In fact, the share of euro-denominated debt securities in total debt securities held in all currencies rose, at constant exchange rates, from 24.7% in 2000 to 26.2% in 2008, while the dollar weight decreased slightly. More significant was the euro's share increase in the narrow measure of international debt securities, i.e. those issued outside of EMU countries. It rose, in the same period, from 25% to 30%, compared with a smaller dollar's share increase, from 42.5% to 44.8% (ECB, 2012). Even the significant convergence of interest rates in the interbank market and on government bonds and the greatest uniformity observed in stock prices proved greater financial integration reached by the euro area. In addition, the euro's share, net of valuation effects owing to exchange rate fluctuations, increased in the derivative markets. In the market for OTC traded interest rate the share was of 39% in April 2007, compared with 32% for the US dollar.

Finally, the stock of euro banknotes held outside the EMU rose gradually and reached the upper end of a range of 10% to 20% of total currency in circulation by end-2007 (ECB, 2008).

The euro official international roles - In the pre-crisis period, the euro also emerged as an international currency at the official level.

Its role as a *reserve currency* increased rapidly. During the 1999-2009 period the share of the euro-denominated official reserves went up, to current exchange rates, from 17.9% to 27.7% of the total, compared with a fall in the dollar from 71% to 61.8% (ECB, 2012) [1]. This result was essentially due to an increasing diversification of reserves favoring the euro that the new accession European States, French-speaking African countries and different developing and emerging countries in the area dollar did. Specifically, the share of euro-denominated reserves in developing countries rose from 19.6% in 1999 to 30.1% in 2003 and then it stabilized around this level until 2009. In contrast, the weight of the dollar fell gradually from 68.5% to 58.6% in the same period. Indeed, the growing gap between the U.S. balance of payments deficits and the surplus of many emerging economies, whose currencies are pegged to the dollar, increased the risk of capital losses related to the detention of dollar-denominated reserves in the case of a possible dollar depreciation, thus favoring the diversification in euro.

As well as in the euro area and in its neighboring countries, where the European currency is the anchor of about fifty countries, before the explosion of the financial crisis in the United States, euro use as an anchor for currency peg also increased in the dollar area. The cases of Kuwait and China are particularly significant. Kuwait has moved from a dollar peg regime to a basket peg, in which there was the euro, since May 2007; Russia has anchored the ruble to a basket of euro and dollars since February 2005, gradually bringing the weight of the European currency from 10% to 45% in 2007. Also several studies have confirmed this conclusion (Cobham, 2007; Ogawa and Yoshimi, 2008; Mele, 2010). The Mele's study, in particular, using an estimation model in time series, reinforced by the use of the Kalman filter and based on the quadratic partial coefficient analysis, has verified that in 2010 the euro weight in the Chinese basket peg was 28%, compared with 71% of the dollar.

Although there are no official data that allow estimation of the currency intervention role of a currency, its ability to fulfill this function emerges indirectly from the characteristics of exchange rate regimes adopted by countries. Indeed, to the extent that a currency is chosen as an anchor for pegging, it will likely be also used as an intervention currency. Thus, it is possible to think that, due to the greater

[1] Data understate the actual size of reserves because several emerging and developing countries, including China, do not communicate the currency composition of their reserves to the IMF.

use of the euro as an anchor currency, it has also increased its role as intervention currency in the period under review.

2. The euro in the financial and economic crisis

The crisis explosion, in 2008, braked the internationalization process of the European currency. Although the crisis began in the United States, it spread rapidly into Europe, affecting the banking system, full of U.S. toxic assets, and imposing its bailout. The result was the rapid deterioration of European public finances and the start of speculative capital movements which, in order to avoid situations of default and contagion, led to employ restrictive fiscal policies. The consequences of these policies were severe recessionary effects on global demand and the employment of weaker euro-zone economies.

The spreading of the crisis has revived the risks, already signaled by economists, connected to a single monetary policy address for countries divided politically and socially, and structurally very different. Indeed, the crisis has affected in different ways the EMU economies, demonstrating their inability to cope with asymmetric shocks, as theorized by the literature on optimum currency areas, and also with the same shock. This has undermined confidence in stability of the euro area and has given rise to a withdrawal of the euro international roles.

With regard to the reserve currency function, the euro's share on the total reserves held by central banks declined from 27.7% in 2009 to 23,9% at the end of 2012, compared with a broadly stable dollar's share at 61,9%. The reduction in the euro incidence was higher in developing countries, where the euro's share dropped from 30.2% to 24,2% (ECB, 2013).

Also the euro role as an anchor for currency peg is decreased. In this regard, a study (Mele, 2012) shows that the euro incidence in the Chinese basket fell from 28% to 8.4% in the 2010-2012 period, compared to an increase in the dollar weight, from 71 to 81,5%, and an upward trend in the weight of other currencies.

In international private markets, furthermore, according to the narrow measure, the euro's share of international debt issuance decreased from 30% of total stock in 2008 to 25.5% in 2012 . By contrast, the US dollar's share increased from 44.8% to 50.9% (ECB, 2013).

Overall, the European experience has shown that it is easy to lose the trust of the rest of the world if a single currency is not efficiently governed and if the political unity and a consolidated statement of the currency as an international currency, which propitious hysteresis phenomena as in the case of the dollar, are missing.

However, at present, the easing of the trust does not yet mean the euro crisis, but it means a crisis of EMU governance. Indeed, despite mounting tensions, the euro has retained its international positions at the private level. In particular, its use has continued to increase in foreign exchange markets. The euro was the counterpart in 40% of all currency exchange in 2012, while the dollar's share was around 90%. In addition, on the same date, foreign demand for euro banknotes was growing at a higher annual rate (11,1%) than banknotes in circulation within the euro area (2,7%), due to the strong demand of non-EU European countries, Russia, Middle East and Africa (ECB, 2013**)**. Finally, the European currency was the main denomination currency of foreign deposits in Central, Eastern and Southeastern Europe countries (CESEE).

All this shows that, despite the current crisis, with reference to the euro, one of the essential conditions for the internationalization of a currency still exists, namely that relating to the size, diversification and the trade openness of the country that issues it. In fact, *ceteris paribus*, if its GDP is large and its economy is diversified and open, the people using its currency in the international exchange, in order to reduce transaction costs, will be great. This fosters the affirmation of that money in the international private market and, consequently, in all other functions of an international currency.

In this context, EMU is an integrated and diversified economic area, with a GDP similar to the U.S., and a trade openness and a population larger than the USA. In addition, the progress of the integration process and the EU eastern enlargement have resulted in an increasing trade not only within the euro-zone and the European area, but also with countries traditionally belonging to the dollar area, such as China. The EMU trade openness (86%), measured by the sum of exports and imports to GDP, significantly exceeds those of the United States (31.6%) and Japan (32.66%). In addition, the euro area has retained its position as the largest exporter in the world, while the relevance of the U.S. has declined. In fact, the share of EMU exports on total world exports was 27.3% in 2011, compared to 8,2% of the United States (UNCTAD database). Additionally, EMU, together with Japan, is the largest exporter to China.

The above results are very important because they demonstrate the success achieved by the long European integration process at the level of the real economy. Unfortunately, severe tensions and imbalances are occurring within the EMU, where the integration degree has reached its peak, reducing the cohesion between the members and threatening to undermine the whole European construction. These tensions, however, are not the result of the failure of the European real economic integration process, but they are deriving from the monetary limits, that an inadequate European governance has failed to fill.

The first major limitation of the European monetary construction has been the admission in the EMU of countries that were not able to bear the cost of a single address of monetary policy, due to conditions of their public finances and /or their structural delays.

The second limitation was the introduction of rigid monetary and fiscal constraints, in the illusion that they would favor the convergence of the real economies of member countries. Instead, they have hindered the use of main economic policy strategies, limiting possibilities to cope with the great crisis of the new century.

In the construction of the EMU, monetary policy has been attributed to the ECB, whose primary objective is price stability and cannot subscribe government bonds on the primary market to help countries in difficulty. The rule of *no bail-out* is fully justified in view of the monetary and fiscal discipline that it can foster. However, it has offered an environment of certainty to destabilizing speculation, in the presence of highly integrated financial markets, capital flows highly speculative and large differences in the public finances of the countries. Thus, speculation has had an easy game in attacking the weaker euro-zone economies, increasing interest rates on their sovereign debt, with negative consequences on public finances and serious repercussions on growth and employment. The constraints placed on the use of fiscal policy by the Maastricht Treaty, first, and by the Stability and Growth Pact and the Fiscal Compact, later, have decisively contributed to the previous result. In addition, the exchange rate policy has been subordinated to price stability needs, leading substantially to establish a flexible exchange rates system in which the euro exchange rates are determined as a residual compared to that of other great actors acting on international markets, often with speculative purposes. In conclusion, when the largest international crisis of the last eighty exploded, the EMU countries founded themselves without of economic policy instruments needed to manage it and with economies and economic problems quite different between them.

However, an effective European governance - capable of reaching rapid, shared and supportive actions and to give precise indications to markets - could have offset the effects of these limits. Instead, the answers to the difficulties of the member countries have generally been partial, conditional and delayed. They have been taken between different positions, after lengthy discussions and negotiations, which have revealed the deep divisions that exist between euro-zone members and the prevalence of national interests over those of the EMU. This has contributed to undermine the credibility of the European institutions actions, weakening also the second necessary condition for the affirmation of a currency at the international level, namely the stability and solidity of the institutional framework of the economy that issues the currency. Nevertheless, the reduced confidence in the

action of European governance has not yet compromise the trust in the euro, which is based on the economic strength of the EMU area.

3. Concluding remarks

The transmission of the effects of the U.S. financial crisis in Europe has highlighted the limits of European monetary construction, spreading fears about future of the euro. However, at present, its tightness on the international monetary markets is still solid, because one of main conditions necessary for the affirmation of a currency as an international currency still persists, i.e. the EMU economic strength: its size, its diversification, its trade openness. The crisis, however, has undermined a fundamental prerequisite for the affirmation of a currency at an international level, namely, confidence in the ability of institutions that govern the economy issuing the currency to ensure a stable growth and to compensate with an efficient and timely action the negative effects related to the limits of monetary construction. To exit from the crisis affecting the EMU countries it is necessary to regain this trust, but this requires a supportive and cooperative governance, as well as severe, which is able to cope with the limitations of an imperfect monetary construction, without jeopardizing the benefits obtained with the economic integration process.

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SUMMARY

The present difficulties of the EMU countries are spreading the conviction of a failure of the euro, suggesting a return to national currencies. The article rejects this conviction, arguing that the current crisis is not yet a euro crisis, but it is a crisis of the European *governance*, which has not been able to cope with the limits of the EMU construction. This conclusion is reached through the review of the international functions that the euro has carried out since its introduction to the present.

Olga MARZOVILLA, Full Professor of Economics, Rome University of International Studies (UNINT), olga.marzovilla@unint.it

Marco MELE, Researcher in Economic Policy, Rome University of International Studies (UNINT), marco.mele@unint.it