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Schroders TalkingPoint

The next steps for the euro: what is needed to ensure its survival?

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The near term outlook for the eurozone remains bleak, with the latest International Monetary Fund (IMF) forecasts showing 2013 as another year of falling output for the region. Better growth is desperately needed and there is a case for more cyclical support through easier monetary policy, but there are also structural obstacles to stronger growth. Unless these are addressed, any pick-up in growth will ultimately flounder. In this Talking Point I look beyond the near term cyclical challenges and consider what the eurozone needs to do to ensure its long term viability.

Fault Lines

There are two areas the eurozone needs to address; both can be seen as fault lines in the design of the common currency, although they are not unique to the eurozone.

Divergence rather than convergence

One of the fault lines to address was predicted before the single currency even started and is the divergence in economic activity which results from a one-size-fits-all monetary policy. Prior to the formation of the euro this was often referred to as the Walters critique (after Baroness Thatcher's economic advisor Sir Alan Walters), where one interest rate across the region would create different inflation rates and hence gains and losses in competitiveness. These would then be reflected in divergent economic performance as those who had improved their competitiveness ran trade surpluses while the rest saw increasing deficits.

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Such a pattern soon became apparent in the eurozone with low inflation Germany and the core countries enjoying increasing trade gains as the periphery sank into deficit. There was some convergence of income per head across the region, but this was accompanied by growing imbalances. Prior to the financial crisis such imbalances were easily financed as cross-border lending accelerated. After the crisis capital flows dried up and went into reverse as banks cut their exposures. Countries running current account deficits then struggled to attract capital, interest rates rose and they were driven into recession.

Having abolished their exchange rates the peripheral nations have struggled to regain competitiveness and the imbalances have persisted. Although there has recently been a narrowing in trade imbalances, this has largely been a function of recession and savage cuts in imports in the periphery, a situation which is not sustainable.

Lasting convergence between the eurozone economies has proved elusive, but as we have seen in other single currency areas, such as the US and UK, regional divergence can persist not just for years, but decades. Think of Scotland and the South East of England in the UK, or the North East and the US southern states. Even with a common language and culture there is not the flow of capital or labour to iron out regional disparities.

The currency unions in the US and UK have proved durable largely because they have a fiscal mechanism which recycles surpluses to where they are needed through public spending and taxation. Such a redistribution is made possible and acceptable by a political union. One reason why the euro has been described as a political project is because it is implicitly recognised that ultimately, the institutions needed to ensure its survival require a political mandate.

Whilst we may eventually get to European political union and a common exchequer for the eurozone, there is no mandate for it at present. So we have to find other means of redistributing the gains and losses. Arguably, this is the direction we have been moving in with the bailouts. Although officially these are loans, the softening of terms to Greece – and now Ireland and Portugal – means that there will be a future transfer from core to periphery through below market interest rates and favourable repayment terms.

This is burden sharing on a case by case basis and yet even with the European Financial Stability Facility (EFSF) and its successor the European Stability Mechanism (ESM) bailout fund in place, there is no automatic mechanism to redistribute surpluses and deficits. Instead each bailout is considered separately, often accompanied by a damaging confidence-sapping crisis.

Eurobonds

One means of moving closer to a fiscal union would be to issue Eurobonds, effectively mutualising the guarantee on the public debt of eurozone counties. The aim would be creation of a euro-area safe asset, where sovereigns would be jointly liable for debt. Not all public debt would have to be mutualised. Instead, it could be split such that the mutualised part would be senior to the non-mutualised part.

Eurobonds also create winners and losers. Germany and the core would be sharing their credit rating and have to pay higher rates of interest, the periphery would enjoy a lower interest rate than if they issued debt in their own name. Currently, Germany has ruled this out.

However, Eurobonds might be acceptable if conditions were attached so that states would lose the freedom to issue debt at will. For example, members wishing to issue Eurobonds would require pre-approval of their budget plans. In this way, the policy system would move from the existing framework of ex-post sanctions in case of infringement of common rules, to a frame-work of strong ex-ante control. Should a draft budget fail to meet common principles, the euro-area partners could veto it before it came into force.

Banks and Sovereigns

The second fault line was not anticipated prior to the creation of the euro: the fact that banks and their sovereigns are inextricably linked such that their debts need to be considered together rather than separately. Banks and Sovereigns each have the potential to bring the other down and the eurozone has had cases of both, with banks in Ireland and Spain bringing crisis upon the sovereign and vice versa in Greece.

In many ways this is a surprising oversight as a long view of history shows that banking and sovereign crises have often gone hand in hand as governments are either forced to bail out their banks to prevent a fatal contraction of credit, or bank balance sheets are undermined by the collapse of the sovereign. Indeed there was just such a crisis within Europe during the 1990s when the Swedish government stepped in to rescue its banking system. However, rather than acknowledging this link, the focus of eurozone policy from Maastricht to the fiscal compact has been solely on public debt limits, thus ignoring the likelihood that the government may have to take on a significant portion of the private debt.

It has proved very difficult to break this link as once a banking crisis has infected the sovereign, the fall in the creditworthiness of government debt further undermines banks' balance sheets, creating a downward spiral. One means of stopping the negative feedback loops would be to build a banking union, which could create a level playing field across the eurozone and help break the vicious cycle linking banks and sovereigns.

This seems to be where we are heading and progress is being made in terms of the appointment of the European Central Bank (ECB) as the region's supervisor and on which banks will be covered. However, the more important issues involve the organisation of a resolution mechanism when banks fail and the nature of deposit insurance. Neither have been settled and both require a means of pooling the resources of the wider group.

So we are back to fiscal union, but limited to a certain type of contingent liabilities. Any banking union will involve the European authorities in distributing bank losses between shareholders, creditors and depositors, as well as between national and European partners. As we have seen, these are very political choices.

Banking union would also help address the fracturing of the euro financial markets. At present, the euro fails to meet one of the key conditions of a single currency in that the trust inspired by a deposit should be the same regardless of its jurisdiction. Today not all euros are equal in this respect. Euros in German banks are more secure than those in the periphery. At the extreme, this has been brought into focus by the Cyprus bailout where depositors were made to share in the bail-in and now face capital controls.

Outlook

So should we be optimistic about the ability of the euro to address these fault lines? On the face of it: probably not. The proposed solutions both involve some form of fiscal union and Germany has already ruled out any cross subsidisation. There may be progress on banking union, although Germany has made it clear it should only deal with new, not old legacy problems.

But that does not mean the end of the matter.

As the euro crisis has evolved, it has become increasingly apparent that Europe makes progress through a series of crises. Only when faced with the prospect of the system breaking down do we discover what is a non-negotiable line in the sand from a bargaining position. As financial markets have found, brinkmanship is an integral part of politics and hence the resolution process.

However, one of the side effects of the ECB's policy of flooding the markets with liquidity (actual or threatened) and reducing market volatility has been to reduce the risk of a crisis. Peripheral bond spreads have continued to tighten as investors hunt yield, believing that the ECB stands behind them. Clearly such action has created a much needed breathing space for the euro, but by removing the danger of crisis it has taken the pressure off governments to take action.

Germany and the other core countries (Benelux, Finland and France) have benefitted from the trade gains created by the single currency and are now benefitting indirectly from the crisis through extraordinarily low levels of interest rates. According to Deutsche bank, Dutch government bond yields are at their lowest for 500 years! The route to a sustainable euro will involve persuading the core to give up some of these gains on rates for higher growth and a stable euro over the medium term.