21 INSIDE THE EURO ZONE

Preview

Although the single market has long been at the top of the agenda of European integration, that market could never be complete so long as the member states retained their national currencies: exchange rates fluctuated, costs and profits could never be firmly predicted, and currency conversion meant additional layers of bureaucracy and planning. The creation of a single currency promised not just to remove these barriers, but to make integration more real to consumers and businesses. It was also hoped that its launch in 1999 would re-emphasize the strengths of the EU as an international economic actor.

Unfortunately, the twin blows of the global financial crisis of 2007–09 and the debt crisis that broke in 2009 revealed not just the underlying domestic economic weaknesses of multiple EU member states but also several core design flaws in the euro. After surviving speculation that some of its members might abandon the euro, and even that the euro, and possibly the EU itself, might collapse, recovery began. However, it did so only after a bitter debate among euro zone members about how best to deal with the crisis and about the extension of the authority of the EU institutions to monitor domestic economic policy in the member states. As of early 2020, 19 EU states now use the euro, and adoption in all the others except Denmark was expected once they met the criteria for joining. Despite this, questions still remain about the future health and direction of the single currency.

Key points

- The euro was launched in 1999 as an electronic currency, and in 2002 as a cash currency. Its creation was not only an economic act, but also a political act designed to help expand the international financial and political reach of the EU.
- Twelve EU states adopted the euro in 2002, and have since been joined by seven more, with expectations that most of the rest will eventually follow.
- The euro started out well, with optimistic speculation that it would quickly become a world-class currency. Then came the global financial crisis, when euro zone leaders at first appeared undecided about how to act, before taking ameliorative action.
- The debt crisis that broke in the euro zone in 2009 not only revealed the dangers to the euro zone of mismanagement and incompetence in just one member state (Greece), but also found euro zone leaders failing to agree on how to respond.
- Upon its creation, the euro became the world's second largest reserve currency, leading to speculation that it might pose a challenge to the US dollar. After its share of reserves grew to just over 25 per cent, it appeared to have settled onto something of a plateau, lagging well behind the 60–65 per cent share of the US dollar.
- Questions remain about the long-term prospects of the euro. How will its problems compare with those of the US dollar, and what changes will arise out of China's evolving position in global currency markets?

Comparing monetary policy

The introduction of the euro – as an electronic currency in 1999, and as a cash currency in 2002 – was one of the most remarkable events in the economic history of Europe. By no means was it the first multinational currency (the CFA franc has been used in more than a dozen West African countries since 1945, and the Eastern Caribbean dollar in eight Caribbean countries since 1965), but never before had such a large group of sovereign states with such long histories voluntarily replaced their national currencies with a common currency. Many of those national currencies were deeply entrenched in the identities of their states:

- The Greek drachma dated back to classical Greece and more recently to the establishment of the modern Greek state in 1832.
- The Dutch guilder dated back to the seventeenth century.
- The Italian lira dated back to national unification in 1861.
- The German Deutschmark – created in 1948 to replace the Reichsmark – may have been much younger but it had become a symbol of West Germany's post-war renaissance, while the West German Bundesbank (created in 1957) developed a reputation for independence and helped West Germany to become the region's dominant economy.

The euro has gone on to change the daily lives of millions of consumers and businesses in the euro zone. It has also changed the dynamics of international financial and foreign exchange markets, where the euro has taken its place alongside the US dollar, the Japanese yen, the British pound and other major international currencies. As well as helping cement the EU single market and offering euro zone states a world-class currency that has expanded the international financial and political reach of the EU, the launch of the euro represented the first serious challenge to the global leadership of the US dollar since the latter had displaced the British pound in the 1950s. It has also been more than an economic or financial project, a point made at the time of its launch by then German Foreign Minister Joschka Fischer (2000):

> [Its introduction] was not only the crowning-point of economic integration, it was also a profoundly political act, because a currency is not just another economic factor but also symbolizes the power of the sovereign who guarantees it.

In policy terms, the immediate effect was to switch responsibility for **monetary policy** from the individual member states of the euro zone to those states working as a collective through the European Commission and the European Central Bank (ECB). However, there is a close relationship at the national level between monetary policy and **fiscal policy**, because decisions about money supply and interest rates cannot be divorced from those about taxing, spending and borrowing. Further complicating the picture, while national monetary policies are usually managed by central banks, many of them enjoying a high degree of independence from government, fiscal policy is usually managed at the national level by executives. While banks are concerned with the stability of the money supply, executives often use the balance between income and spending to manipulate the economy. Policy can be expansionary or contractionary, depending on the supply of money; the

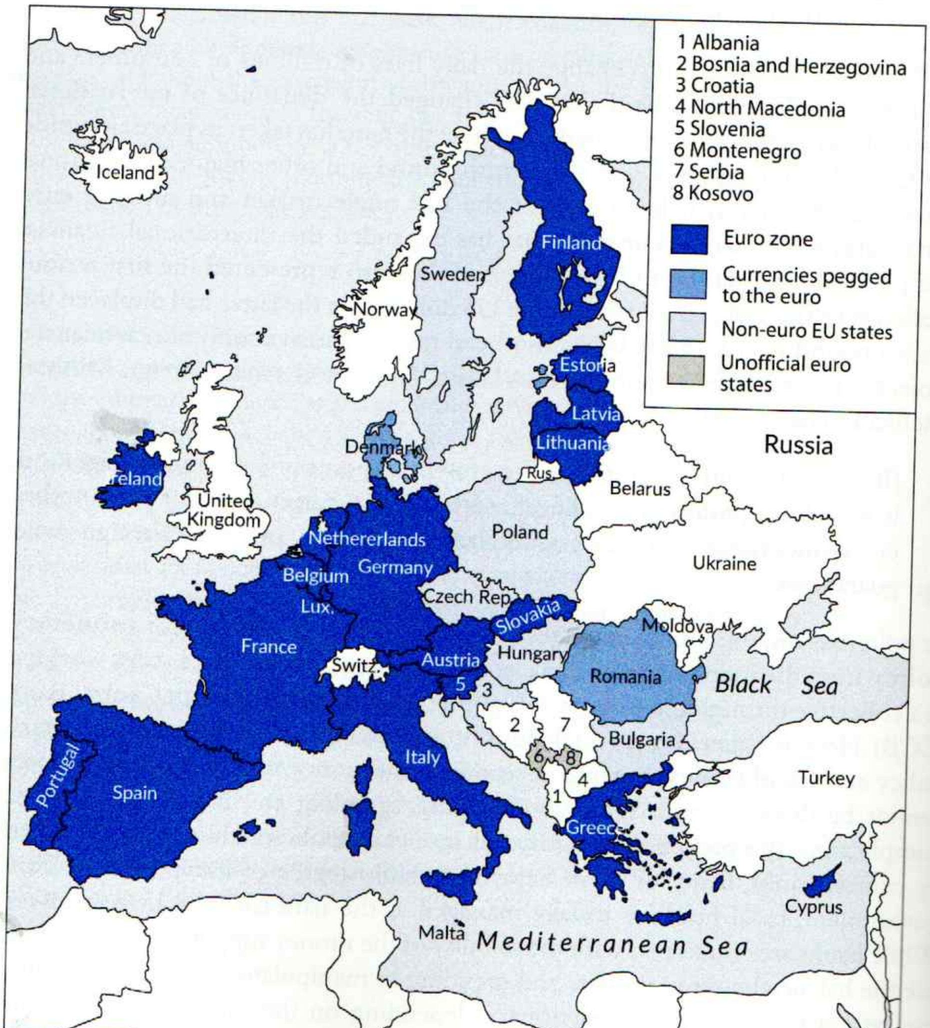
Monetary policy Policy concerned with money supply: the value of a currency, confidence in that currency, the control of inflation and the setting of interest rates.

Fiscal policy Policy concerned with budgets, notably how government raises revenues, how it spends that money, and what effect this has on deficits, taxes and the broader fortunes of an economy.

former involves lowering interest rates during a recession in an effort to encourage job creation, while the latter involves reducing the money supply or taking on inflation by raising interest rates.

One of the structural problems faced by the euro was that while the ECB had a high degree of control over monetary policy in the euro zone (although it still had to work with central banks inside and outside the euro zone), control over fiscal policy remained with the member states. Matthijs and Blyth (2015) went further by writing about the three 'forgotten unions' in the original design of the euro: a financial and banking union (see discussion in Chapter 15), supporting institutions for fiscal union, and political union. Meanwhile, the one obvious coordinating body (the European Commission) was left with few powers beyond its limited options as a mediator and confidence builder. Further complicating matters, not all the EU states have yet adopted the euro. These structural problems were not immediately clear to most ordinary Europeans as they familiarized themselves with the new currency, but problems were already brewing that would soon come home to roost.

Map 21.1 *The euro zone*



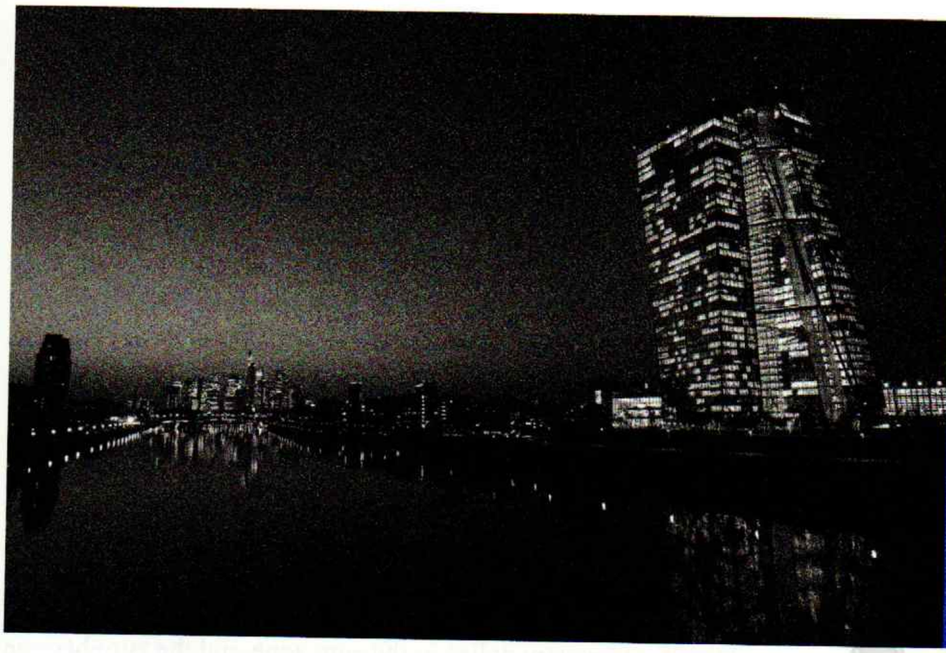


Illustration 21.1: The new European Central Bank headquarters in Frankfurt, Germany. The ECB unexpectedly became a central actor in EU affairs during the euro zone crisis that broke in 2009.

Source: EC - Audiovisual Service

The origins of the euro

As we saw in Chapter 5, stable exchange rates had long been considered an essential prelude to the building of the European single market, most of the early concerns of western European governments being addressed by the Bretton Woods system. Its stabilizing effects through the 1950s and 1960s were reflected in the numbers: the British pound remained steady at a value of about $2.80 between 1950 and 1967, while the West German Deutschmark ranged between 3.90 and 4.20 to the dollar. Early steps were taken towards European monetary cooperation with the signature in 1958 of the European Monetary Agreement, the convening in 1964 of the Committee of Central Bank Governors, and the 1969 agreement among Community leaders to work towards economic and monetary union. The Werner committee report in 1970 recommended monetary union within ten years, beginning with reduced exchange rate fluctuations, to which end the 'snake in the tunnel' was launched in 1972.

As we also saw in Chapter 5, the viability of the snake was undermined by the 1971 US decision to end convertibility between gold and the US dollar, followed by the energy crises of the 1970s. To complicate matters, there was a philosophical split among Community governments on how to proceed: 'monetarists' such as Belgium, France and Luxembourg wanted to fix exchange rates as a means to economic convergence, while 'economists' such as the Netherlands and West Germany saw economic convergence leading to the fixing of exchange rates (for details, see Hosli, 2005). The monetarist view won out, paving the way for the launch of the European Monetary System (EMS) in 1979, based on an **Exchange Rate Mechanism (ERM)** intended to encourage exchange rate stability. The EMS encouraged a new focus on monetary policy, paving the way for the introduction of the three-stage Delors plan of 1989, which was confirmed by Maastricht. As we saw in Chapter 6, this set a target of January 1997 for monetary union (later changed to January 1999), and outlined several 'convergence criteria' for states wanting to adopt the currency, including limits on budget deficits, public debt, inflation, interest rates and exchange rate fluctuations.

Exchange Rate Mechanism (ERM) An arrangement under which member states of the EEC undertook to keep the values of their currencies stable relative to one another.

In 1995 the European Council named the new currency the euro. In 1997 it was decided that 11 member states were ready to begin Stage III of the Delors plan in January 1999, the exceptions being Britain, Denmark and Sweden (which did not want to participate), and Greece (which was not ready). In 1997, at the insistence mainly of Germany, and prompted by concerns about the mixed record of member states in meeting the terms of the convergence criteria, EU leaders signed the **Stability and Growth Pact**. This obliged them to keep their budget deficits to less than 3 per cent of gross domestic product, placed a 60 per cent limit on government borrowing (Hosli, 2005), and allowed the Commission to fine any state in breach of the pact. While supported by most EU leaders in principle, the pact was criticized for being too inflexible, and was described forthrightly in 2002 by Commission President Romano Prodi as 'stupid'. However, the costs of a failure to impose the rules were made only too clear by the case of Greece, which was allowed to adopt the euro in 2001 in spite of its failure to meet the budget deficit target, and went on to so mismanage its economy that in 2009 it set off a debt crisis that rocked the euro to its core.

Stage III of the Delors plan was completed on 1 January 1999 when exchange rates among the participating currencies were permanently locked in place, the ECB took over responsibility for monetary policy in the euro zone, and the euro became available electronically – people could open euro bank accounts, make transfers to other accounts and so on. It became a cash currency in January 2002 when euro coins and banknotes finally replaced national currencies in 12 states (all the EU15 except Britain, Denmark and Sweden). The euro zone expanded to Slovenia in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2104 and Lithuania in 2015. The euro has also been adopted in Kosovo and Montenegro (although they are not formally part of the euro zone), several African countries have pegged their currencies to the euro, and it is increasingly widely accepted in those parts of the world that rely most heavily on European tourism.

Following the launch of the euro in 1999, the ERM was transformed from a project to keep EU member states within a band of exchange rate fluctuations to one designed as something of a waiting room to link other EU currencies to the euro. The purpose of this **ERM II** has been to improve the stability of these currencies and provide a better sense of how potential euro members are faring. Its members are allowed to let their currencies fluctuate within a wide band of +15 per cent relative to the euro, but can choose to follow narrower bands. Any EU member state can adopt the euro once it has met the convergence criteria and stayed within ERM II for at least two years. With most of its former members now part of the euro club, only Denmark remains within ERM II, and no other remaining non-euro country has yet taken the first step of joining ERM II.

Stability and Growth Pact An agreement reached in 1997 by which euro zone governments undertook to control their budget deficits in the interests of currency stability.

ERM II A reformed Exchange Rate Mechanism designed to help improve the stability relative to the euro of currencies in EU states outside the euro zone.

The one clear outlier in the debate over the euro was Britain, where opposition to joining was clear and constant. The Blair government was in favour of joining, but only with a supporting vote in a national referendum that it kept postponing for fear that it would lose. Gordon Brown – then Britain's chancellor of the exchequer (finance minister) – developed his own set of domestic tests of British readiness to join, including convergence between the British and euro zone economies, and the flexibility of business and the workforce. When Brown became prime minister in 2007, he drew unflattering comparisons between growth and unemployment rates in the euro zone and Britain, arguing that domestic policy had helped Britain achieve financial stability and avoid the economic downturn that hit some euro zone states (Buller and Gamble, 2008) (an argument whose ironies became that much clearer as the British economy suffered a downturn during the global financial crisis). The coalition government that took office in 2010 declared that Britain would not join the euro during its parliamentary term, Prime Minister David Cameron going a step further in 2011 when he said that Britain would 'never' join the euro. The discussion became moot following the Brexit vote.

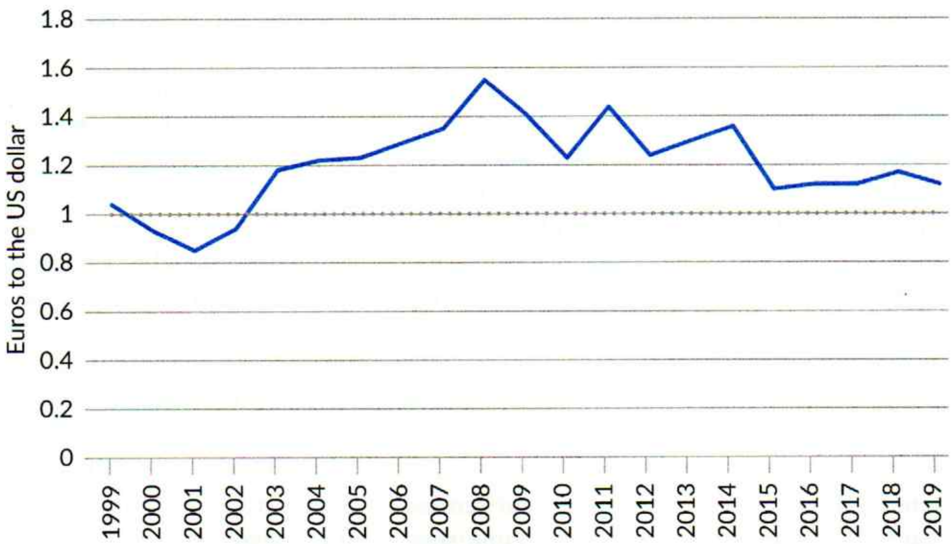
Growing pains of the euro

At first, all went well for the euro. Its adoption was driven by political leadership coming mainly out of France and Germany, and had the paradoxical twin effect of promoting European unification while also unleashing new debates about how decisions on integration were taken (Dyson, 2008). It also proved to be one of the most complex of all EU policy initiatives, contrasting the technical opinions of policymaking elites and professional economists with the instinctive reactions of a bemused European public, for which the advent of the euro meant more direct changes in their daily lives than perhaps any other European initiative. Although the preparations for the switch had been carefully made, and can be dated back at least to the launch of the snake in the tunnel in 1972 (but perhaps arguably to the adoption of the 1958 European Monetary Agreement), the final launch of the euro was still a leap of faith.

On foreign exchange markets, the euro set out at a sturdy $1.18, but fell quickly to a low of 82.5 cents in October 2000, regaining ground to a new high of nearly $1.60 in July 2008 before falling back to $1.19 in June 2010 as a result of the fallout from the Greek debt crisis (see Figure 21.1). Since then, and even in spite of the pressures created by the crisis, the value of the euro against the dollar has remained steady at €1.10–1.20 to the dollar.

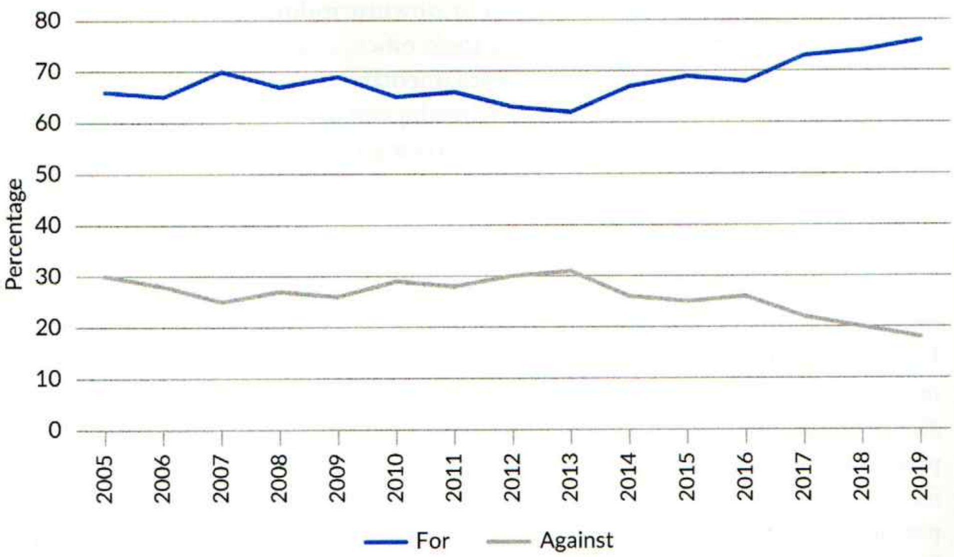
As far as public opinion is concerned, Europeans were doubtful at first, but then became more supportive as they became used to the euro. In early 1997 there were majorities in favour of the euro in only 8 of the 11 potential member states, and for the EU15 as a whole, supporters outnumbered opponents by the

Figure 21.1 *The value of the euro*



Source: *European Central Bank (2019). Exchange rate as of May each year.*

Figure 21.2 *What Europeans think: The euro I*



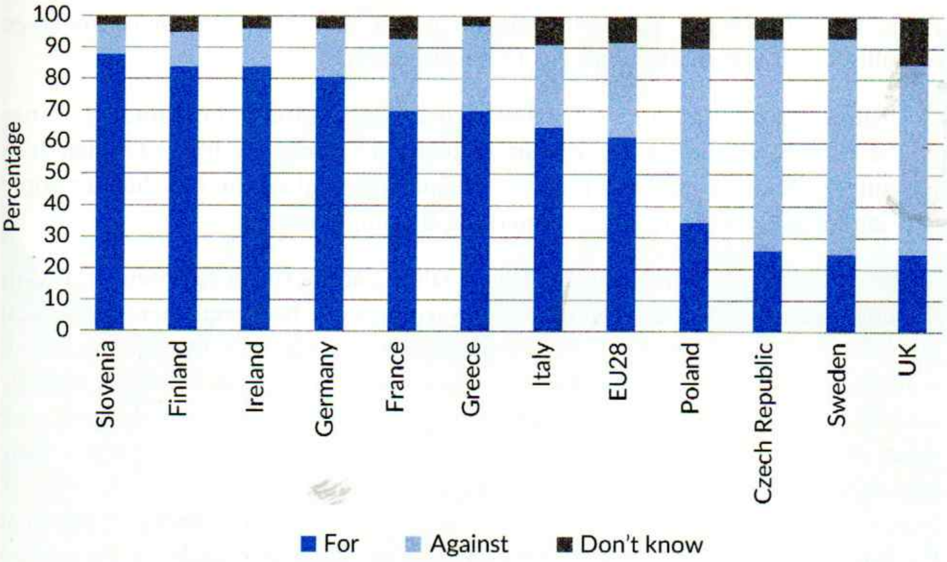
Source: *European Commission (2019). Data for euro area only.*

modest margin of 47 to 40 (European Commission, 1997). A year later, favourable opinions had generally strengthened, with supporters outnumbering opponents by 60 to 28 in the EU15 (European Commission, 1998). By the time euro coins and notes went into circulation in 2002, supporters outnumbered opponents by 67 to 25 in the EU15, and only in Britain did opponents outnumber supporters (by 50 to 31) (European Commission, 2002).

Public opinion on the euro fell slightly during the euro zone crisis, from about 70 per cent in favour to 62 per cent, with less than one-third opposed, since when it has steadily recovered, reaching a new high of 76 per cent in favour by 2019 (see Figure 21.2). It is revealing that every member state of the euro zone has consistently had large majorities in favour of the euro (from a high in 2019 of about 85–88 per cent in Slovenia, Estonia, Portugal, Finland and Ireland to a low of 65 per cent in Italy), while the only opposition is found in those countries that have not yet joined the euro: (in order) Romania, Hungary, Bulgaria, Portugal, Denmark, the Czech Republic, Sweden and the UK (see Figure 21.3). This begs the question of whether or not familiarity breeds support. Even in Greece, with all its problems, supporters of the euro outnumbered opponents in 2019 by 70 to 27 per cent.

The political calculations surrounding the euro – based on a set of often opaquely technical economic and financial considerations – are more complex than the personal calculations of ordinary Europeans, most of whom respond to the euro almost entirely from the perspective of convenience. The most immediate benefit of the euro to consumers is that they can travel to multiple countries without having to exchange currencies or pay fees, and they can more clearly see how prices compare without having to translate them back into their home currency. The existence of the euro has also had an important psychological effect on Europeans, making the foreign seem more familiar, and removing one of the most persistent reminders of the differences among EU states. It has also given each euro zone state a more clearly vested interest in the economic welfare of its partners. Finally, the existence of the euro helps

Figure 21.3 *What Europeans think: The euro II*



Source: European Commission (2019).

businesses, whose transactions are easier to undertake, and who do not have to be concerned about fluctuations in exchange rates.

At the same time, there are disadvantages to a single currency, the biggest concern being loss of policy independence. A national currency gives a government (or central banks, at least) a powerful means of managing its economy through adjusting interest rates, which in turn have an effect on inflation and rates of spending and saving. Independent decisions that were once made by the central banks of the euro zone states are now made jointly by those states working within the ECB. Where different EU states with different economic cycles, economic structures and levels of wealth and poverty could once borrow, adjust interest rates and, if necessary, devalue their currencies in response to changed economic circumstances, they must now move in concert with their neighbours. An economic downturn in one (particularly crises as dramatic as those that came to Greece and Ireland in 2010) has implications not just for all the other euro states, but even for the global economy.

States adopting the euro must also give up a powerful symbol of national identity and independence. This is true for smaller EU states that have seen their currencies as the last means of exerting some real control over national economies, and has been especially true for bigger and wealthier EU states with world-class currencies. Consider the case of Germany, where the success of the Deutschmark was central to the country's post-war renaissance. Consider also Britain, where national pride explains much of the reticence about giving up the pound; it is the world's oldest currency still in use (dating back to Anglo-Saxon times), once circulated through much of the British Empire, and was the world's leading international currency for decades. For many Britons, giving up the pound is not just about a loss of economic independence, but would further confirm the decline of Britain's world role. (Some might argue, however, that participation in the euro – like its continued membership of the EU – would have actually helped increase Britain's global economic influence.)

CONCEPT

Sovereign debt

The amount of debt accrued by a national government, otherwise known as government, public or national debt. The debt can be owed to lenders inside a country and to foreign lenders, including other governments, and can be either short term (usually less than a year) or longer term (often ten years or more). It is issued in a foreign currency, the level of risk for investors usually reflected in the credit rating earned by a borrowing country. In the event of debt repayment problems, the usual response is to renegotiate the terms of the debt. The Greek debt crisis emerged in part because Greece was unable to service (make the payments on) its debt.

The crisis in the euro zone

Pisani-Ferry (2014, p. 3) argues that currencies should not occupy the centre-stage of politics, and that their purpose is to go unnoticed:

> Money serves its purpose when it helps to measure the value of things as reliably as the metric system helps to measure lengths, and when it is unpretentiously used as a medium of exchange and a store of value. If people start talking about it, surely something is going wrong.

There was little question that people were talking about the euro when a crisis hit the euro zone in 2009, but many of the warning signs had been there for several years. A red flag was raised in 2002–03 when recession came to most industrialized countries, and most euro zone countries breached the budget deficit limit, thereby undermining the prospects for economic growth. It was particularly worrying when the two biggest euro zone economies – France and Germany – not only breached the limit but blocked attempts by EU finance ministers to fine them. Instead, the French and German governments argued (with British support) that the rules of the Stability and Growth Pact were too rigid and needed to be applied more flexibly. By December 2003 the pact had all but collapsed, and in 2005 the rules were relaxed in order to make it more achievable and enforceable.

Then came the global financial crisis of 2007–09. The implications of an economic downturn had been anticipated and warned against by some economists, but politics overrode economics, and the recession revealed some of the advantages and disadvantages of monetary union. It particularly showed the degree to which EU states were part of a globalized financial system, where problems in one part could have immediate and sometimes surprising knock-on effects in others. At the same time, the contrasts between Ireland and Iceland gave pause for thought; while the former took some comfort from its membership of the EU and the euro, sharing the costs but also the opportunities, the isolation and vulnerability of Iceland was made clear by a banking crisis in 2008 that sent shockwaves through the Icelandic community and undermined its national currency, the krona. Parties and political leaders that had been lukewarm towards EU membership now changed their positions, seeking a haven in European integration, and Iceland lodged its formal application for EU membership in July 2009, although its enthusiasm for the EU has since waned, and it withdrew its membership application in 2015.

After some initial indications of independent national responses to the crisis, EU governments improved their policy coordination (see Cline, 2014). On the monetary front the ECB made interest rate cuts, while calls were made for a complete overhaul of the EU financial system. Then in late 2009 came the most severe test ever faced by the euro, and indeed by the EU: the **sovereign debt** crisis that began in Greece, but which quickly revealed not just that many EU economies were in trouble, but that problems in one promised to have knock-on effects in the others. For Pisani-Ferry (2014), it was the moment when the euro ceased to be boring. Above all, the crisis posed a severe test of the abilities of euro zone leaders to make policy, and threatened to undermine the international credibility of the euro. 'Is Greece's debt trashing the euro?', asked *The New York Times* in February 2010. 'Could Greece kill off the euro?', asked the host of an influential BBC radio news show in May 2010. 'The experiment of a monetary union without political union has failed', argued a commentator in the *Financial Times* in May 2010. 'The EU is thus about to confront a historic choice between integration and disintegration.'

Illustration 21.2: Demonstrators take part in a 2015 referendum in Greece on the question of whether or not to accept the terms of an EU bailout agreement. The result was a heavy defeat for the Greek government.

Source: iStock/tatakis

While hard to explain simply (see Focus 7), the crisis was the result of a combination of domestic problems in what quickly became known as the PIGS (Portugal, Ireland, Greece and Spain), resistance by Germany to compromise its well-deserved reputation for economic management and success, design flaws in the euro (in particular the inability of the ECB to influence borrowing policies in the member states), and the fallout from the global financial crisis, for which no country was prepared. After months of debate and confused responses to the crisis, with a combination of bailouts and demands for austerity measures, which were in turn followed by complaints that growth should take precedence over austerity, the euro zone saw the adoption of a stronger Stability and Growth Pact, tighter requirements for balanced budgets, and the creation of new institutions to oversee the European banking sector, securities markets, insurance policyholders and pensions schemes (see Chapter 7).

Opinion on the future of the euro remains divided, the absence of certainty being illustrated by two articles written by American financial experts in 2012. Early in the year, the economist Martin Feldstein (2012) declared unequivocally that 'the euro should now be recognized as an experiment that failed', that its failure 'was not an accident or the result of bureaucratic mismanagement but rather the inevitable consequence of imposing a single currency on a very heterogeneous group of countries', and that 'the political goal of creating a harmonious Europe' had also failed. However, Feldstein hedged his bets by acknowledging that the euro zone was 'likely to continue with almost all its current members', their challenge now being to change their economic behaviour with balanced budgets and the avoidance of current account deficits.

A few months later, Fred Bergsten (2012) acknowledged the remaining problems of the euro zone, but declared that fears of the collapse of the euro were 'vastly overblown'. The euro zone states had shown that they could and would cooperate to address each stage in the crisis, and had created new institutions and a 'financial firewall to prevent debt problems from spreading'. When the dust had settled, FOCUS 7

Explaining the euro crisis, by George Soros

It is difficult to explain the euro zone crisis without causing either bafflement or rebuttal. The needs of the euro were not fully understood from the outset, the rules on membership were often broken, and the ECB was long working with one hand tied behind its back because of the resistance of national governments to giving up control over fiscal and tax policy. When the euro's problems began to emerge, the experts differed over how to explain them and what action to take in response. One of those experts, who has a skill for clarity, is the international financier George Soros (2012), who in early 2012 offered a remarkably clear explanation of the causes of the crisis.

Before the introduction of the euro, Soros argued, poorer EU states such as Greece, Spain and Ireland had to pay more than wealthier members to borrow money, and thus were mainly obliged to live within their means. With the introduction of the euro, all euro zone countries could borrow at the same cheaper rate, and banks were quick to lend to the poorer states. While the German economy was doing well, exporting more and becoming more competitive, poorer countries were living beyond their means, using their new access to cheap credit to buy imports and build houses, while exporting less.

The breaking of the global financial crisis in 2007 confirmed what many had long known: the economies of the euro zone states were quite different in terms of their structures and possibilities, and lending to one was not the same as lending to another. Once it became clear that poorer euro zone states might have trouble repaying their debts, the interest rates on loans were raised, placing enormous pressure on the banks that had made the loans. Thus, the debt problems of borrower states became intertwined with the problems faced by the banks that had made the loans, which now faced the prospects of insolvency.

It was clearly in German interests, Soros continued, to lead a resolution of the problem, because the collapse of the euro would have left it with uncollectable debts and surrounded by countries to which it had exported a great deal, but for which German imports were now much more expensive. The option chosen was to bail out the at-risk euro zone states while demanding austerity (cutbacks in spending) in return. However, Soros believed that the authorities did not understand the nature of the euro crisis: they thought of it as a fiscal problem when it was more of a banking and competitiveness problem. Instead of trying to reduce the debt burden by shrinking economies, they should have been trying to grow their way out while working to address the design flaws in the euro. Failing to understand the problem, and unable to see a clear solution, they sought instead to buy time.

he confidently concluded, the single currency and indeed the entire project of European integration was 'likely not only to survive but to emerge even stronger'.

The debate about the future of the euro has continued since then, pitting the optimists against the pessimists (see Sawyer, 2018). In 2016, for example, the Nobel laureate American economist Joseph Stiglitz argued that the euro 'was a system almost designed to fail', because it took away the ability of governments to adjust economies through changes in interest and exchange rates while imposing new strictures on deficits, debt and structural policies. It was supposed to bring shared prosperity, and to advance the goal of European integration, he concluded, but it had instead done the opposite by slowing growth and sowing discord (Stiglitz, 2016). Conversely, Brunnermeier et al. (2016) were arguing that despite its problems, the seemingly incompatible differences between France and Germany could be reconciled in a way that would give new strength to both the EU and the euro. It should also be remembered that in spite of its many problems, the euro continues to survive, and also survived the enormous stress test of the sovereign debt crisis. Changes made in the wake of the crisis have made the euro stronger, and its popularity among ordinary Europeans has been growing.

The euro as a global currency

Before the shock of the euro zone crisis, speculation had begun to grow in some quarters that the euro had a bright future in store as a global currency, and might pose the first real challenge to the dominance of the US dollar. For Nobel laureate Robert Mundell (2000, p. 57), the euro promised to 'challenge the status of the dollar and alter the power configuration of the international system'. A 2005 study predicted that if the euro zone continued to expand in size and if US economic policies continued to undermine confidence in the dollar, then the euro could supplant the dollar as the world's leading reserve currency by 2022 (Chinn and Frankel, 2005).

DEBATE 5

Will the euro survive?

YES

- It is too big to be allowed to fail. Problems with the euro have already undermined the single market and cast unprecedented levels of doubt over the exercise of European integration, something that cannot be allowed to go too far.
- Public support for the euro is strong and growing.
- The euro zone crisis was at least as much the fault of poor policy choices made by national governments and financial institutions as of problems with the euro itself. The design flaws in the euro and the policies pursued by its members have been largely addressed in the wake of the crisis.
- Regional integration has always been an exercise in improvisation, driven by frequent crises, but national governments have proved adept at learning from (most of) their mistakes.
- The costs for a state opting out of the euro (or being expelled) are too great. As well as the immediate expense of converting to a new national currency, there would be numerous longer term costs in the form of reduced investor confidence and currency revaluation.
- If the euro is seen as weak, then we have to ask: compared to what? The US dollar remains strong, but US economic policy – with its enormous national debt, trade imbalance and inadequate spending on infrastructure – does not help the dollar, and China is not yet in the position to offer an alternative global currency.

NO

- The euro had critical design flaws from the beginning, the most notable being the decision to leave fiscal policy in the hands of the member states. Efforts have been made to fix these problems, but the crisis has shaken the structure of monetary integration.
- There is still not enough confidence in the ability of euro zone leaders to agree policy or fully understand the implications of the euro's structural faults. The kinds of reforms needed to fully fix the euro are too politically troubling to be accepted by all EU governments and their voters.
- The euro zone states continue to have different economic cycles and sometimes different sets of economic policies and priorities, and several suffer high unemployment rates. There can be no 'one-size-fits-all' policies for the euro zone, a problem that is not made easier by the existence of the euro.
- A middle-range option is for selected states to leave the euro and the remainder to reformulate themselves as a smaller, deeper and better managed euro zone. This is likely to be as politically unacceptable – and to cause as many problems – as states leaving or being ejected from the euro.

CONCEPT

Reserve currency

A reserve currency (or an anchor currency) is a foreign currency held by central banks and other major financial institutions as a means of paying off international debt obligations, or in order to influence domestic exchange rates. Since the 1950s, the US dollar has been the dominant global reserve currency, thanks to a combination of the size and openness of the US marketplace and the pricing of internationally traded commodities in dollars.

The stability and credibility of a currency depends mainly on three qualities (see Chang, 2016):

1. *Its strength as a medium of exchange*: meaning that it can be used to settle international financial transactions.
2. *As a unit of account*: it can be used to invoice foreign trade, anchor exchange rate regimes or denominate international commodities.
3. *As a store of value*: investors hold deposits and loans in the currency, governments use it as a reserve, and its purchasing power remains reasonably steady over time.

Government and consumer confidence also plays a role: the bigger, wealthier and more open a national economy, the more likely that its currency will circulate internationally, and consumers and businesses will trust and use that currency.

In all senses, the currencies of most advanced capitalist societies are stable and credible, in contrast to those of weaker states whose currencies might be overvalued, or might not have developed much long-term stability or credibility, or might – in extreme cases – be almost worthless. The latter problem, for example, encouraged Zimbabwe in 2009, following years of hyperinflation, to abandon the Zimbabwe dollar and replace it with credible currencies such as the US dollar and the euro. Having a world-leading currency offers many benefits to the state that owns and controls that currency:

- It means political leadership, because the government that controls that currency will inevitably play a major role in international monetary policy decisions, which can be turned to the benefit of its home state.
- Other countries are more likely to hold more of their foreign reserves in that currency, helping it maintain its value.
- There is more chance that key internationally traded commodities such as oil, gold and silver will be denominated in that currency, which means fewer exchange rate problems for the home state when it comes to buying those commodities; if they are denominated in another currency, the price will fluctuate according to the relative values of the two currencies.
- It makes it easier for a country to run foreign trade deficits, and gives a country the advantage of borrowing in its own currency, making it less a hostage to fluctuations in the value of its currency relative to others.

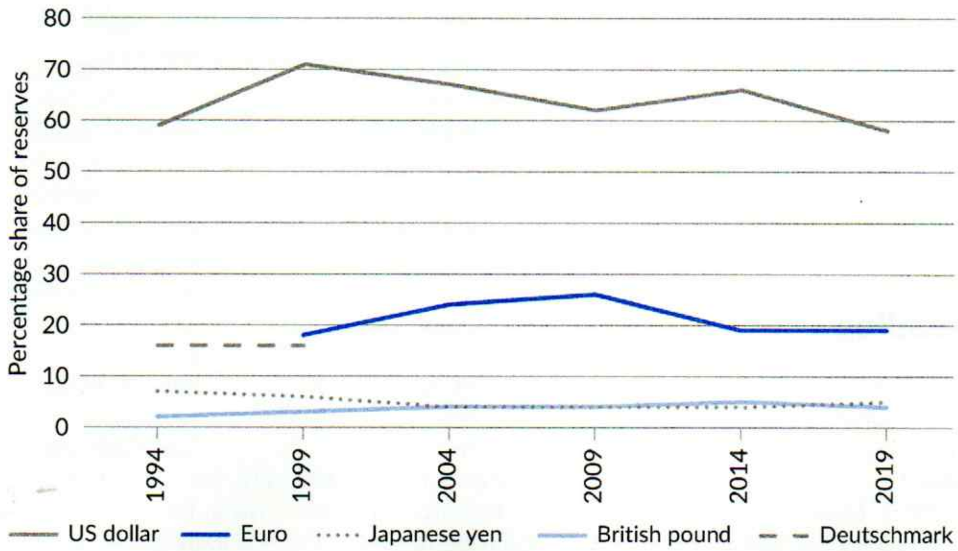
The most telling measure of global monetary influence is the extent to which a currency is used as an anchor or **reserve currency**, in which other governments hold a significant amount of their foreign exchange reserves, and in which products traded in the international marketplace (such as oil and gold) are denominated. During the eighteenth and nineteenth centuries, the British pound was the world's primary reserve currency, its strength underpinned by the size of the British economy and the trade network linking Britain to its empire. However, the costs of fighting two world wars, combined with the rise of the US as an economic power, had put paid to the dominance of the pound by the 1950s. Underpinned by the size and reach of the US economy and encouraged by the US role as anchor of the Bretton Woods system, the dollar became the world's dominating and most respected currency. Its global leadership continued to be unquestioned until the 1990s, its share of international foreign exchange reserves far exceeding those of the German Deutschmark, the British pound or the Japanese yen.

The launch of the euro had the potential to change the nature of the game. Even though two-thirds of international foreign reserves were held in US dollars at the time, the euro took over nearly one-fifth of foreign reserves (thanks mainly to a switch from the Deutschmark), its share growing to a peak in 2009 of just over one-quarter (see Figure 21.4). Its share grew even while holdings in foreign currencies were growing, from \$1.4 trillion in 1999 to \$4.5 trillion in 2009, and nearly \$12 trillion in early 2019. After its initial burst of speed, however, the euro settled onto something of a plateau, falling in the wake of the euro zone crisis to about 20 per cent of the share of reserves. The role of the dollar continued almost unchanged in spite of the global financial crisis, when the reputation of the US as the home of high-quality and dependable financial assets took a drubbing. It also held despite the rapidly growing US national debt, which reached a new record in 2019 of \$22 trillion (and was expected to keep growing).

Several developments have meanwhile suggested that there is new international interest in seeking an alternative to the US dollar, even if it is not necessarily the euro. Concerns have been driven by the level of influence the US has over international economic policies, but also by the risks that countries such as China are taking in holding large dollar reserves against a background of escalating US debt. Also, as countries trade more with the EU, runs the argument, so they might want to switch more of their foreign reserves into euros. Several countries – including Russia, China and Saudi Arabia – had switched from holding all their foreign reserves in US dollars to using a basket of currencies before the euro zone crisis. There has also been talk in Russia and China of using the Special Drawing Rights made available by the International Monetary Fund since 1969 as an alternative to the US dollar – but these cannot be traded and cannot be used to pay bills. Finally, there has been talk of the development of an Asian currency unit, and even that changes in China might allow the yuan to trade freely on international markets and become a new reserve currency and a lynchpin of world currency markets along with the dollar and the euro (O'Neill, 2010).

Prior to the euro zone crisis, Cohen (2008) argued that the euro suffered several handicaps, the most difficult of which was the lack of clear leadership within the

Figure 21.4 *The euro as a reserve currency*



Source: *International Monetary Fund (2019).*

European Central Bank, where decisions are made communally by the Governing Council and the Executive Board, and members may be inclined to think more in terms of national interests than euro zone interests. The president of the ECB had failed to win the same kind of international status and exposure as the chairman of the US Federal Reserve. The failure of the euro to live up to expectations was meanwhile helped by the continuing dominance of the US dollar.

The euro zone crisis inevitably raised questions about the euro as a global currency, particularly during the more pessimistic days when questions were being asked about countries leaving the euro and its possible collapse. The EU continues to face many economic problems, not least high unemployment and low growth, and the imbalance between its richer and poorer members. However, many of the design flaws in the euro have been resolved, the leaders of euro zone states have learned much from the crisis in regard to how national governments should approach their budgets and borrowing, and new rules and institutions have been agreed that are designed to strengthen the foundations of the euro. Given this, and the ongoing concerns about US economic problems and questions about the transparency of Chinese economic policy, the speculation about the global role of the euro is certain to continue unabated.

Discussion questions

1. Was moving ahead with the euro a wise choice?
2. Would non-euro EU countries be better advised to wait and see, or work more actively to pave the way to joining?
3. What are the long-term implications of the euro crisis?
4. Will the euro survive?
5. Why has the euro been unable to take a bigger percentage share of international foreign reserves?

Key terms

ERM II
Exchange Rate Mechanism
Fiscal policy
Monetary policy
Stability and Growth Pact

Concepts

Reserve currency
Sovereign debt

Further reading

- De Grauwe, Paul (2018) *Economics of Monetary Union*, 12th edn (Oxford University Press). A general survey of monetary union, placing the EU experience within its wider context.
- Chang, Michelle (2016) *Economic and Monetary Union* (Palgrave). A survey of EMU, including chapters on monetary and financial integration, the work of the ECB, and the structure and effects of the euro.
- Pisani-Ferry, Jean (2014) *The Euro Crisis and its Aftermath* (Oxford University Press). While the story of the fallout from the crisis in the euro zone will continue to evolve, this is a lively and informative look at its immediate aftermath.