Breaking Up is Hard to Do

The Eurozone and the political economy of monetary disintegration

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Introduction

Marriages start off with vows of commitment and high hopes of happiness for the partners involved. Either via a somewhat serendipitous process, or increasingly via a process that involves computerised dating, the respective partners will have tried to find someone with whom they are compatible. Dating agencies will seek to ensure this by identifying key personal and social characteristics, and endeavouring to match them between the partners. The assumption seems to be that similarities rather than opposites attract, and are the recipe for a lasting marriage. Even where incompatibilities exist to begin with, successful marriages rely on couples 'growing together' in a way that narrows the differences.

While full of good intentions at the outset, the hard fact is that marriages do not always work, and some end in separation and divorce. Indeed, in anticipation of this possibility, a pre-nuptial contract may be signed. Calculating compatibility is not a perfect science, and differences may turn out to be both fundamental and irreconcilable. However, divorces are stressful and signs of failure. While on some occasions they will be amicable, on others they will be messy and acrimonious, and filled

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with accusations of misconduct and recriminations. But even given the pain of divorce, the perception of those involved is that it is sometimes less undesirable than struggling on with an unsuccessful and unhappy marriage.

This article examines the 'monetary marriage' involved in the formation and evolution of the Eurozone. Were the partners compatible at the outset? If not, did they become more compatible over time? Have they shown a willingness to make the compromises necessary to make the marriage work and to avoid irreconcilable differences? Has a point been reached where divorce – the break-up of the Eurozone in its current form – is a serious option? And, if so, how should the break-up be arranged to minimise the pain, anguish and disruption it causes? Or is there still scope for effective marriage guidance counselling that encourages the partner countries to reform the Eurozone in ways that will sustain it?

The article is organised in the following way. It begins by examining the compatibility between partner countries at the time that the Eurozone was set up, drawing on well-established optimum currency area theory. It then investigates the extent to which member countries have 'grown together' by considering whether OCA criteria have turned out to be endogenous. Next it examines the scope for reconciliation aimed at saving the Eurozone. Finally, it analyses the costs of breaking it up and the manner in which this might be achieved in a way that minimises the adverse effects on the partners. There is little doubt that breaking up will be hard to do, but this does not necessarily mean that it is the most undesirable option.

Assessing compatibility

What factors affect the compatibility of countries when they consider establishing a currency area and participating in a process leading to full monetary integration with a single currency? There is a well-known list of optimum currency area criteria that attempt to determine this. The relevant issues include the degree of factor mobility, the openness of the economies involved and the extent to which they trade with one another, the degree to which the economies move in macroeconomic step, the flexibility of their labour markets and the scope for financial transfers and the degree of financial integration among the partner countries. Taken together these issues affect, first, the extent to which macroeconomic disequilibria are likely to arise between the partners, and, second, the extent to which disequilibria can be dealt with should they arise, either by using measures other than the exchange rate to correct them, or by providing balance of payments financing for the countries encountering current account deficits.

At the time that the European economies began to 'court' one another in the 1970s, and then became 'engaged' by setting up the European Monetary System in 1979, which incorporated exchange rate pegging in the form of the Exchange Rate Mechanism, the general consensus was that the potential partners fell some way short of meeting many of the OCA criteria. Factor mobility was limited by both culture and language, many countries had important trade links outside Europe, and the European economies were not highly synchronised macroeconomically. On top of this, a stylised fact about many European economies concerned the inflexibility of their labour markets, which limited the scope for 'internal devaluation' by adjusting relative price levels. The conclusion reached by many was that the lack of a strong economic case for integration revealed that the prime motivation for it was political. Of course history shows us that some high-profile marriages have been arranged for political reasons, to reaffirm alliances or placate potential enemies. It also shows us that such marriages can end up with someone losing their head – literally.

The lack of a strong economic case for monetary integration revealed that the prime motivation for it was political.

The resolve of the potential European partners to carry on with their plans to marry was tested during the period of engagement by the crisis in the ERM in 1992. Critics of the project interpreted this as illustrating the underlying incompatibilities between the potential partners. They advised that the plans to marry, in the form of introducing the euro and setting up the Eurozone, should be abandoned. Meanwhile supporters of European monetary integration interpreted it as showing that the engagement had been too prolonged and half-hearted. According to them what was needed was the greater commitment that full monetary integration and the introduction of a single currency would signal. 'New' OCA theory emphasised the role of credibility. The suggestion was that, while countries retained a way of pulling out of the ERM engagement by altering their exchange rates, the commitment not to exploit this option would not be believed. Instead, the stronger commitment associated with the formation of the Eurozone in 1999 (the marriage) was seen as a means of delivering the greater credibility that was needed to make the partnership work and to derive the benefits from monetary integration.

How long should the engagement have lasted and at what point should the wedding have taken place? The idea was to ensure that the necessary degree of compatibility had been achieved before the marriage was arranged. Convergence criteria were designed to try to make certain that this was the case, bringing inflation rates and interest rates into line, and limiting the size of fiscal deficits and debt. The marriage ceremony eventually began in 1999 with the introduction of the euro as a common currency and it was completed in 2001 when the euro took over as the single currency in the partner countries. However, some observers of the Eurozone wedding remained sceptical about whether the marriage would last. They were still worried about the underlying and, as they saw it, irreconcilable differences between the partners. Even at this time the Eurozone economies could not offer a completely compelling case for full monetary integration based on conventional OCA criteria.

The early years of the Eurozone marriage: growing together or growing apart?

The hope was that the partners would grow closer together over time and become more compatible so that they would find it easier to live together. Institutionally Europe's Stability and Growth Pact (SGP) was supposed to encourage this, or at least prevent the partners from growing apart. As things turned out, however, the aspirations were not fulfilled. The claim that OCA criteria are endogenous and would be brought about as a consequence of monetary integration has remained more of a theoretical notion than a reality. Trade among the Eurozone partners has increased but not significantly more than among non-Eurozone European countries. Growth rates across the Eurozone countries have not been particularly highly correlated. Fiscal balances have not been synchronised, and there has been a fairly general failure to comply with the SGP rules. The SGP has conspicuously failed to constrain fiscal excesses. Under the security of a European marriage some of the partners continued to exhibit their bad fiscal habits or even indulged in them to a greater extent than before. The Eurozone countries have also been exposed to asymmetric shocks as they were not all equivalently affected by the global financial and economic crisis in 2008/09. At the same time, and without the ability to use monetary policy independently or to alter exchange rates, they have lacked the policy tools needed to handle the macroeconomic disequilibria that have arisen. Internal devaluation has turned out to be a poor substitute for the real thing.

For a time, the underlying deficiencies in the design of the Eurozone did not seem to matter. Countries on the periphery enjoyed excess credibility, and imported the reputation of their core partners. By 'tying the knot' with stronger European economies the weaker ones were able to increase their access to international capital, and this enabled them to finance their fiscal and current account deficits. From their point of view, there was a 'honeymoon' period. They behaved in a way that suggested that they were oblivious to the harsh realities of married life that they would encounter once the honeymoon was over. In effect, some of the partners used their credit cards too much; many marriages break down over money matters and excessive indebtedness.

The compromises that would have made the monetary marriage stronger in the long term were not made by the respective partners. In particular, there was no genuine attempt to undertake the necessary degree of fiscal coordination. Deficits got much bigger in some countries than in others, and while some countries experienced current account deficits others experienced surpluses. As the honeymoon period came to an end, these apparently irreconcilable differences came to the surface. The Eurozone entered into a phase during which there were rather weak attempts to patch up the problems by providing additional finance to countries with unsustainable current account deficits and excessive levels of debt. This has been the strategy – if that is the right word – that has been pursued from 2009 until the beginning of 2012. There has also been some renewal of the vows to avoid fiscal excesses in the form of the 'fiscal compact' negotiated in March 2012. But the big question is whether the commitment to the marriage is sufficiently strong to bring forward the more enduring compromises that are needed to avoid the eventual break-up of

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the Eurozone. Will the stronger partners ultimately be prepared to relax domestic fiscal policy or to increase the amount of finance aimed at helping to bail out the weaker partners either directly or indirectly by assisting the banks that hold their debt? Will the weaker partners be prepared to make the sacrifices that will be entailed in restoring debt sustainability, especially in circumstances where they might argue that fiscal austerity will merely reduce economic growth and make fiscal imbalances worse as well as debt less sustainable? Elections in Greece have shown that the commitment to the Eurozone marriage is less than full.

Reconciliation and marriage guidance counselling

What is needed to save the monetary marriage that is represented by the Eurozone? And what if the partners are unwilling to pursue the appropriate policies of their own volition? Perhaps counselling from an outside agency can help. The IMF, the European Central Bank (ECB) and the European Union, the so-called 'troika', have been heavily involved in trying to help reconcile the differences between Eurozone partners. Of course, their involvement has not only been advisory. They have also put their money where their mouths have been. Such direct financial involvement has enabled the 'counsellors' to exert some degree of leverage on deficit countries, but less so on surplus ones, and in particular Germany.

The IMF has stated clearly and forcefully its views on what needs to be done in both deficit and surplus countries. But, as things have turned out, it has had little effective way of ensuring that its advice is heeded, particularly in surplus countries that only need financial support from the IMF in the sense of reducing the claims that there would otherwise be on them to provide finance for the weaker deficit countries. As with marriage guidance in general, the success of counselling in the end depends on the strength of the partners' desire to save the marriage, and their willingness to make the compromises and concessions needed to achieve this. In the case of the Eurozone, and as noted above, the question remains as to whether Greece and some other troubled economies are prepared to make domestic sacrifices on the scale that the counsellors are demanding when they are confronted with severe political opposition to cuts in government expenditure and tax increases. Similarly, there must be doubts as to whether Germany will be prepared to adjust its own fiscal policy, or to continue to bankroll deficits in other countries when this is acutely politically unpopular domestically. Will the ECB feel able to circumvent its mandatory obligation not to bail out countries in crisis by buying their bonds? The answers to these questions affect the probability of Eurozone divorce. How close to the prospect of breaking up does the Eurozone have to come before the measures needed to repair it are adopted? For how long can the Eurozone teeter on the brink of breaking up without either collapsing or being forced to put in place a credible strategy for saving the marriage? The short answer is that no one knows for sure. However, the inability or unwillingness of the partners to come up with such a coherent strategy has certainly raised the spectre of a potential break-up. In such circumstances, other observers of the Eurozone's marital problems, the international capital markets, can make matters worse by losing confidence in the durability of the marriage.

Predicting what will happen to the Eurozone in the future and whether it will disintegrate is not much helped by looking to the past since there is no close historical precedent. The break-up of the Czech and Slovak monetary union and the dissolution of the ruble zone are not directly comparable. By the same token, although many currency crises in the 1990s and early 2000s shared some features with the Eurozone crisis, they did not take place within the context of a monetary union. Crises in Mexico in 1994, East Asia in 1997/98, Brazil and Russia in the late 1990s, and Argentina and Turkey in 2001, did however show that devaluation and debt default are normally delayed for as long as possible, but are ultimately unavoidable. There is also relevant European experience since both the UK and Sweden withdrew from the ERM, the precursor of the euro, when they reached the conclusion that the costs of staying inside outweighed the costs of pulling out. Other countries devalued without withdrawing. In some respects the UK in 1992 found itself in a situation that is not dissimilar to that found in Greece in 2012 in as much as there was a classic second-generation crisis reflecting the incompatibility between internal and external targets at the exchange rate that was being pegged. It is also interesting to note that Germany did not adjust its own policies in ways that would have made UK withdrawal less likely.

Of course Greece and other troubled Eurozone countries would not be able to devalue without withdrawing from the Eurozone and, as the Maastricht and Lisbon treaties imply, to do this they would have to pull out of the European Union as well. There is therefore an additional factor at work that will further delay any decision that might otherwise have led to devaluation. Withdrawing from the Eurozone involves economic, political and technical issues, the combination of which has not been confronted before.

Divorce: the break-up of the Eurozone and monetary disintegration

While, over the years, a great deal of attention has been paid to the process of monetary integration and to the stages through which it passes, there has been no equivalent attention paid to the reverse process – that of monetary disintegration. In the case of the Eurozone marriage there was no pre-nuptial agreement to guide divorce proceedings Apart from reflecting the view that marriage was an irreversible step, there was a logical reason for the absence of a 'pre-nup'. As noted in the introduction, new OCA theory claimed that monetary integration would lead to benefits only if it carried credibility, and it would carry credibility only if the commitment to it was seen to be strong and complete. Having a pre-nuptial agreement about withdrawing from the Eurozone, or dissolving it, would have undermined its credibility. Ironically, as things turned out, it was excess rather than deficient credibility that turned out to be the problem. The risk of things going wrong to an extent that threatened the future of the euro was underestimated. The hope was that, by opting not to have an escape route, the probability of needing to escape would be reduced to zero.

The problem with this approach is that if things do go seriously wrong, as they have, there is no straightforward means of getting out of the mess. Withdrawing from the Eurozone will be difficult because, almost subconsciously, the partners in the project designed it to be that way. But what would be the potential benefits and costs of withdrawal, and would they be the same for all the partners. If not, which partners are most likely to file for divorce?

Divorce (withdrawal) would allow Greece to behave in a way that is not possible while a member of the Eurozone. Greece's policy targets would remain the same but the number of policy instruments available to help hit them would increase to include devaluation and independent monetary policy. The debt default option would also be available. From one point of view this would make life easier for Greek policymakers, since there would be less need to rely on short-term fiscal policy and labour market reform – policies that encounter strong political resistance and are therefore difficult to implement. However, once a country is in a crisis, there are no easy solutions, and this would apply to Greece and any other troubled economy that opted to withdraw from the Eurozone. As noted earlier, devaluation tends to be used as a last resort in crisis resolution. This is because there are problems associated with it: devaluation is not a magic bullet.

The potential problems with devaluation include the following: it might take time for it to have an effect on the current account; it could lead to a sharp increase in inflation that would offset the gain in competitiveness; it would have adverse balance sheet effects as the drachma value of liabilities expressed in euros rose, and there would almost certainly be significant contractionary consequences; it could generate a strongly negative market response that would lead to pronounced overshooting, which would in turn make the balance sheet effects worse.

To add to the potential economic problems, there are the political ones. The Greek government would have to abandon what had previously been presented as a centrepiece of its economic and political agenda. How could this be made to appear other than a failure, something to which governments are reluctant to admit? Withdrawal might be seen by other members of the Eurozone as an aggressive competitive move, and this could induce some form of retaliation. Would Greece's membership of the European Union be threatened with the related loss of EU trade concessions? Certainly Greece would lose what might be perceived as a privileged position as a member of the Eurozone.

If all this is not enough to deter withdrawal, then there are the technical issues involved. For a start, vending machines and ATMs would need to be modified to take drachmas; not an inconsequential cost.

The problem for any troubled economy contemplating withdrawal is that many of these issues are very uncertain. Things may not turn out to be nearly as bad as they could be. After all, the UK's withdrawal from the ERM was associated with an improvement in economic performance and no discernible political backlash from other member countries. Would it be the same for Greece? Other Eurozone members might see Greek withdrawal as the best solution to the crisis, and seek to support it economically and politically. They might leave open the chance of Greece rejoining the Eurozone at a subsequent point in time.

It seems less likely that Germany will be the country that files for divorce and seeks to leave the Eurozone. There are a number of factors that work against this scenario. First, the value of a reinstated Deutsche Mark would appreciate against the weakened euro, and this would damage German competitiveness and undermine a strategy of export-led growth. Second, German banks with euro-denominated assets would lose out. Third, while Greek withdrawal would allow Greece to change the direction of its macroeconomic policy, German withdrawal is not needed in order to accommodate German macroeconomic preferences in terms of monetary and fiscal policy. Finally, and perhaps most importantly, the whole process of European integration has been driven strongly by Germany for political reasons and it would be difficult to envisage such a strategic reversal in foreign policy. Thus while Germany will remain conflicted by its desire for political unity in Europe on the one hand and its preference for monetary stability on the other, it seems improbable that this will result in a German withdrawal from the Eurozone.

European integration has been driven strongly by Germany for political reasons and it would be difficult to envisage a reversal in foreign policy.

There is a slight caveat to this. During the process of European monetary integration, the perceived political benefits came at little perceived economic cost and even some possible economic gain, although the size of the gain has regularly been debated. Sustaining the Eurozone and the perceived political benefits that are derived from it now have a price tag attached to them, and in theory a point could be reached where the political benefits are seen as being insufficient to justify the economic costs. At present this point would seem to be still some way off.

Concluding remarks: gazing into the crystal ball

Analogies are rarely perfect. Certainly the one between the Eurozone and marriage that has been used throughout this article only goes so far. After all, few marriages have multiple partners. In the case of the Eurozone, the withdrawal of a relatively small economy (or even a few of them) does not mean that the Eurozone will break up completely. Indeed, by allowing or even encouraging the weaker economies to disengage, the remaining elements of the Eurozone may be made stronger.

In retrospect, the form that the Eurozone took at its outset looks rather ill advised; the marriage ceremony was held too hastily. With the benefit of hindsight, the notion of a two-speed Europe might have been a better option, and more attention should have been paid to the underlying economics of optimum currency areas with less reliance being placed on the idea of endogeneity. Allowing political considerations to dominate in the short term has been shown to lead to significant economic and political problems in the long term.

However, it is always easier to be wise after the event. How do things currently stand? Gaining the compromises and concessions that are needed to sustain the Eurozone in its current form seems unlikely whether viewed from the perspective of the surplus countries or the deficit ones. Fiscal coordination could make the long-term future of the Eurozone brighter, but there can be little confidence that this will be achieved on the basis of past experience, and it would not do much to cure the Eurozone's ills in the short to medium term. The tighter fiscal discipline envisaged in the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union is not designed to accommodate differences in private-sector imbalances across the Eurozone. It continues to place the adjustment burden on deficit countries, erodes still further national sovereignty over macroeconomic policy and may, as a consequence, fail to carry credibility with capital markets. It may turn out to be more of a short-term political response to the crisis than an effective and realistic economic reform that increases the longer-term prospects of the Eurozone marriage surviving. Moreover, the notion that there is an easy answer in the form of Eurobonds also seems highly optimistic and unrealistic. German opposition to the idea reinforces the suspicion that compromises will be difficult to achieve.

For a time, the Eurozone may be patched up with 'band aid' financial packages of one type or another, but again it seems unlikely that this will impress markets unless there is also clear evidence that the necessary structural changes are being made, and there is rather little to suggest that this is the case. Ultimately therefore there is an increasing possibility that Greece will be forced by circumstances to withdraw from it, and follow a path of devaluation and perhaps default. Other relatively weak economies on the periphery might then be tempted to follow, depending on how things turn out for Greece and on how the other members of the Eurozone and the markets respond to the withdrawal. But withdrawal is far from an easy answer either, and will create its own problems. Breaking up is hard to do and divorce is painful. Should some of the weaker economies withdraw from the Eurozone, the chance that they may at some stage return to it cannot be ruled out. An extended trial separation lasting many years rather than a permanent divorce may therefore be the most likely course of events.

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