There Is an Alternative: The Flexible European Currency Community

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1. Background

The following text is part of a longer article which, in its preceding sections, is trying to make several connected points (Scharpf 2016):

The Eurozone includes structurally different "Northern" and "Southern" political economies that had performed as hard-currency and soft-currency economies under the previous regime of flexible exchange rates. Northern economies with relatively large exposed sectors had relied on export-led growth models and their coordinated industrial relations systems were capable of generating wage restraint under the leadership of export-sector industrial unions. By contrast, Southern economies with large sheltered sectors had depended on domestic demand-led growth, and their

industrial relations were characterized by union competition and persistent wage dynamics. As a result, inflation was generally lower in the North than in the South, and as long as these differences were compensated by the revaluation and devaluation of exchange rates, both types of political economies had been equally viable in pre-1999 Western Europe.

These structural differences were not acknowledged, let alone dealt with, by the original regime of the Monetary Union. Since they nevertheless persisted after entry, economic trajectories diverged widely after 1999. Low-inflation Northern economies were handicapped by average-oriented ECB monetary policies and high real interest rates, whereas Southern economies were boosted by the fall in interest rates and the rise of credit-financed domestic demand. Until the credit squeeze of the global financial crisis of 2008-09, rising current account deficits in the South were easily sustained by capital inflows from Northern surpluses. But when these stopped, Southern banks were collapsing and the states that came to their rescue were soon faced with challenges to their liquidity and ultimately solvency – which were treated as a Euro crisis requiring institutional changes beyond the minimalist regime established by the Maastricht Treaty and the Stability and Growth Pact.

The new Euro Regime, defined by the European Stability Mechanism, the Excessive Deficit Procedure, the Excessive Imbalances Procedure and the Fiscal Compact, has greatly extended and intensified centralized controls over the fiscal, economic, labor market and social policy choices of EMU member states. As structural differences are ultimately perceived as the root causes of the Euro crisis and of EMU's persistent vulnerability, the regime's acknowledged purpose

is to achieve the structural convergence of Eurozone economies. And since the Euro crisis struck at economies with large current account deficits, it appeared plausible to define a regime that will enforce a structural transformation towards the model of export-oriented Northern political economies. For Ireland with its large export sector, a Euro regime imposing fiscal austerity and wage repression does seem to facilitate export-led economic recovery. For Southern economies, however, the main (and intended) effect of the present regime is to reduce domestic demand to such an extent that not only demand for imports but domestic economic activity and, ultimately, the size of the large domestic sector are drastically reduced. Once that is achieved, the export sector will grow in relative size and political influence, and export-sector unions may come to dominate wage-setting processes. In other words, Southern political economies will converge on the Northern model, the membership of the Eurozone will be structurally coherent and internationally competitive, and the Monetary Union will finally be safe. Or so it is hoped.

For Southern political economies, however, enforced structural conversion has been and still is extremely painful – with massive job losses, excessive youth unemployment, rising poverty – and a legacy of business failures that has reduced the capacity for domestic growth. Even if exports are picking up eight years after the onset of the crisis, the road to export-led recovery of the economy at large continues to be at best arduous, uncertain and very long. And though all Southern governments have treated the Euro regime as being "without alternative", the suffering it imposes on their societies has been immense, and its political impact so negative that none of the regime's loyal supporters has yet

been able to win re-election. In other words, even though the present Euro regime might succeed as a huge economic gamble, it may yet collapse if the failure of its even more risky political gamble triggers the chaotic exit of one or more EMU member states.

Amid rising criticism of its operation and consequences the present Euro regime is generating ever more proposals for its modification. Most of these suggest either a strengthening of centralized capacities to enforce present rules, or a softening of these rules and some sort of financial support to ease the structural transformation of Southern political economies. In terms of the dual gamble, however, both appear counterproductive. More powerful and rigid enforcement would greatly increase the risks of political collapse. And softer rules and transfers are likely to prevent structural transformation and may turn the South into a permanently subsidized European "Mezzogiorno".

Other critics are asking for a more "symmetric" regime that would also treat Northern (and in particular, German) current account surpluses as a major problem. Before EMU, the DM had appreciated when German exports had exceeded imports – and rising imports had then prevented the rise of persistent high trade surpluses. In the Monetary Union, however, the exchange-rate corrective was disabled, and since 1999 German imports have indeed been persistently lower than exports. The effects of the German surplus for the stability of the EMU or for the recovery of Southern economies are in dispute. But even if they should be considered a major problem, on closer examination most suggestions for correcting this imbalance turn out to be ineffective or unfeasible; and the one that might work

– lower VAT (Value Added Tax) rates on imports – is not even considered in academic and political discussion.

To summarize: The paper argues that the Monetary Union is ill designed for dealing with the basic structural differences among Northern and Southern political economies, and that the present Euro regime's attempt to enforce structural convergence may perhaps succeed in economic terms at enormous social costs, but will remain extremely vulnerable to political protests, rebellion and anti-European populist governments. In the absence of good solutions within present constraints, therefore, the paper concludes by suggesting that the Monetary Union itself should be transformed into a more flexible Currency Community that is able to accommodate Northern and Southern political economies at the same time.

2. A Non-catastrophic Alternative to EMU: The European Currency Community

At present, there are two plausible fears which may explain not only the defense of the EMU by its Northern beneficiaries but also the fundamental loyalty of Southern governments even in the face of deep political dissatisfaction with the economic and social sacrifices imposed by the present regime. The first is the belief that exits would not only be catastrophic for the country in question but might also destroy the Monetary Union itself. But though the consequences of individual exits need serious attention, there is surely no need to abolish the common currency for those Northern and Eastern political economies whose

interests and political preferences are well-served by it, or for member states that are politically committed to continue on a course of structural transformation under external supervision (Ferrera 2016). The second concern is the fear of the economic and political isolation of countries that might otherwise be better off outside of the EMU. It is these fears which the following discussion primarily seeks to address.

Under present conditions, an individual exit from the common currency is indeed not an economically and politically viable option. Though its designers did not know how to make EMU work, they were devilishly clever in making it nearly irreversible. Even though in retrospect the move from the flexible European Monetary System of 1979 (EMS) to the EMU may be seen as a dreadful mistake, its reversal is almost universally ruled out by the anticipation of horrendous transition costs and irresolvable uncertainties (Tsoukalis 2016). Indeed, under the present rules, exit may happen as a disaster, but it is not a policy option that could be chosen by responsible governments as a lesser evil, no matter how devastating the Euro regime's impact is on its country's economy or society.

But these conditions could be changed.

In addition to creating a formal right to leave the EMU without having to leave the EU, the feasibility of orderly exit presupposes at least three bodies of rules that would deal with state insolvency, with exit procedures, and with the subsequent relations between exiting states and the EMU. None of these rules is likely to be well-designed under the pressure of an acute crisis. Hence they ought to be discussed and adopted in relatively calm times as precautionary amendments or additions to the general rules governing the Eurozone.

2.1 Rules for state insolvency and an "amicable divorce"

With regard to the first requirement, discussions about rules for state insolvency have been under way for some time at the international level (International Law Association 2010), and it should be possible to adapt these to the restructuring of excessive public sector debt under the conditions of the Eurozone. A more difficult challenge will be the second requirement of procedures and rules facilitating the orderly exit of a member state from the EMU. To minimize repercussions in global capital markets, it would be highly desirable to avoid the uncertainties of controversial and long drawn-out "Brexit-type" bargaining. It might thus be helpful to construct a small set of pre-defined "exit models" with well-balanced rules for different types of problem constellations. They all would need to include procedures for the transition to a national (or parallel) currency, for the treatment of public and private debts defined in Euros, and for financial, legal, and procedural support during the transition period. While I lack the expertise to suggest specific solutions, I am encouraged to see that reputed and knowledgeable economists of very different theoretical and political persuasions appear to be quite sanguine about the availability and effectiveness of practicable options that would reduce the transition costs of a country's exit from the EMU through a cooperatively managed "amicable divorce" (Stiglitz 2016, ch. 10; Sinn 2014; Sinn 2015, 480–492; 2016, 306–309).[1]

2.2 Learning from the faults of the EMS

Even more important may be the third requirement of an economically and politically viable regime governing the future relations between exiting economies and the remaining EMU (rEMU). It would have to be clear (which at present it is not) that leaving the EMU does not conflict with continuing membership of the European Union. Even then, however, the prospect is bound to provoke disturbing concerns about the post-exit fate of economies that will continue to depend on integration in the Single Market: They might suddenly have to cope on their own with turbulent global capital markets and with speculative exchange-rate fluctuations that could wreak havoc on the viability of economically interdependent national industries and that might also trigger vicious price/wage devaluation spirals that could overwhelm all national efforts at stabilization. With regard to these fears, however, promising solutions can be derived from a re-examination of the achievements and deficiencies of the monetary regime that had preceded the EMU.

Before the post-unification crisis of 1992, the EMS regime of pegged but adjustable exchange rates had succeeded in achieving three purposes. It had helped reduce average inflation rates in Europe by obliging member states to use monetary and fiscal policies in order to keep their currencies within 75 percent of the exchange-rate bandwidth (2.25 percent above and below the agreed rate). At the same time, its Exchange Rate Mechanism (ERM I) had protected member currencies against short-term imbalances and speculative attacks by (symmetrically!) obliging

central banks to intervene in currency markets in order to maintain the upper and the lower limits of their respective exchange-rate corridors. And finally, it had prevented the rise of persistent trade imbalances by allowing for agreed-upon currency realignments (Artis and Taylor 1993).

After an initial period of frequent adjustment, the EMS worked reasonably well, not only in dampening currency fluctuations and inflation rates but also in achieving a pattern of nominal exchange rates that reflected economic fundamentals and avoided the dynamic divergence of real effective exchange rates and the emergence of persistent external imbalances. The regime was institutionally vulnerable, however, because it lacked a central bank that was committed to the common interest. As exchange rates were defined pairwise between all national currencies, the Bundesbank (in charge of the largest and hardest currency) came to play a dominant role in all adjustments. Moreover, it had been allowed to insist – in the famous "Emminger letter" (Tietmeyer 2005, 79–80) – that it would not have to engage in monetary policies and currency interventions that might conflict with its basic commitment to price stability in Germany. As a result, the symmetry of interventions was incomplete, and currency realignments were more frequent than they otherwise would have been.

These had to be adopted through difficult and often highly confrontational intergovernmental negotiations (Marsh 2009; Höpner and Spielau 2015) in which Germany was typically forced to accept greater DM revaluations than was good for its domestic growth. After 1987, however, revaluations were ruled out in the quest for even greater exchange-rate stability. When the Bundesbank then chose to

brutally clamp down on the German post-unification boom, it triggered major crises in other member states which in fact destroyed the EMS (Marsh 2009).

The critical design fault that destroyed the ERM 1 has been corrected in its successor regime, the ERM II. It was created on January 1, 1999, for European states that would not immediately join the Monetary Union. Although all of its one-time members, except for Denmark, have now entered the EMU, its institutional framework still exists and remains available for new accessions. It differs from the ERM I in two crucial respects: the ECB retains its role as the central bank for the system as a whole, and the "central exchange rate" of a member currency is defined in relation to the Euro, rather than in a network of bilateral rates among all currencies. As a consequence, market interventions to stabilize the exchange rate of a member state are also negotiated between its national central bank and the ECB, rather than among all national banks.

Under ERM II rules, currencies are presently allowed to fluctuate up to 15 percent above and below their agreed-upon "central exchange rate." This broad bandwidth, which was introduced after the EMS crisis of 1992, may be narrowed by agreement so as to circumscribe the politically desired action space of national macroeconomic management. Hence, if the central exchange rate is initially set to correspond to the underlying economic fundamentals, stabilizing interventions in international currency markets should be required only to ward off speculative attacks – which, however, are likely to be deterred by the ECB's quasi unlimited fire power.[2] Nevertheless, there have been a few cases of agreed-upon revaluations of currencies in the history of the ERM

II. Thus, exchange-rate adjustments in response to persistent imbalances and changes in the underlying economic fundamentals continue to be available as well.

2.3 Toward a two-level European Currency Community

Until now (and except for Denmark), membership of ERM II has been a trial period in which candidates for full EMU membership had to achieve perfect exchange-rate stability with the Euro. Hence, even if present rules remained in place, the regime would change its function if it were to become part of a "European Currency Community" (ECC) that may permanently include two types of member states – those belonging to the EMU (the future Euro Area) and those whose currencies are related to the Euro through the ERM II. In spite of the heterogeneity of its membership, however, the ECC would be a most powerful player on the global scene. All of its member currencies would form a large "Euro bloc" with the Euro itself at the center and ERM II currencies connected to it by agreed-upon exchange rates and commitments to mutual support against external attack. In other words, its currencies would float together in a global environment of flexible exchange rates, and the Euro bloc, represented by the ECB, would negotiate as a unitary actor in international negotiations about global, multilateral or bilateral currency regimes. Contrary to frequent apprehensions, therefore, Europe's influence in international monetary affairs might even increase by way of the ECC.

One reason for this would be the reduction of internal conflicts if present political tensions between Northern and

Southern EMU states are resolved through flexible coordination in a two-level system of monetary integration. In this context, the members of a more coherent EMU would benefit from the greater effectiveness of uniform ECB monetary policies and perhaps also from the closer coordination, envisaged by the "Five Presidents' Report," between the monetary, fiscal, and economic policies among structurally convergent economies. Moreover, opportunities for further political integration might also allow the EMU to move beyond the present constraints of a rigid hard currency regime toward a wider range of macroeconomic options.

The members of the ERM area, by contrast, would not be required to be economically coherent and structurally convergent. It could include members like Greece and other Southern political economies for whom the present coercion to achieve structural convergence appears economically, socially, or politically intolerable. Other members might resemble Denmark, the only current participant in ERM II; for them, structural convergence on the Northern model and EMU rules may be economically unproblematic, but their sense of political autonomy and democratic accountability may not allow them to submit to the directives, controls, and sanctions of centralized European authorities.

Regardless of their diversity, they all depend on economic exchanges in closely integrated European markets and hence would benefit from protection against speculative currency fluctuations. Moreover, some of them might benefit even more from protection against downward currency speculation in situations where they are trying to fight a wage–inflation devaluation cycle. If the ECC were successful, both ERM and EMU members would enjoy the

economic benefits of being able to trade in the European economic space under nominal exchange rates reflecting the underlying fundamentals of their respective economies.

In order to enjoy these benefits, however, ERM members would have to forswear the temptation of competitive devaluation. Both the central exchange rate and the permissible bandwidth would have to be set and could only be changed by agreement with the ECB, and willful noncompliance would entail exclusion from the ECC. In other words, membership of the ERM area would not relieve states from the discipline of having to manage the conflicting requirements spelled out in the Mundell-Fleming Trilemma.[3] But it would allow them to use their own macroeconomic instruments in managing the trilemma and they would have more political discretion in doing so. Moreover, they would retain the safety option of being able to ask for a readjustment of the central exchange rate in the case of massive changes in economic fundamentals.[4]

Under these conditions, it might not be utopian to think that not only Sweden, Poland, or the Czech Republic, but ultimately also Norway, Switzerland, and perhaps a post-Brexit UK might come to prefer ERM membership to either joining EMU or struggling on their own in international currency markets. In other words, flexible coordination in the ECC could indeed contribute to further European integration and an enhanced European weight in world affairs.

2.4 Assistance in transition

More immediately, however, countries like Greece – for whom EMU has become a prison regime with destructive

impacts on the domestic economy, the welfare state, and the political system – would need assistance in making the transition to ERM II. The need for such support was explicitly acknowledged by the German finance minister in the last paragraph of his "non-paper" of July 10, 2015, in which the possibility of Grexit (described as a "time-out" from EMU membership) was suggested. It proposed that

> The time-out solution should be accompanied by supporting Greece as an EU member and the Greek people with growth-enhancing, humanitarian and technical assistance over the next years.[5]

The size, form, and conditions of such support would have to be negotiated, of course. Nevertheless, its purposes are well identified in the paragraph cited: technical support would be needed to facilitate the installation of a new currency, and humanitarian support would have to assist the rebuilding of minimal public and social services in areas where they have been devastated by austerity requirements. However, the third item, "growth-enhancing assistance," requires comment.

In passages summarized above, I argue against proposals amounting to a "transfer union" that would ease the burdens of Southern adjustment by financial assistance in the context of the present EMU. By relaxing the pressures of fiscal austerity and internal devaluation, transfers would counteract the purposes of structural transformation; and as long as competitiveness is not restored, subsidies to private investments could not induce sustained economic growth. Hence, moral appeals to European solidarity would be undermined by expectations of economic futility. But once Grexit and

nominal devaluation[6] would establish the preconditions of external competitiveness, the availability of financial support for productive investments and essential imports may play the same positive role for economic recovery which the U.S. Marshall Plan played in postwar German reconstruction after a massive devaluation of the Deutsche Mark in 1949 (!). In other words, claims to solidarity and burden-sharing that invoke a common responsibility for damages inflicted by an ill-designed Monetary Union (e.g.,Tsoukalis 2016; Stiglitz 2016) would then cease to be economically counterproductive.

3. Conclusion

In June and July of 2015, none of the three preconditions postulated above was in place. There were no general rules for dealing with state insolvency and the restructuring of public-sector debt; there were no standardized procedures allowing a state to leave the EMU without jeopardizing its EU membership; and there was no institutional framework defining the supportive relationship between the EMU and membership of the ERM II. But if this institutional background had existed, it would have been less plausible to think that the Tsipras government would still have preferred the humiliation of accepting the even harsher conditionalities of another rescue loan to the Grexit option suggested by Germany.

From a Greek perspective, moving from the EMU to ERM II would have allowed devaluation to an exchange rate corresponding to the country's international competitiveness. It would have reduced imports and facilitated exports without the ruinous contraction of aggregate

domestic demand and internal devaluation imposed by the present euro regime.[7] Moreover, with the background guarantees of ECB interventions, the new exchange rate would be protected against speculative attacks triggering a spiral of devaluation, wage push inflation, and further devaluation. This would allow governments and unions to work out a social pact that would plausibly combine wage restraint and social policy commitments in a way that is compatible with sustainable economic growth. At the same time, this scenario would more plausibly allay geopolitical fears in Washington and Brussels than the continuing enforcement of structural convergence with its risk of political collapse could promise.

Beyond that, the institutional preconditions discussed would allow the evolution of a two-level European Currency Community. The first tier would include a structurally more coherent Monetary Union combining a core group of Northern political economies and other members of the present Eurozone which might not wish to jeopardize the gains already achieved through painful structural transformation or may have intrinsic preferences for hard currency policies and export-led economic growth. Their members would benefit from more effective macroeconomic management and from opportunities for greater institutional and political integration. The second tier of a future European Currency Community would include economies for which enforced structural transformation appears unrealistic or that have strong political preferences for a greater autonomy in macroeconomic policy choices, but would still appreciate the benefits of reduced currency fluctuations and of mutual support against speculative attacks associated with membership of the wider community.

Even more important would be the benefits for European integration itself. Allowing member economies to grow in accordance with their structurally conditioned "growth models" would help to overcome the persistent economic stagnation of the Eurozone. At the same time, replacing the rigid institutional shell of a Monetary Union with a flexible two-level Community, and replacing enforced structural convergence with coordination among different political economies, would defuse the potentially explosive North–South conflicts that cannot be politically resolved at the European level. Economically and politically, therefore, Europe would not become weaker but stronger, internally and externally, by the transition from the coercive European Monetary Union to a cooperative European Currency Community, a community that could unlock capacities for European cooperation and political action that are presently paralyzed by the need to suppress the politicization of an irresolvable conflict.

Notes

1. Like George Soros, Mervyn King, and other economists, Stiglitz (2016, 292-203) also suggests that transition would be much easier if Germany and other Northern economies would exit the EMU instead. In my view, this would be politically impossible. But Germany should have an interest in a smaller, structurally more coherent, economically more stable, and politically less conflict-ridden Eurozone – and, hence, should be willing to facilitate the transition to a more flexible monetary regime (Sinn 2014).
2. This assumes that the future Euro Area will be much larger than any individual ERM economy. Under these conditions, the ECB – unlike the

Bundesbank in 1992 – will be able to defeat (economically unjustifiable) downward speculation against any one ERM currency without jeopardizing its commitment to price stability in the EMU. And its willingness to intervene in currency markets would – again unlike that of the Bundesbank in 1992 – be supported by the voice of ERM states in ECB governing bodies. In addition to the buying and selling of currencies, one might also consider currency exchange controls (which the Bundesbank had used extensively in earlier decades) as a useful part of the option set.

3. The trilemma, identified independently by both authors at about the same time, suggests that fixed exchange rates, capital mobility, and monetary autonomy cannot be strictly maintained at the same time.
4. Unfortunately, Finland, whose (highly competitive) economy is suffering from the collapse of Nokia and the rise of EU sanctions against Russia, did not have this option under EMU.
5. http://www.sven-giegold.de/wp-content/uploads/2015/07/grexit_bundesregierung_non_paper_10_juli_2015.pdf.
6. The present Euro regime is trying to achieve the same effect through downward pressures on wages and prices ("internal devaluation"), which are much harder to implement and politically much more controversial – and hence inherently precarious. In purely economic terms, under both types of devaluation, debtors will suffer – which is likely to impede domestic demand led economic growth. But in the case of nominal devaluation, the effect could be avoided by legislation defining a 1:1 conversion rate for domestic wages, prices and debts. The conversion rate for border-crossing transactions would have to be defined in the agreement governing exit from the EMU.
7. Compared to internal devaluation (through wage depression and rising unemployment) whose costs will have to be borne by labor, the rise of import prices caused by nominal devaluation will affect all consumers. In both cases, however, the gain in competitiveness would be nullified through compensatory wage increases.

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