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The Euro has a Future

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ABSTRACT Even before its creation the future of the euro seemed to be in jeopardy. The economies in the euro area were losing currency trade as an adjustment tool without however being able to take advantage of any other mechanism that would enable them to absorb economic crises.

However the euro has become the most traded currency after the dollar and the enlargement of the euro area has increased its economic weight.

Greater awareness and the differential in the monetary policy of the euro area and the US lend promise to the future of the euro. In addition to this crises usually provide the impetus for institutional progress in Europe. However we should not deceive ourselves, the European Union still has to cross some areas of turbulence since its governments are postponing the moment when they will have to choose a sustainable, coherent growth model.

INTRODUCTION

Although the problems in hinging together monetary and budgetary policies weaken the European currency, its undeniable status as an international currency should enable it to recover the dividends of the disaster course in terms of the American monetary policy.

Indeed by continuing to monetize public debt the President of the Federal Reserve is diminishing the value of the dollar and above all he is throwing doubt over the future value of the real effective exchange rate of the very same dollar.

The Governor of the European Central Bank opted for currency stability by focusing his monetary policy on liquidity supplies. It is quite possible then that Jean-Claude Trichet will win his "bet", thereby enhancing the international nature of the euro.

Moreover the Greek crisis was overcome thanks to greater budgetary integration on the part of the European States. Recent events are helping towards strengthening the euro's future. But at the end of the day its fate depends on the institutional future of Europe and the dynamism of the European economy. It is therefore vital that EU governments do not miss their target if they want to set the euro sustainably amongst the international currencies which count [1].

THE EURO, A INTERNATIONAL CURRENCY IN SPITE OF THE INCOMPLETE NATURE OF EUROPEAN INTEGRATION

The euro has become an international currency because it is used by non-residents for commercial and financial transactions. Indeed the European currency represents 22% of the foreign currency assets of non-resident banks and 27% of Central Banks' official foreign exchange reserves. In addition to this the euro is one of the most frequently used currencies in currency exchange transactions. Its market share has grown since the reduction in the use of the dollar has benefited the European currency which gained two points between 2007 and 2010 to reach a 39% market share against 85% for the dollar; the sum being 200% since the transaction implies two currencies simultaneously.

Further to this with the dollar, the euro is the privileged currency employed in the issuance of debt: in the fourth quarter of 2009 29.8% of international debt instruments were issued in euros and 38.2% in dollars. In short the European currency is used as a peg by 48 countries or territories against 51 for the dollar [2].

However emphasis is often placed on the euro's weaknesses which arise from a lack of budgetary policy coordination and the incomplete nature of European integration. Indeed Mundell [3] indicated that the building of a monetary area, i.e. the removal of currency exchange flexibility between countries could only be envisaged if labour market flexibility within

1. Initially this text was published in the review Sociétal, in the first quarter of 2011. We would like to thank Jean-Marc Daniel for having allowed us to reproduce this article.

2. Cobham, 2007

3. 1961

the area was sufficiently high so that adjustments between any remaining national economic areas could be made. If this was not the case it would be necessary to establish a federal governance system in order to correct growing differences in the wake of a crisis. For example in the event of an oil crisis the most seriously affected economies in the euro area would be those with the greatest energy dependency. It would then seem appropriate to implement a budgetary support policy in these countries in order to underpin their domestic demand. Indeed the "exchange" instrument is no longer available and monetary policy intends rather more to limit the effect of symmetrical crises, i.e. those which affect all countries in the area equally.

The original choice made in building Europe was to integrate European economies so that long term they converged to form an optimal monetary area.

The Maastricht Treaty was a decisive stage in this but its ambition stumbled over the draft Bolkestein directive and the jealous protection of national competences. The draft proposal on services within the internal market, adopted by the European Commission on 13th January 2004 before it was communicated to Parliament and the Council was part of the Lisbon Programme launched in 2000 "to make the European Union the most competitive, dynamic economy in the world by 2010". It aimed to facilitate the movement of services within the EU notably with regard to the freedom of establishment on the part of service providers and also with regard to the possibility for any European service provider to undertake cross-border transactions without being established in the State where the service was being provided. Hence the integration process would have continued thereby helping the economic management of the euro area in the event of an economic crisis. Its deferment comforted the idea that a status quo was being maintained and which might be summarised as follows: single currency, halt to integration, national assertion. From this time on the credibility of the European currency would be questioned during a crisis, the repercussions of which would differ from country to country in the euro area. The European currency's lack of stability-predictability [4] would condemn it to remaining local tender.

4. Hayek defined the two features of a currency with international status : liquidity-acceptability and stability-predictability

THE CRISIS COULD WEAKEN THE DOLLAR WHILST EUROPEAN BUDGETARY INTEGRATION COULD STRENGTHEN THE EURO.

Although the lack of coordination in budgetary policy effectively weakens the European currency nothing however has yet been set in stone. For the time being it is impossible to foresee the outcome of present monetary policies; but it is quite possible that the choices made by the European Central Bank will strengthen the euro's international nature long term to the detriment of the dollar and will improve its reserve currency status.

A currency's exchange rate is determined by countable balance and imbalance in the balance of payment, but also short term by the differential in interest rates and anticipated monetary policy.

The crisis has changed matters since it has led monetary authorities, particularly the American, British and Japanese, to include a non-quantitative chapter into their traditional monetary policy of reducing key interest rates. This comprises the purchase of assets and emerges in the monetization of the public debt. Now the differential in interest rates no longer suffices to explain developments in the currency exchange market, notably in terms of the euro against the dollar.

Indeed the decision taken by some Western Central Banks to purchase unsterilized assets is inevitably leading to further expansion of the monetary base which tends, via anticipated inflation, automatically to depreciate the value of the currency of the country in question with regard to the currencies of countries which are not implementing a similar monetary policy. Hence the prospect of relative price rises, that may automatically result, reduce any real future yield which furthers the depreciation of the exchange rate of the country concerned.

A mechanism like this is all the more evident for the nominal effective exchange rate on the dollar since the Federal Reserve is undoubtedly the Central Bank which has implemented the most aggressive quantitative easing policy. This development is incidentally more significant for the euro/dollar exchange rate in a context in which the European Central Bank has committed to purchasing assets on a smaller scale than the Fed and has decided to sterilise such a purchase.

Hence three periods of significant decline in the effective exchange rate of the dollar have gone hand in hand with

announcements of quantitative easing measures by the Federal Reserve. The first came at the end of November 2008 when the American Central Bank indicated that it intended to purchase assets and agency mortgage-backed securities (MBS) issued by government agencies; the second came in March 2009 when it announced that it was going to purchase 300 billion $ in Treasury securities by the autumn; then in September 2010 it intimated that it was about to launch a new programme to purchase government bonds which finally totalled 600 billion $.
Although this kind of policy could be justified from the point of view that the President of the American Central Bank had observed a risk of deflation, this may lead to a loss of confidence in the dollar which might then gradually lead to doubt being cast over its status as a reserve currency status. Conversely the European Central Bank has privileged an exit to the crisis via the steepening of the interest rate curve. Short term this kind of policy can weigh on economic activity but it facilitates the stabilisation of bank balances and the recovery of fractional reserve banking. This prevents a reduction in the value of the currency, which can be seen as a means to guaranteeing the "stability" of the European currency long term and therefore preserve its status as an international currency as strengthen its reserve currency status.
Moreover, the crisis forced governments to make up for the inadequacies in European integration and has improved "the predictability" of the Euro. Member States overcame their institutional reticence to palliate Greece's insolvency. Not only did the European Central Bank decide to purchase both public and private sovereign bonds on the secondary market but the Heads of State and government created a European Financial Stability Facility in order to ward off any danger of the restructuring of a Member State's debt.
Of course the latter decision took time to take; but the difficulty of the subject justified this. Indeed by creating this fund European countries were implicitly exercising a reciprocal guarantee over their public debt by improving the debt ratings of the most distressed countries. And in order to encourage these countries to balance their public finances it was necessary to define a new means of budgetary policy governance since the Stability and Growth Pact and the broad economic policy guidelines (BEPGs) had demonstrated their limits.
Finally the European Commission took advantage of the crisis to put forward audacious budgetary proposals thereby opening the way to major progress in European integration. Indeed until now budgetary questions remained within the realm of national competence. By putting forward a complete set of legislative proposals that aimed to "extend and improve Member States' budgetary supervision" the European Commission entered the national domain. The next stage would be for this to become a community domain.
Decisions therefore seem to depend on proposals exclusively put forward by the Commission and are to be taken by the qualified majority which would facilitate the continued strengthening of economic governance in the European Union.
Consequently the divergence in monetary policy between the US and Europe could speed up the international development of the euro; the Greek crisis has improved European integration and has enabled Member States to take further step towards federalism. Isn't the loss of sovereignty of the part of Greece and Germany as a result of the creation of the European Financial Stability Facility (EFSF) proof of this? The end of this story is far from being written and the future of the euro seems to be reinforced thanks to a stronger "stability" and "predictability".

THE EURO HAS A FUTURE IF THE EUROPEAN GOVERNMENTS DO NOT MISS THEIR TARGET: A DYNAMIC AND SUSTAINABLE GDP GROWTH

Although economic theories show that the European alternative boils down to continued economic integration or a more federal management of the euro area we must not forget that the future of the single currency depends above all on economic dynamism.
However the recent crisis has shown that certain governments have benefited from European integration to implement growth strategies which are open to criticism to say the least. For example creation of the euro led to a reduction in financing costs particularly in Spain, Portugal and Greece. Between 1999 and 2007 the average real key rate of the Central European Bank per year was -0.2% in Greece, -0.1% in Spain and -0.1% in Portugal against 1.2% in France and 1.5% in Germany.
Moreover the real yield in 10 years lay at 1.3% in Spain and 1.6% in Portugal and Greece per year on average

whilst it lay at 2.6% in France and 2.8% in Germany.
Nothing prevented the Governments of these countries from using these lower real interest rates to apply the Lisbon Programme put forward in 2000 and to invest in research, development and training. But some, like the successive governments in Spain, preferred to help economic distortion in support of the real estate sector which is more sensitive to interest rates. The free distribution of profits associated with the creation of the euro area was more or less successful but it led to national growth strategies. Hence the European crisis is not just the result of a problem of European governance but also of the democratic process. For the time being European governance has been responsive and strong enough to compensate for national inadequacies by pooling the sovereign risks. But this is time for the main European governments to really improve the sustainability of their public finance and change the source of GDP growth.
Greater European integration cannot solve divergence in national growth strategies or prohibit GDP growth by debt strategies This is why it is now urgent to define the framework to limit choices in terms of budgetary policy. It is likely that the proposals put forward by the Task Force led by President of the European Council, Herman Van Rompuy will take this direction. Achieving a balance between public spending growth rates and GDP growth would undeniably be a major step forward since it would help towards improved coherence of active growth support policies. But in the first half of 2010 GDP growth was higher than expected in the euro area and with the purchase of sovereign bonds by the European Central Bank the budgetary vice has slackened its grip somewhat. Governments were therefore able to find a less restrictive compromise.
Greater awareness and the differential in the monetary policy of the euro area and the US lend promise to the future of the euro because the European currency "stability-predictability" has improved. Therefore, its international nature as its reserve currency status could be strengthen However we should not deceive ourselves, the European Union still has to cross some areas of turbulence since most of its governments are postponing the moment when they will have to choose a sustainable, coherent growth model not only based on private or / and public debt.

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