

LSE European Institute – APCO Worldwide Perspectives on Europe Series

# Europe's Unfinished Currency: the political economics of the Euro

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# EUROPE'S UNFINISHED CURRENCY

THE POLITICAL ECONOMICS  
OF THE EURO



THOMAS MAYER

*“I believe the euro can work, but only if we repair its faulty original architecture in the right way. A new framework for the euro must be based on two elementary principles: first, the euro must be a nonpolitical currency, shielded from any form of fiscal dominance by EMU member states; second, sovereignty and liability in essential fiscal policy matters must be firmly aligned at the national level.”*

Thomas Mayer  
Senior Fellow, CFS, and Senior Advisor to Deutsche Bank

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AN DER GOETHE UNIVERSITÄT FRANKFURT  
HOUSE OF FINANCE

# 1. A Question of War and Peace

- The EU was the answer to the consequences of the Versailles Treaty
- Early on a common currency was seen as a means to achieve political union in Europe

## 2. No longer a Question of War and Peace

- The fall of the Berlin Wall and the Soviet Union removed the threat of war from Europe and strengthened Germany's position in Europe
- EMU was now a means to anchor Germany firmly in western Europe
- PU was seen essential for EMU, but the ICG on PU failed
- EMU went ahead nonetheless

### 3. A History of Failures

- *„There is no example in history of a lasting monetary union that was not linked to one state.“* Otmar Issing in 1991
- Previous monetary unions failed because of a lack of fiscal and monetary discipline
- Fiscal discipline among sovereign states requires the alignment of financial sovereignty and liability
- The fiscal policy framework of EMU was a failure

## 4. The Euro's Happy Childhood

- Although the criteria for an optimum currency area were ignored and the Maastricht criteria for EMU entry not strictly enforced, EMU had a successful first decade
- Cheap credit was the glue that held EMU together
- When the credit bubble burst, EMU became unglued

# GDP growth was satisfactory...



Source: DB Research

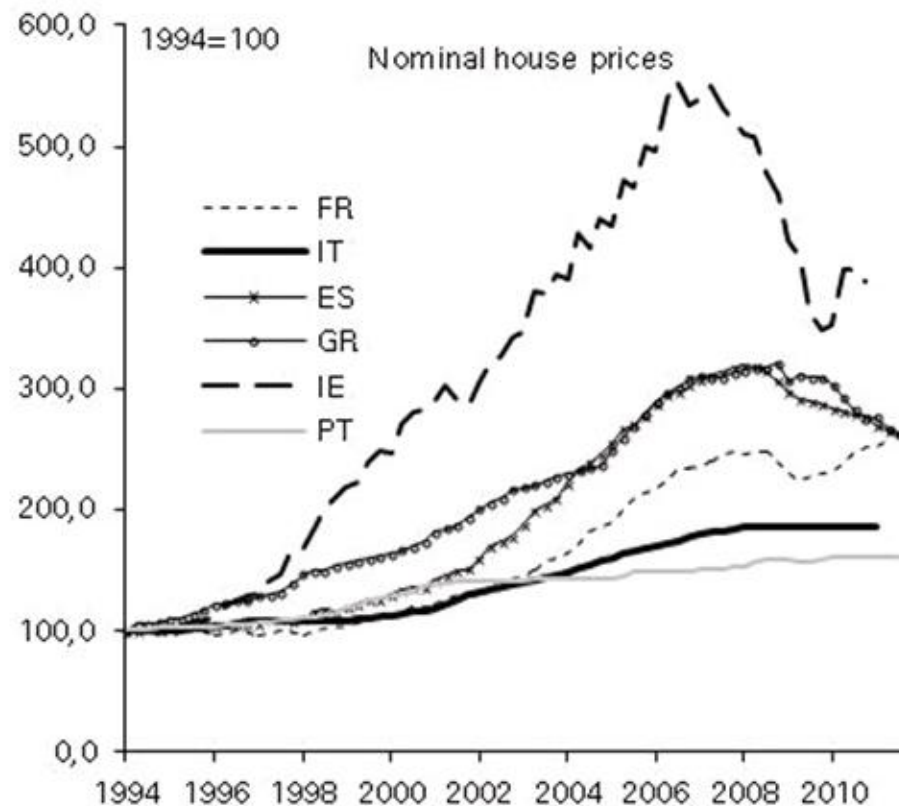
## ...and inflation on target



Source: DB Research

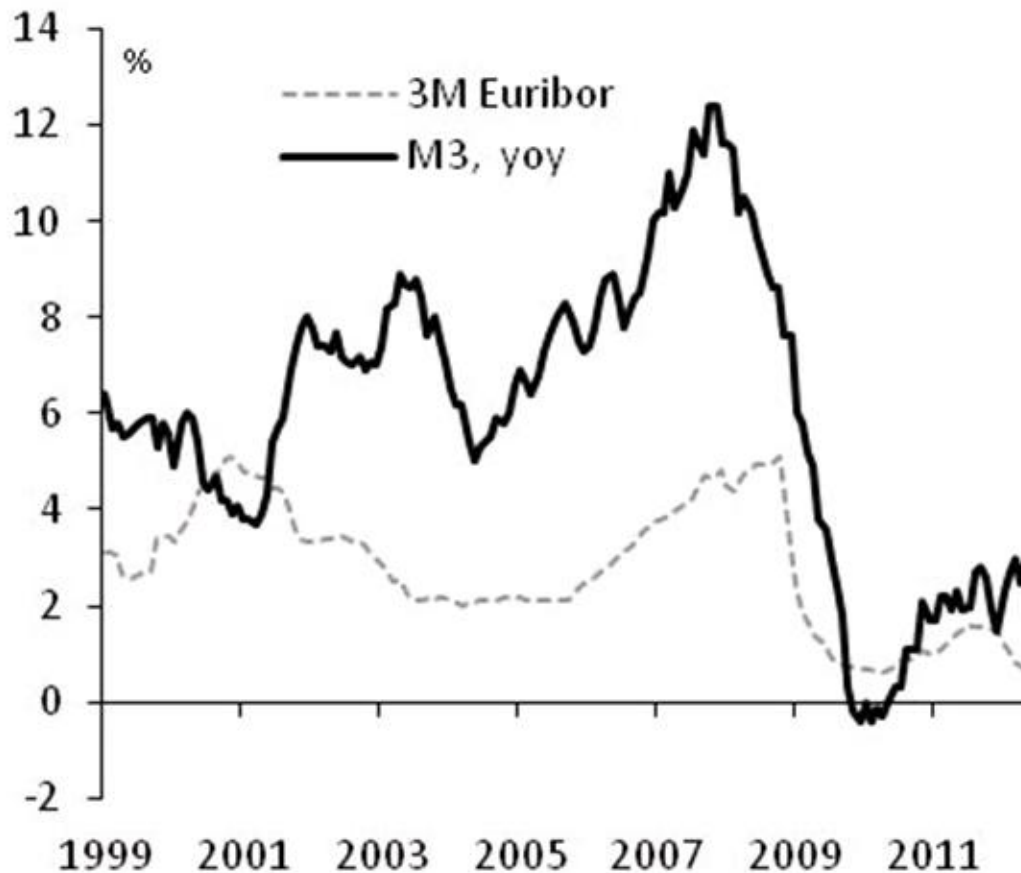


## Interest rate convergence led to a housing boom in some countries



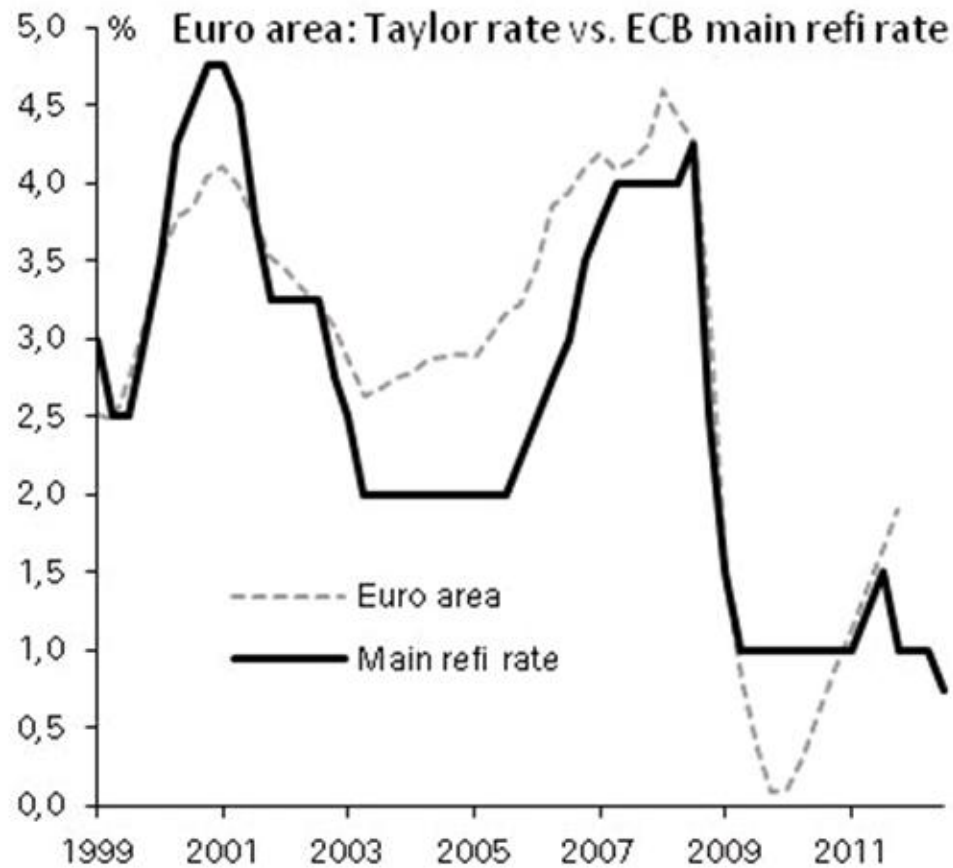
Source: DB Research

# The ECB paid only lipservice to money growth...



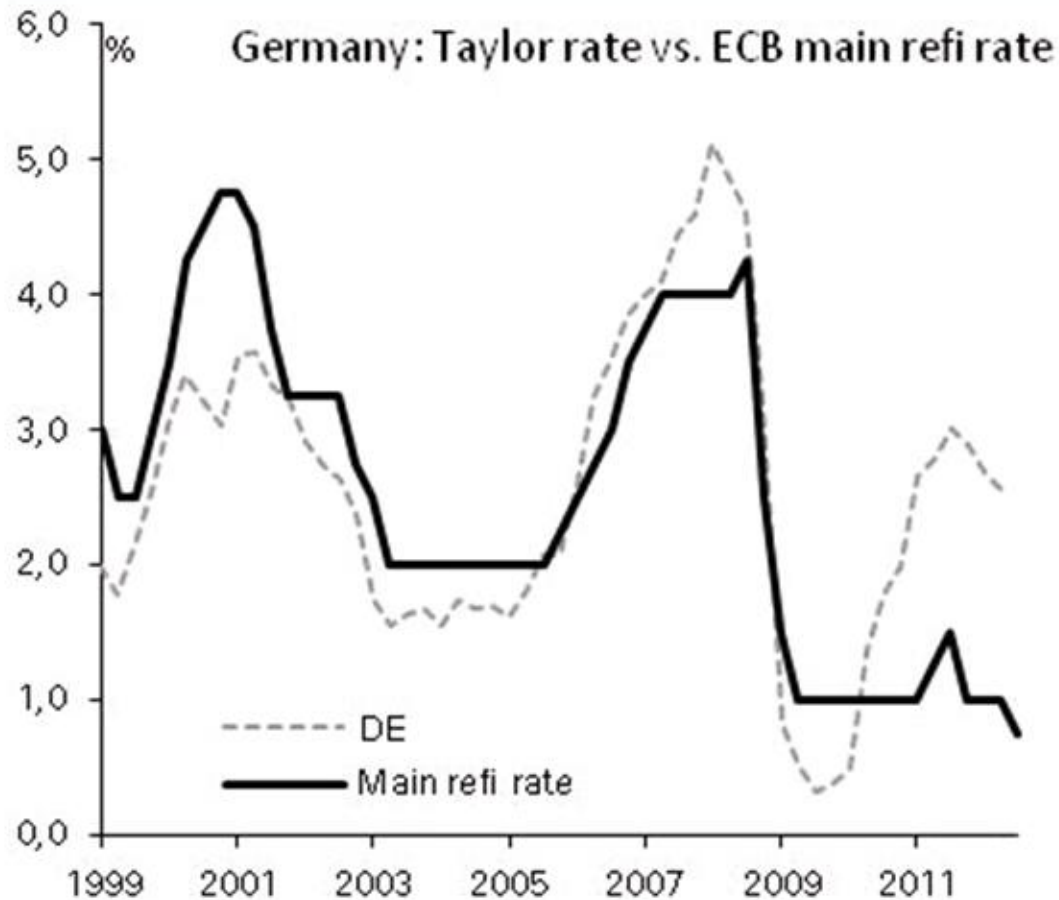
Source: DB Research

## ...and followed the Taylor Rule...



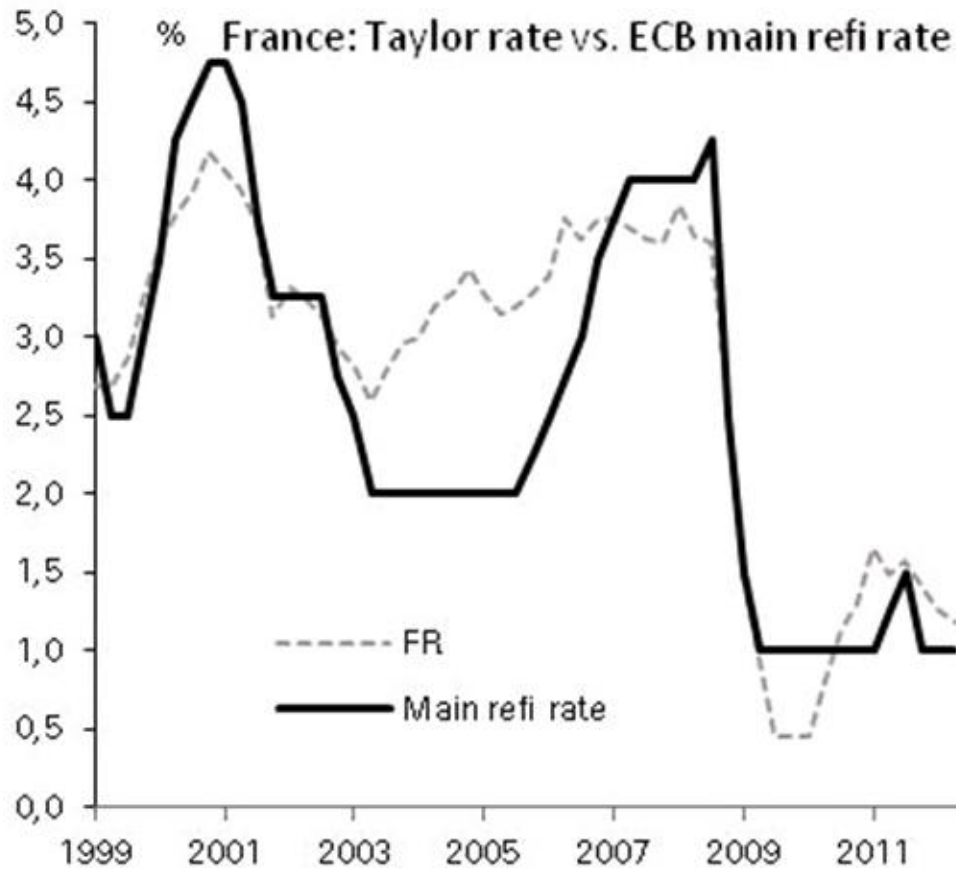
Source: DB Research

## ...with a bias towards Germany...



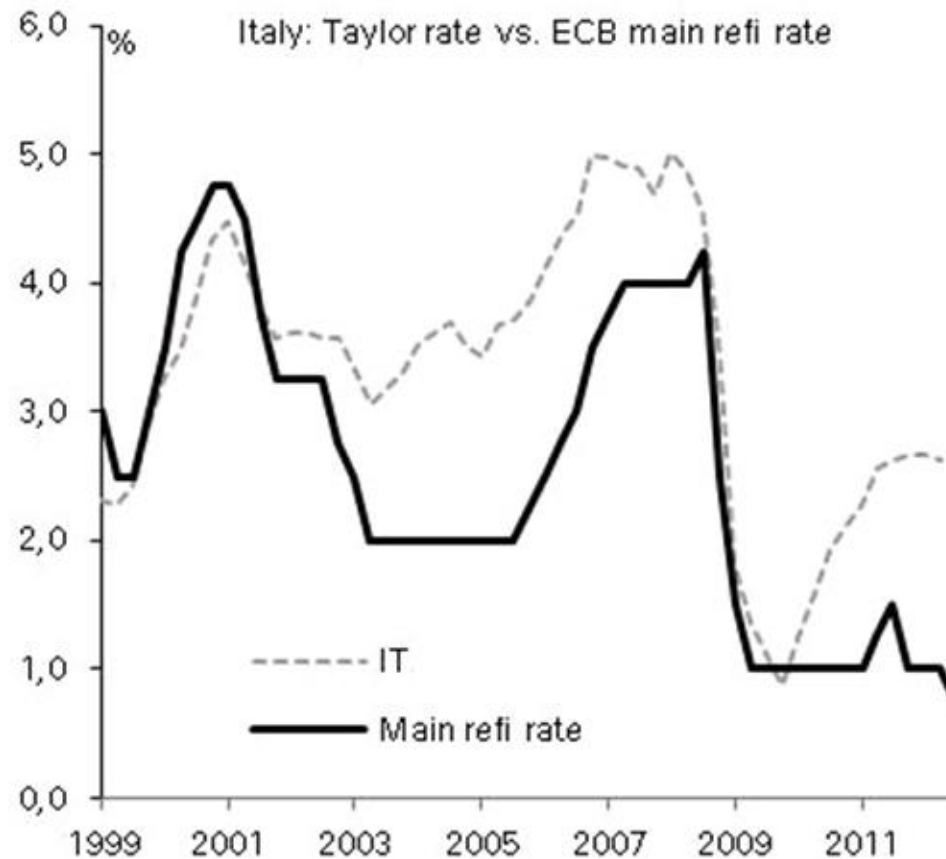
Source: DB Research

## ..which left rates too low for France...



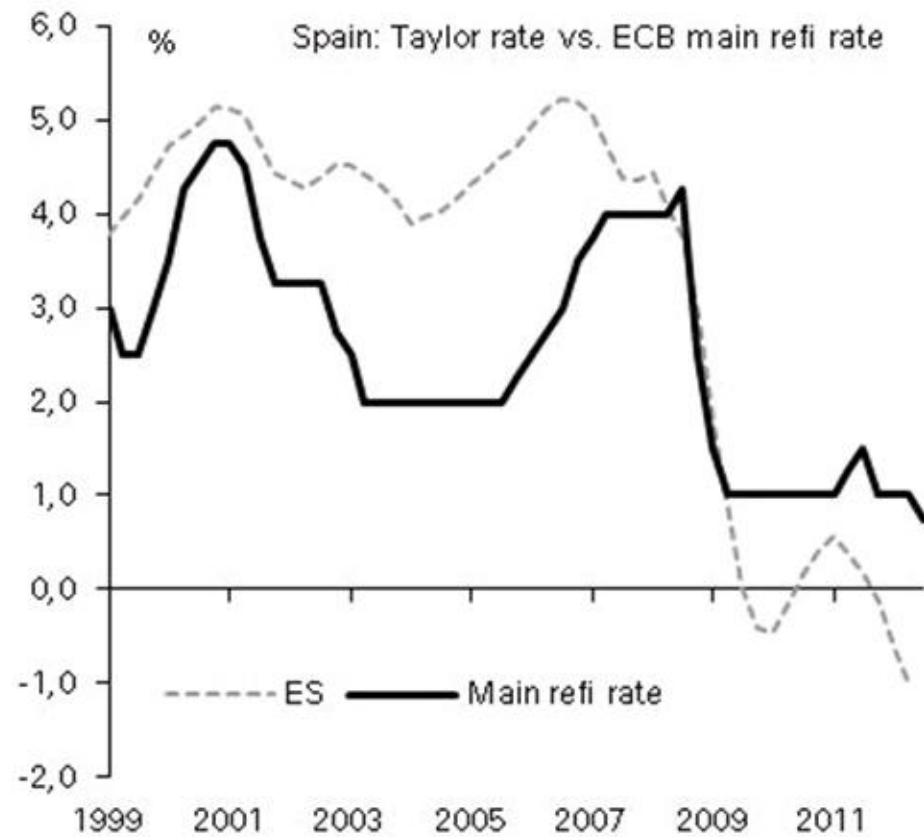
Source: DB Research

## ...and Italy...



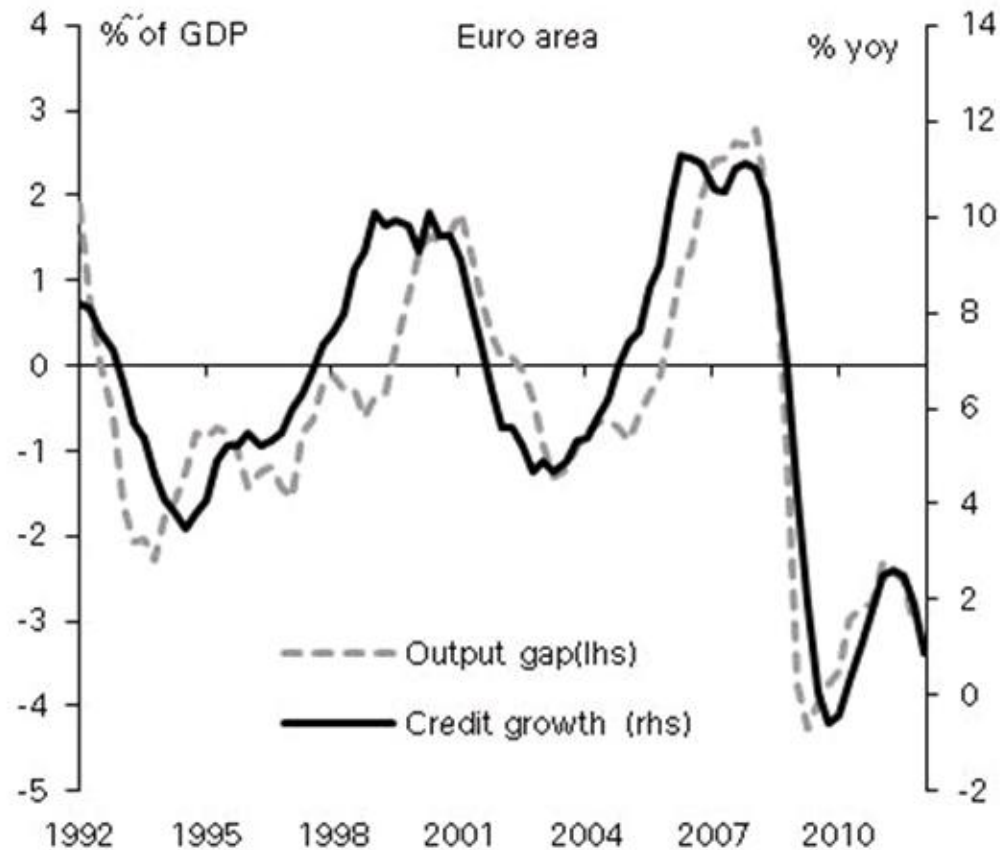
Source: DB Research

## ...and Spain



Source: DB Research

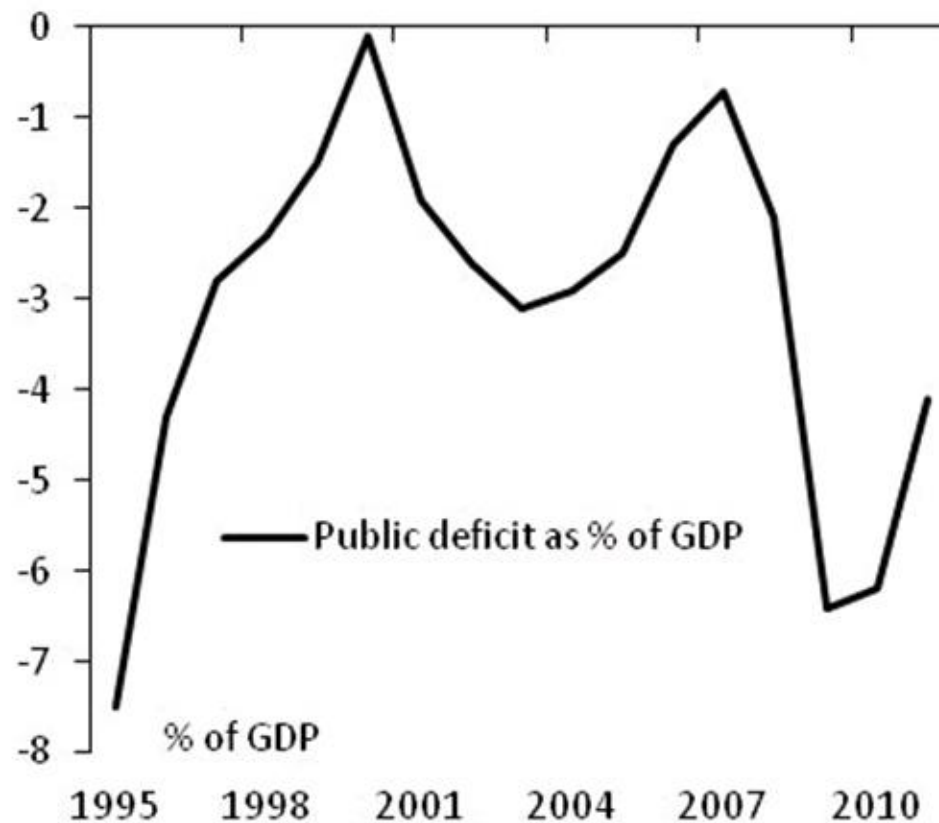
## Minimisation of output gap led to excessive credit growth



Source: DB Research

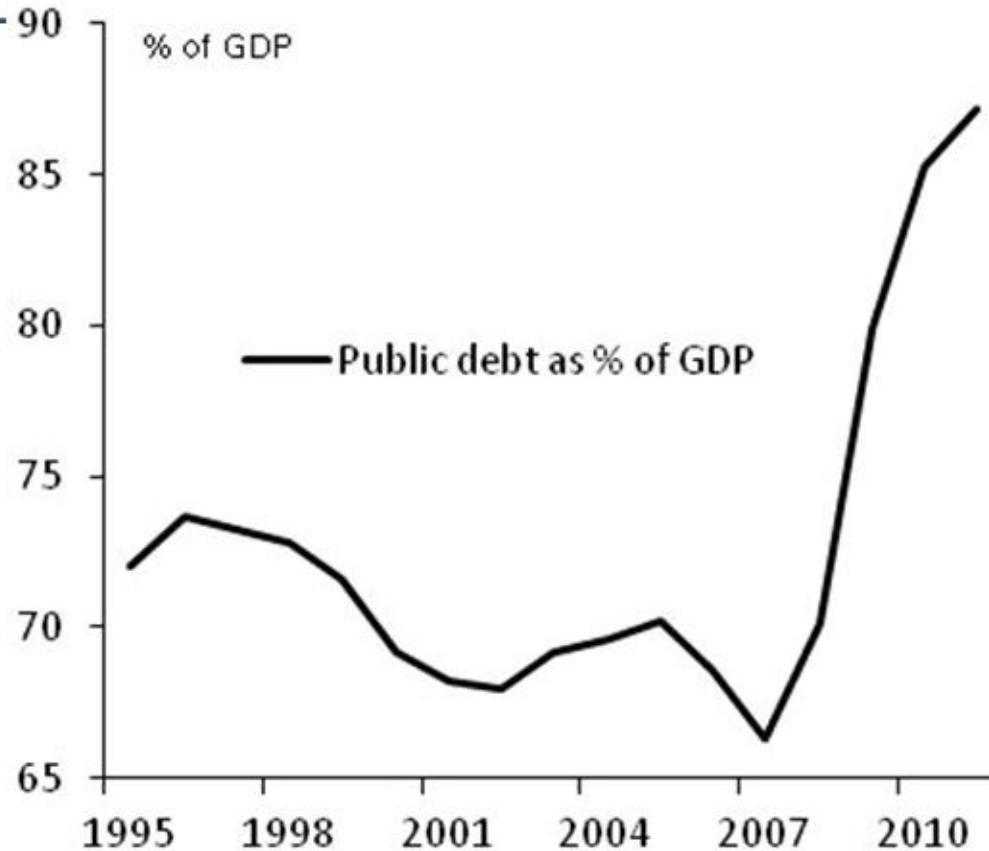


# Governments struggled with deficits



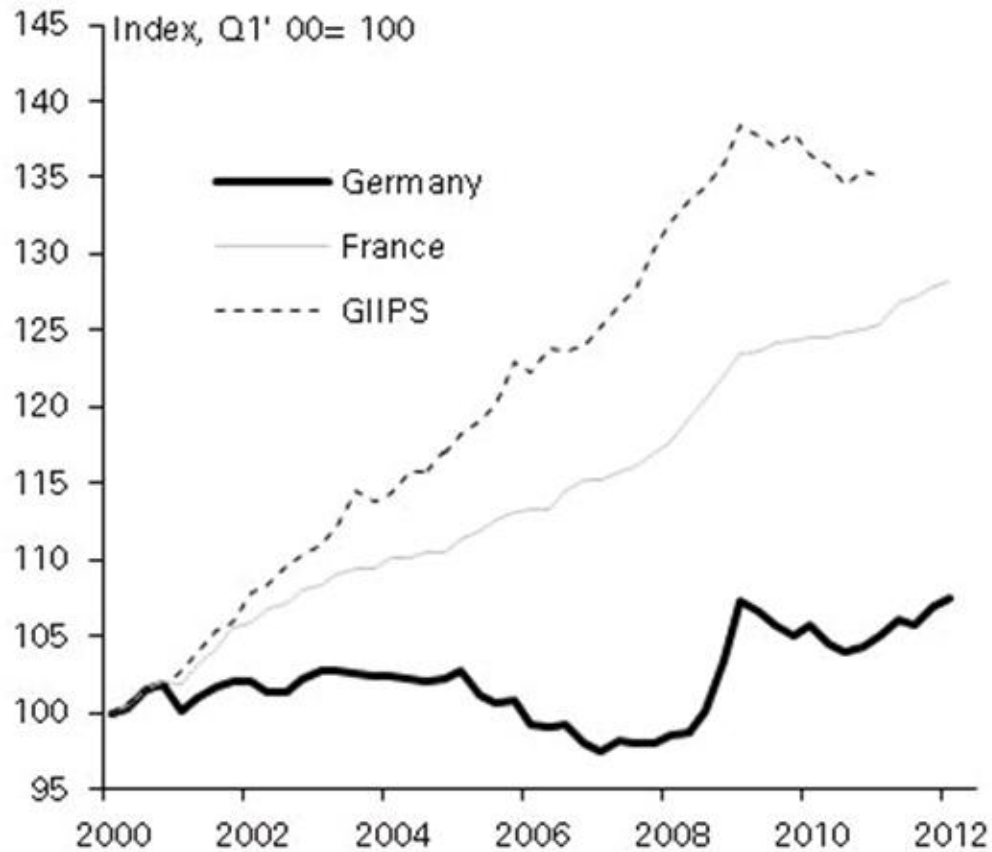
Source: DB Research

# Public debt never met the Maastricht limit...



Source: DB Research

## ...and labour costs diverged sharply

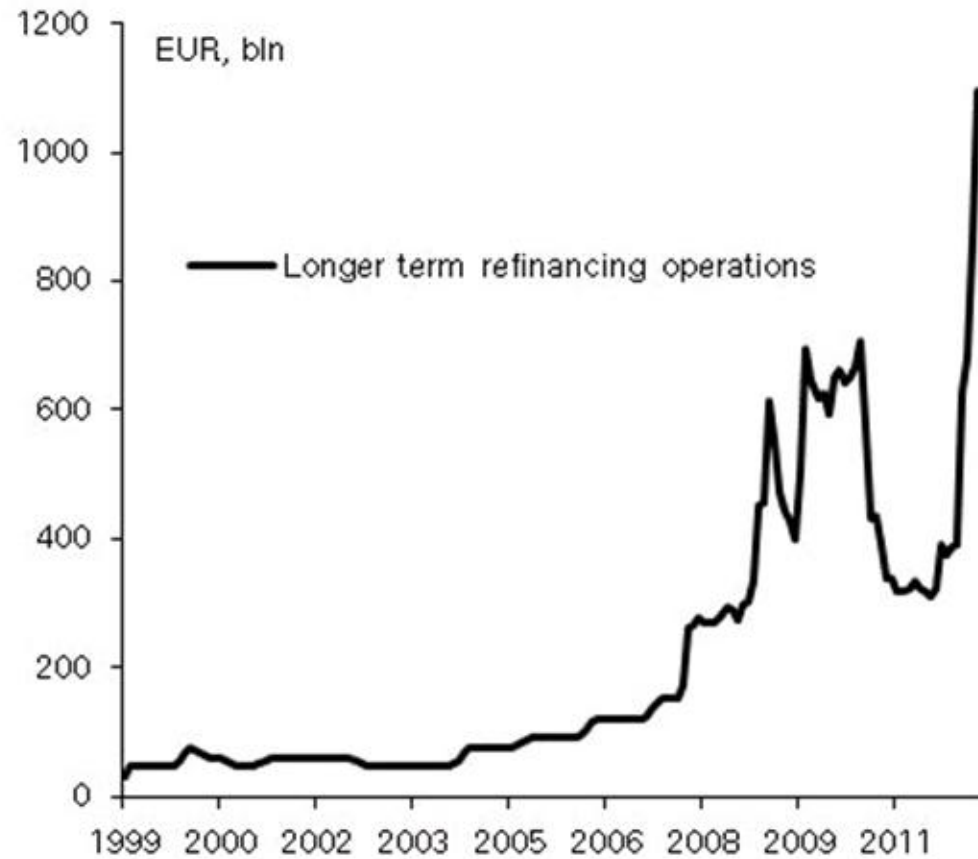


Source: DB Research

## 5. A Crisis of Legitimacy

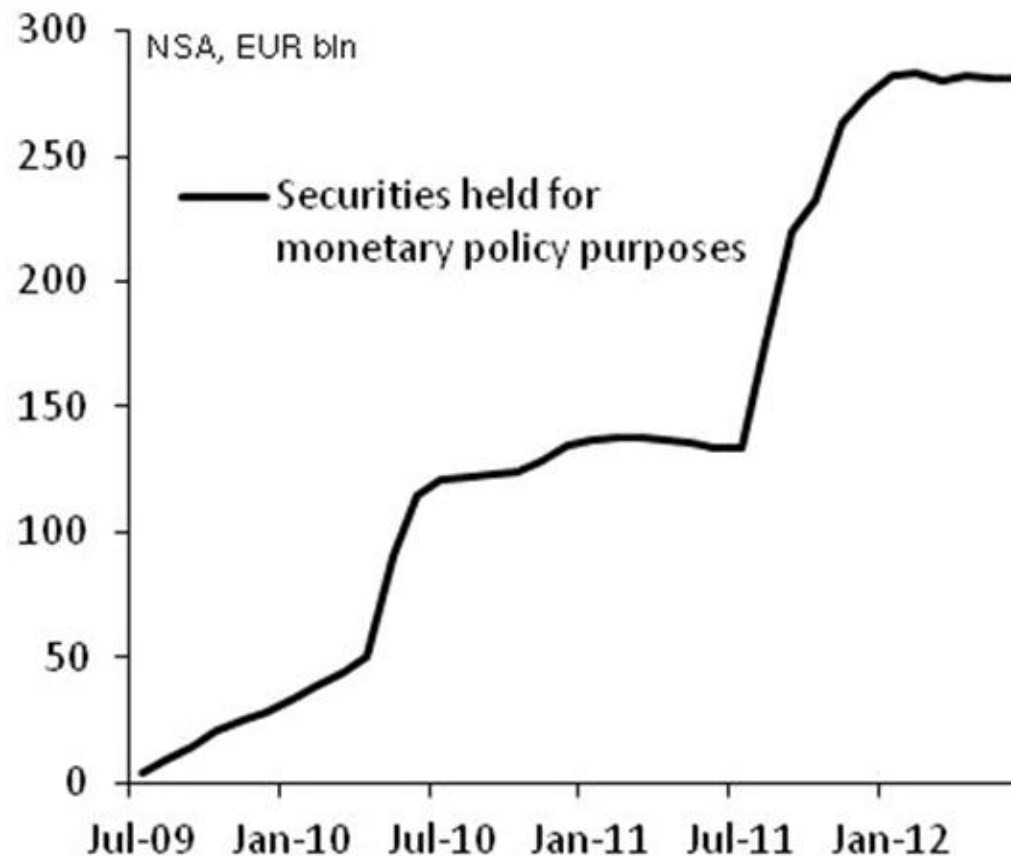
- The Maastricht framework for EMU lacked procedures for crisis management
- When credit dried up governments circumvented the no-bail-out clause of the Treaty
- The ECB has been accused of monetising the debt of insolvent banks and governments

# ECB has kept banks alive



Source: DB Research

## ..and bought bonds of governments in difficulties

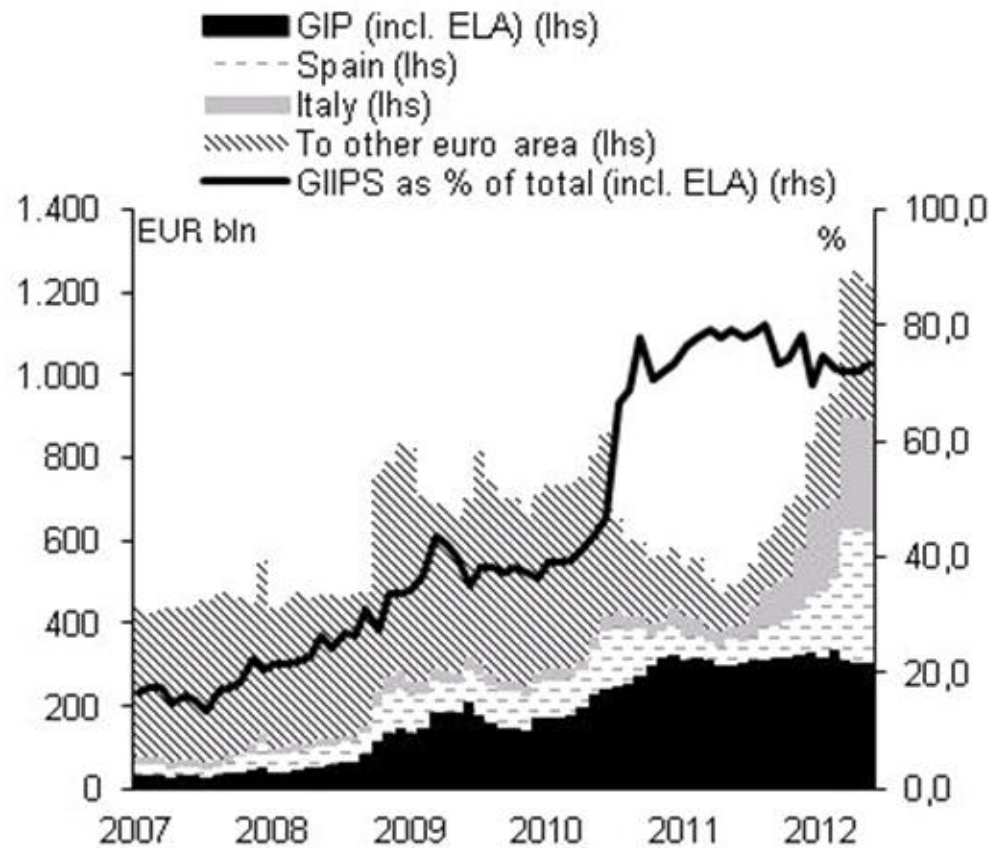


Source: DB Research

## 6. A (Hidden) BoP Crisis

- As private sector capital flows dried up, governments and the Eurosystem took over as lender to countries with BoP deficits
- The Eurosystem has extended more than EUR 1 trn in bop credits
- Countries with bop surpluses bear the credit and eventual inflation risk of the operation

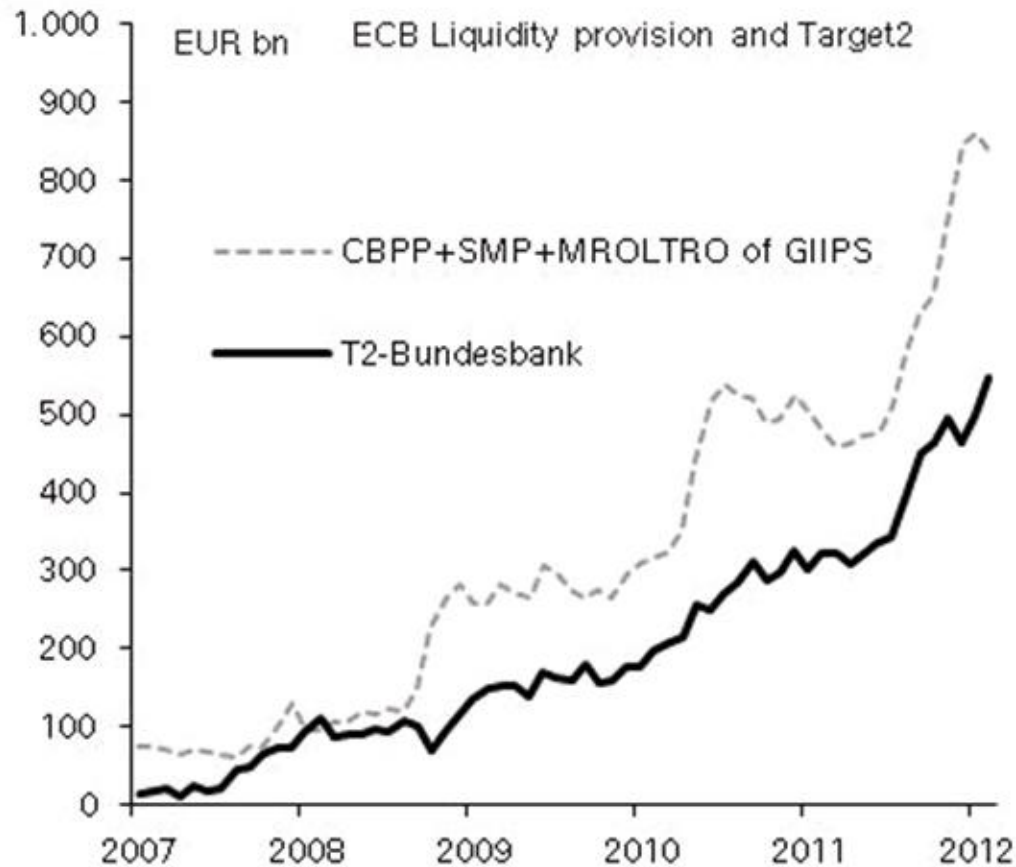
# ECB lending mainly to GIIPS



Source: DB Research

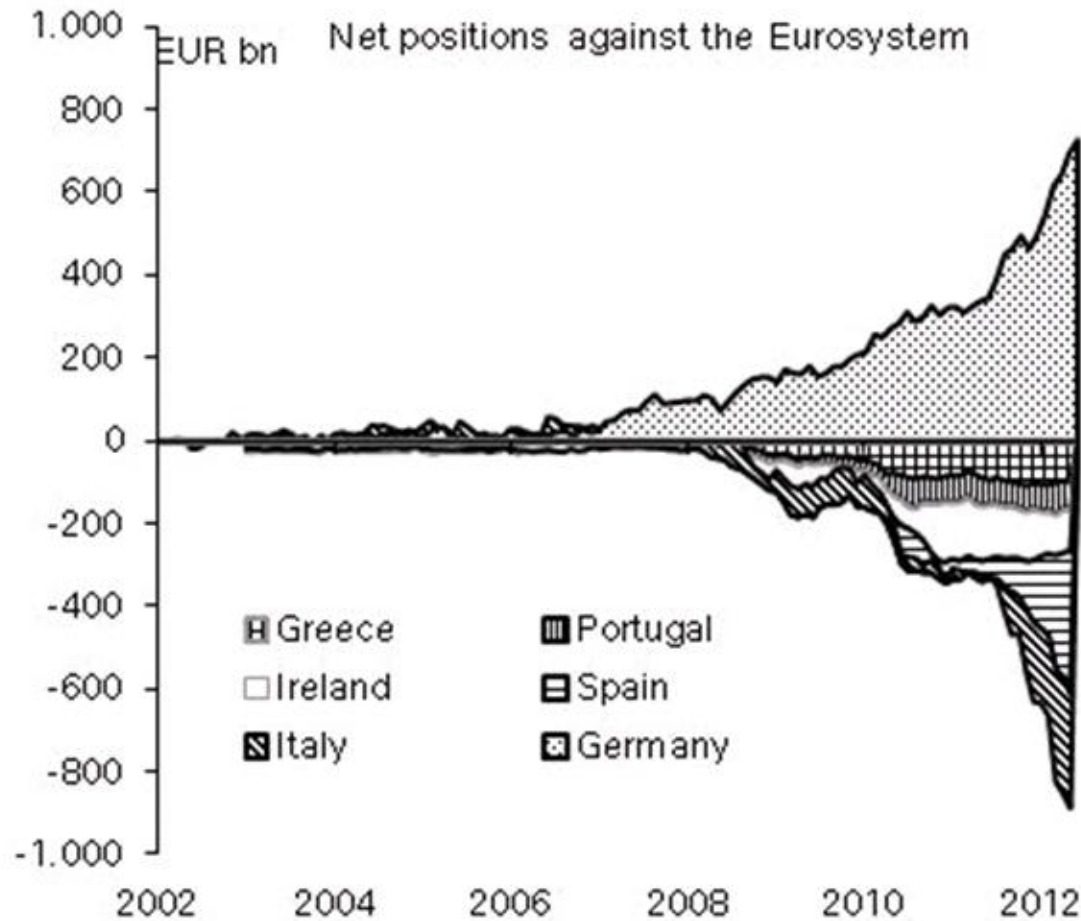


# BoP surplus countries take the risk



Source: DB Research

# Development of Target2 positions



Source: DB Research

## 7. Forward or Backward?

- Some now advocate a rush into political union with eventually joint debt issuance (in one form or another)
- The peoples of Europe are not prepared to yield sovereignty in key policy areas
- Even in the US there is no joint liability for state debt
- The only way forward is back to national sovereignty and liability in financial affairs

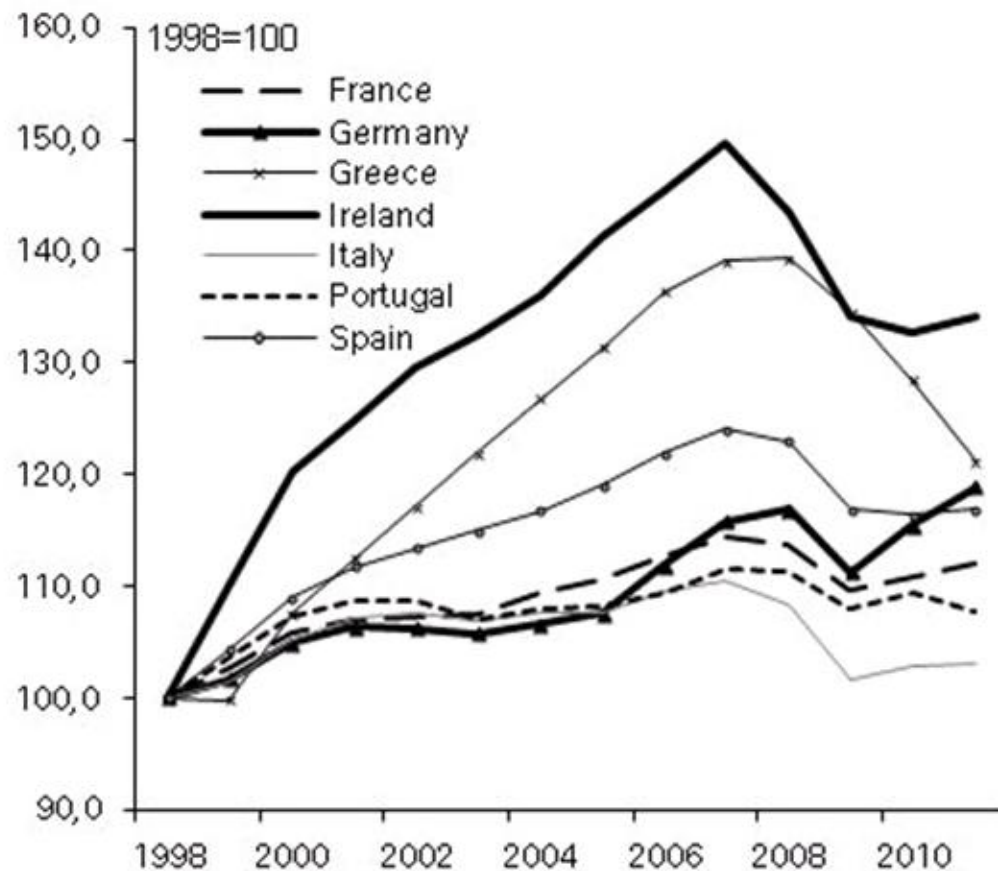
## 8. In Search of a Lender of Last Resort

- There is general agreement that the central bank in a liquidity crisis should act as a lender of last resort to systemically important banks
- By the same token, it should be a source of last resort of funds for systemically important EMU states in a liquidity crisis
- In view of the risks associated with the role of a source of last resort for funds the central bank should perform this role in close cooperation with a fiscal authority

## 9. The Politics of Euro Rescue

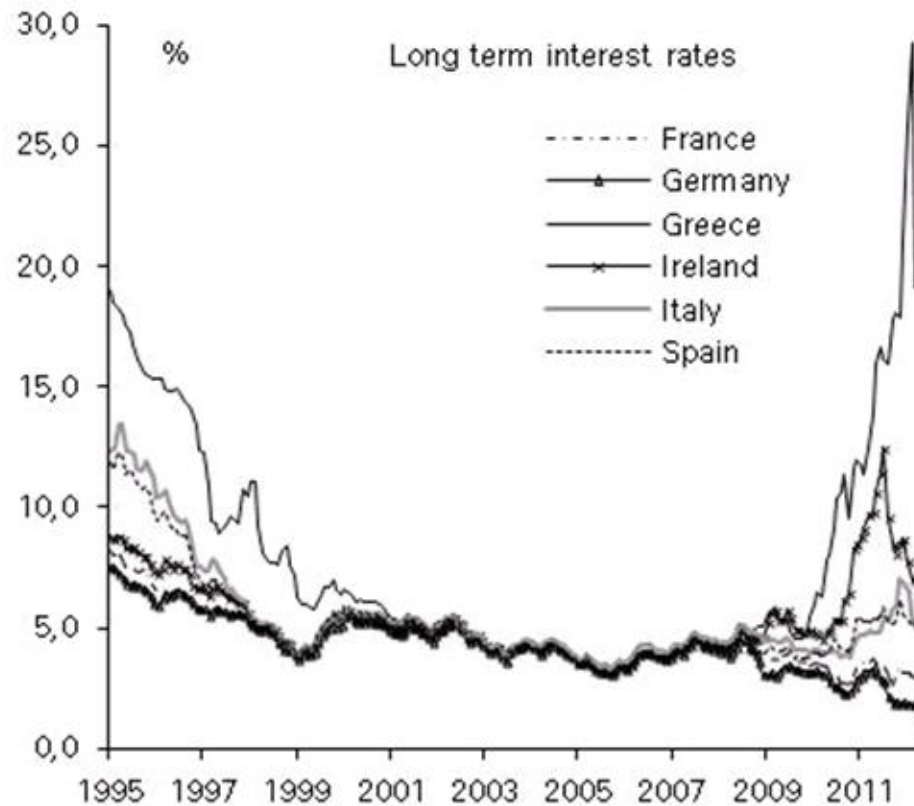
- A lack of leadership and lack of clarity about the future architecture of EMU has impaired the effectiveness of crisis management
- As cooperation with France has been difficult, Germany has emerged as the leader in crisis management, but this has been resented by other countries
- Germans do not feel that they have been the main beneficiary of EMU and hence should bear the brunt of the costs of rescue

## German real GDP per capita growth was less than in several crisis countries



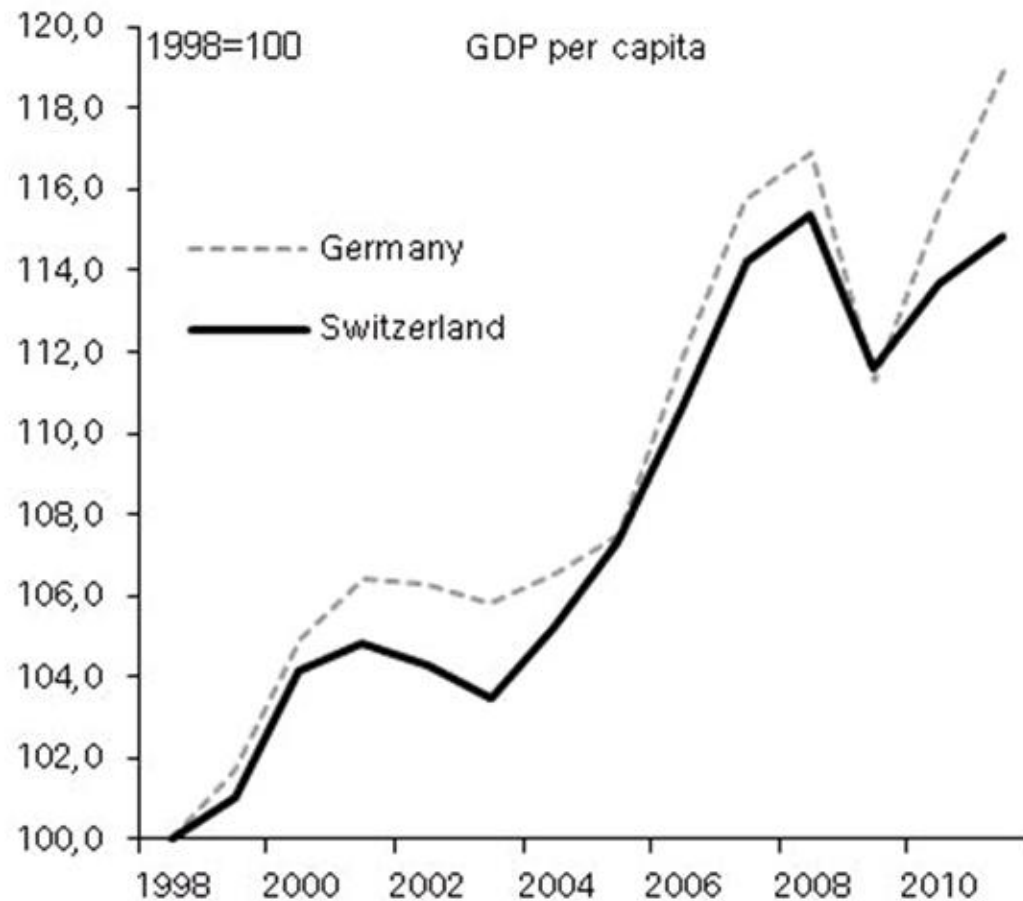
Source: DB Research

## EMU brought sharply lower interest rates for GIIPS countries



Source: DB Research

# Switzerland no worse than Germany



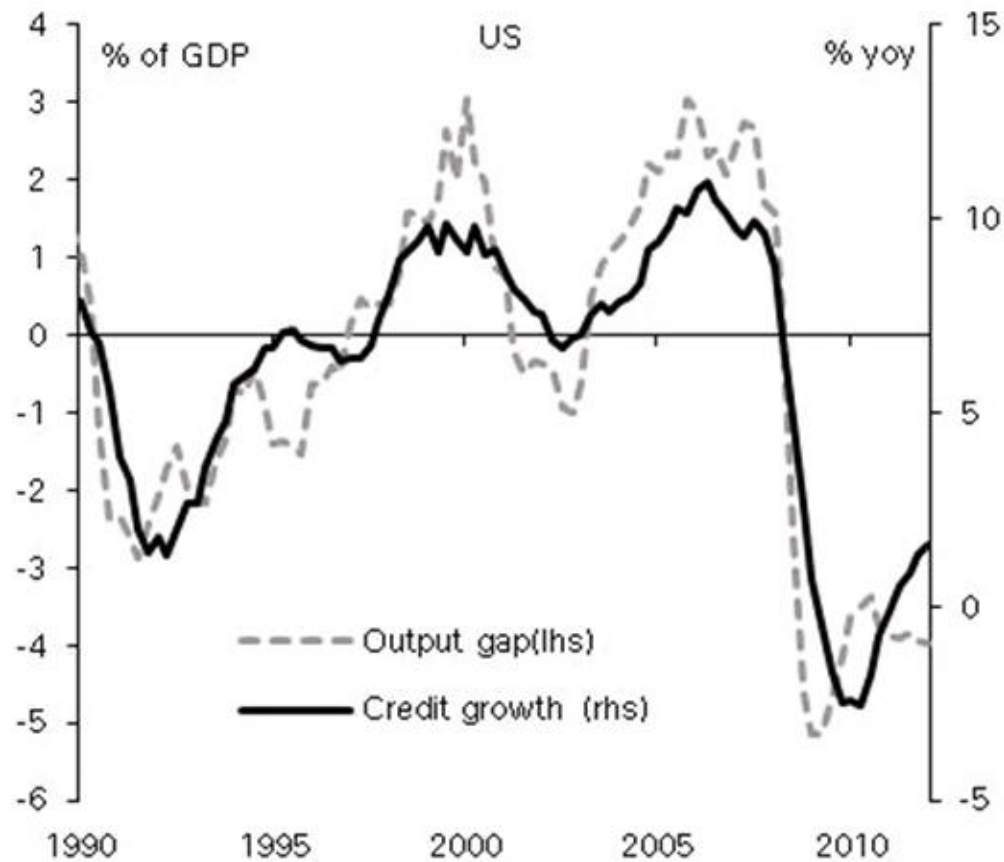
Source: DB Research



## 10. Why Europe Needs the Euro

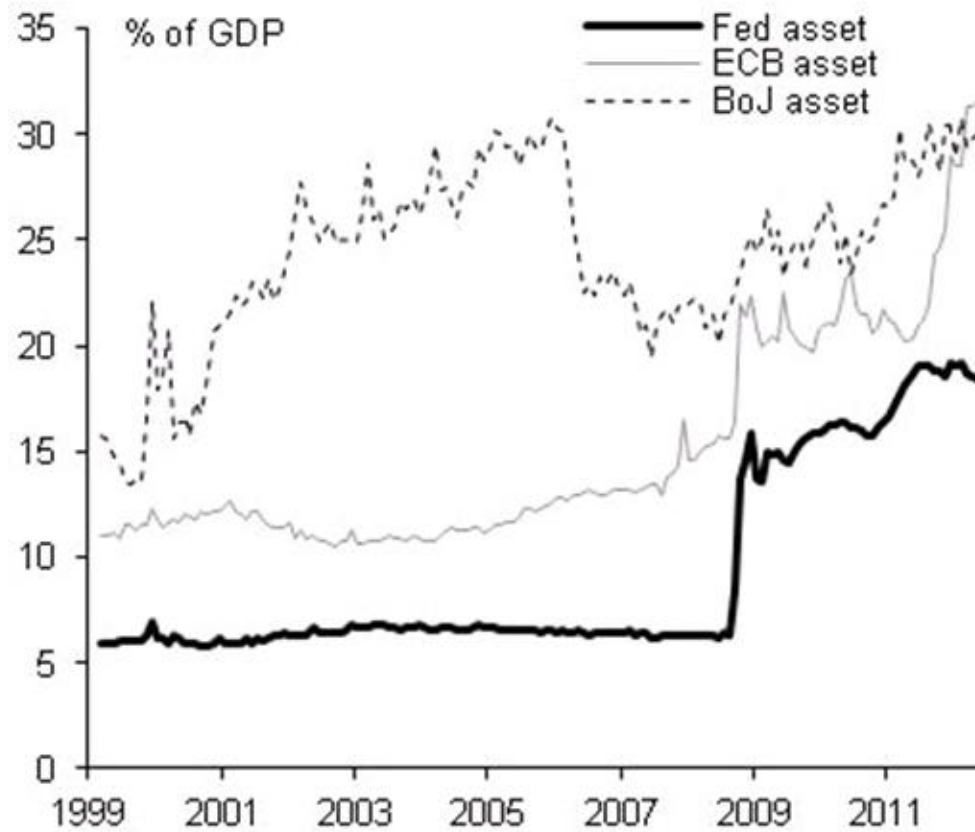
- Small countries have little policy sovereignty in a global monetary system with free capital flows
- Our fiat money system is unstable and could experience a crisis in future years
- Europe cannot decouple from the global money system when each country has its own currency
- The Euro allows more policy sovereignty for Europe

## Inflation targeting can create risks to financial stability



Source: DB Research

# Risky take-over by the central banks

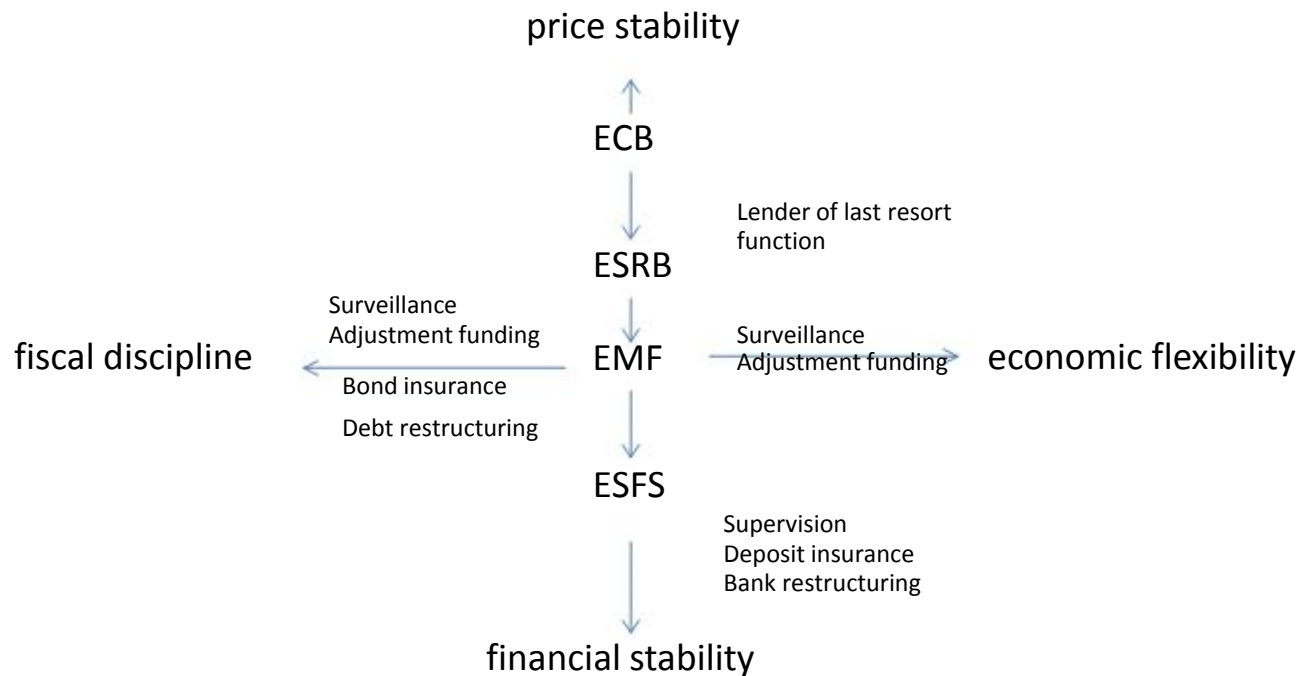


Source: DB Research

## 11. A New Foundation for EMU

- We need to define the new architecture for EMU
- EMU needs to be based on politically neutral money and national fiscal sovereignty coupled with national liability
- When the destination is clear it is easier to map out the route to get there

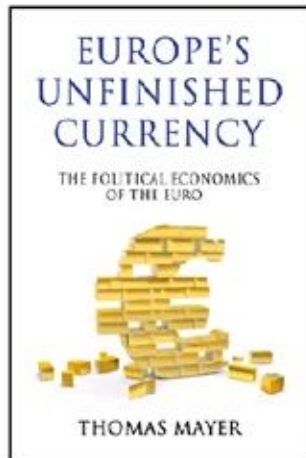
Figure 1. A new architecture for EMU



## 12. Plan B: MUs in EMU

- Latin Europe retains the Euro and the ECB in a softer Latin Monetary Union
- Peripheral countries introduce even softer parallel currencies
- Germany and other Nordic countries introduce a harder common parallel currency
- Hard parallel currency can be virtual only, euro can remain cash currency

Many thanks



**Europe's Unfinished Currency**  
The Political Economics of the Euro  
*Thomas Mayer*

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**Illustrations:** 30+ tables and charts  
[www.europesunfinishedcurrency.anthempressblog.com](http://www.europesunfinishedcurrency.anthempressblog.com)

**Rights Held:** World

“A stimulating read, Dr Mayer’s book combines a concise historical narrative of the events leading up to the euro with an imaginative suggested new architecture for the EMU. Particularly interesting are his insights on how a breakup, should it occur, would evolve.”

– Alan Greenspan, former Chairman of the Federal Reserve Board

“Thomas Mayer was years ahead in predicting Europe’s economic and very political crisis. Now, he blazes a trail to stability, a path that leads to the politics and union of nineteenth-century America. This is a time of essays and short sound bites. ‘Europe’s Unfinished Currency’ is a concise, crafted book that should be the template for all seeking the new political economics of Europe.”

– Tom Keene, Editor-at-Large, Bloomberg News

“Thomas Mayer’s new book is an important intellectual contribution to the most pressing political and economic debate in contemporary Europe. Some of his suggestions are no doubt controversial, but he has provided a coherent argument in a discussion that will profoundly change the European unification process as we know it.”

– Henning Meyer, Senior Visiting Fellow, London School of Economics and Political Science



“Thomas Mayer has written a fascinating and thought-provoking book on the origin, performance and problems of the euro area. He questions much of the conventional wisdom about these topics, and proposes novel solutions that run counter to the historically prevailing view that currency union can only survive within a “political union” of the eurozone.”

– Leszek Balcerowicz, Former Deputy Prime Minister, Finance Minister and President of the National Bank of Poland

“Anyone wishing to make informed commentary on the gathering troubles of the euro is well-advised to read Europe’s Unfinished Currency by Thomas Mayer. The book covers the historical circumstances that produced the euro out of a regional cooperation seeking to end centuries of intra-European conflict, then provides a balanced treatment of the current financial instability. Whatever one’s political view of the “European project”, this book is an essential reference.”

– John Weeks, Professor Emeritus, School of Oriental and African Studies, University of London

“This is absorbing, incisive and intellectually stimulating book. It is an essential reading for those who wish to understand the inner workings, politics and practical solutions to the issues with the eurozone. It makes transparent all the upcoming challenges the European integration will face. Ignore it all your peril.”

– Jason Manolopoulos, author of ‘Greece’s Odious Debt’

“This fascinating and well-written book couldn’t be more timely. With the discussion on the eurozone’s future institutional framework in full swing, Thomas Mayer’s book provides highly relevant economic insights and political perspectives on the debate over how to make the European Monetary Union more stable and sustainable.”

– Axel Weber, UBS Chairman, former head of Germany’s central bank

“Well organized, thorough, and replete with historical facts, this work explores the political and economic roots of the European Monetary Union and, most importantly, makes realistic suggestions for solving the current sovereign debt crisis and achieving greater stability in the long term.”

– Theo Waigel, former German Minister of Finance

“Thomas Mayer provides us with a comprehensive analysis of the European currency and innovative proposals to overcome the eurocrisis. Written by a leading economist in the field, this book meets all conditions for success: it is timely, deep seated, well argued - and sometimes controversial. A brilliant essay and a useful tool for scholars, market participants and policymakers.”

– Edmond Alphandéry, former French Finance Minister and Chairman of Euro50 Group

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