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Is there a future for the Euro?

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A Greek exit could spell the euro zone's disintegration.

The Greek referendum last Sunday resoundingly backed its embattled government over its tortuous negotiations with the Troika of the European Central Bank (ECB), the European Union (EU) and the International Monetary Fund (IMF). Greece is now back at the negotiating table, which may ease the terms of loan repayment and lighten the reforms demanded or it may lead to a Grexit.These efforts are part of an ongoing initiative to brand Singapore as an ideal place to live, work, and play in. In recent years, art installations, night festivals and concerts have been staged across Singapore's downtown precincts, livening up public spaces there.

In August 2012, I was invited by the European Aeronautic Defence & Space Co (EADS, now Airbus Group) to deliver a lecture on the Future of Europe at its Cassidian Summer Academy 2012. As I was driven from Munich to Salzburg, Austria, I was impressed by the seamless travel, with no border checks and the use of the common currency, the euro. Along the way I could not help marvelling how peace and prosperity had replaced the devastation of World War II. Interestingly, my lecture was given high up in the Austrian Alps. My audience was seated on the grassy hill slope. I felt like Jesus delivering the Sermon on the Mount, especially the verse "Blessed are the peacemakers for they will be called the children of God".

Indeed, Europe has enjoyed unprecedented peace and prosperity since 1945. The EU was a project designed to promote peace and economic cooperation. As a common market, it has been very successful. In 2002, the common currency, the euro, became a physical reality with 12 members, including Greece. Ironically, Greece may be the first to leave the euro zone (EZ).

At my Austrian lecture I outlined four possible scenarios for the future of the EU/EZ:

- Lurching from crisis to crisis
- Reduced euro: coalition of the able (exit of weaker members)
- Implosion and disintegration
- More Europe: fiscal, financial and political union

Sadly, despite attempts to create a Stability Fund and a nascent banking union, the EZ is still lurching from crisis to crisis. What is wrong with the euro? What should be done to ensure its viability and future?

Faulty foundations

Most economists agree that the establishment of the common currency violated most of the requirements of an optimal currency area, particularly, similarity of economic (industrial) structure to ensure similarity of business cycle, high degree of labour mobility with sufficient wage and price flexibility, and a fiscal mechanism for transfers to distressed regions. The only positive factor was the high degree of intra-industry trade.

Joining the EZ meant that a country would have to forgo control of monetary and exchange rate policy. In exchange for this, it would enjoy currency stability with a lower rate of inflation, zero transaction costs with payments and receipts within the EZ, free capital mobility and potentially free labour mobility. However, the common monetary policy (CMP) and resulting exchange rate (ER) may not suit every member: almost right from the birth of the euro in 2001, less competitive states were complaining of the CMP being too tight and the ER too strong.

Not a regular central bank

One fundamental problem of the EZ is that the ECB was not set up to be a regular central bank. Regular central banks like the US Federal Reserve have regulatory oversight of banks. More crucially, central banks are lenders of the last resort. The recent EZ crises involving countries like Ireland, Spain, Portugal, Cyprus and Greece revealed the dangerous deficiency of the ECB. Banks in the EZ are still national responsibilities and the ECB was not set up to do quantitative easing (QE), which is a euphemism for printing money to monetise government debt (that is, buying government bonds).

It was only on March 9 this year that the ECB was allowed to do QE, somewhat too late for beleaguered Greece.

The ECB is still not an unconditional lender of last resort. Greek banks have had to be closed because access to ECB lending facilities is subject to the Troika. Without a banking union which transfers regulatory oversight to the ECB which in turn provides lender of last resort facilities, distressed countries like Greece suffer financial instability because of massive flight of capital from its banks to northern European and Swiss banks. Right now, Greeks are suffering cash shortages because of bank closures and limited ATM withdrawals of only €60 (S$90) or less. Until the ECB is enabled to function as a regular central bank, the EZ will be unstable and crisis-prone.

Fiscal union

To understand the tortuous negotiations between the Troika and the hapless Greeks, one must appreciate that the current bailout funds come from the EU (27 member countries, but mainly from Germany, France and Italy), the ECB and the IMF.

The EU fund is called the European Stability Mechanism (ESM), with a maximum lending capacity of €700 billion. Bailouts of EZ states are conditional upon their compliance with budgetary discipline (austerity programmes) and structural reforms (pensions, welfare, industry and labour market). It is the conditionality of ESM loans that is so grating and humiliating to Greece. The Greek view is that the ESM loans had served as bailouts for EU banks, principally northern ones like German and French ones and had no direct benefit to Greece, apart from staving off default to financial institutions.

In return for this, Greece is subject to fiscal austerity (raising taxes and cutting expenditure on pensions, welfare and other social items) and painful reforms. The austerity programme has not helped Greece to grow sufficiently to pare down its alarming debt to gross domestic product (GDP) ratio. Despite small tentative signs of growth last year, the country is still in severe economic depression (GDP is still 25 per cent below pre-crisis level), with 25 per cent or more unemployment.

The crucial point to note is that belonging to a common currency means that monetary policy (easing/monetising the debt) is absent as an adjustment policy tool and the exchange rate of the euro cannot be changed by Greece. Hence the only policy tools are fiscal stimulus via bond issues and deflation of wages and prices.

Unfortunately, Greece has long passed the point of credit-worthiness because of its rapidly escalating debt-GDP ratio. Bailouts by the Troika largely meant transference of ownership of Greek debt from European banks to the ECB, EU and IMF, with little net benefit to Greece by way of additional fiscal stimulus. Moreover, the conditionality of Troika loans resulted in budgetary austerity, with tax increases and severe cuts in expenditure to produce a primary surplus to repay the loans.

What Greece badly needs is funds for fiscal stimulus to create jobs and incomes. Instead, the austerity programmes produce deflation.

Contrast this with countries like the United States, Japan and Britain, which have their own currencies.

They have the ability to launch QE. This enables continued fiscal stimulus without running into interest-rate escalation. The leakage of capital from expansionary monetary policy further helped by weakening the currency, helping boost exports and curtailing imports, benefiting production of export and import-competing goods. In other words, currency devaluation enabled such countries to escape the straitjacket of fiscal austerity and the debt- deflation spiral of Irving Fisher. It may, of course, be noted that Japan is still struggling with stagnation, but, at least, it is not in an economic depression like Greece, with widespread unemployment.

Evidently, what is really needful for the EZ is a full fiscal union. This would entail political integration, with a federal government for the EU. Such a union would mean a budget big enough to bail out individual states that are in distress.

Think of the US: there is no dollar crisis because the Fed takes care of bank regulation and support while the federal government can help distressed states. Such a union for Europe would take a political quantum leap which is hard to imagine now. If this option is out, then the other three scenarios outlined earlier are in play. What is critical for Europe is that a Grexit may lead to disintegration and a rupture of the peace that has endured for 70 years.

Labour markets

Except for recent additions from East and Central Europe, most EU members enjoy the right to work in other member states. Unfortunately, for reasons of high unemployment, language and cultural barriers, labour mobility is much less than in America. This lack of sufficient labour mobility has robbed the EZ of a vital adjustment mechanism. A Grexit may open the way to Europe's fragmentation/balkanisation.

In June 2012, German Chancellor Angela Merkel declared: "We need more Europe. We don't only need monetary union, we also need a so-called fiscal union. And most of all, we need a political union - which means we need to gradually cede powers to Europe and give Europe control."

Will the EU/EZ take the huge leap or will disintegration take place instead? The geopolitical impact of a Grexit may also lead to conflict, as Russia expands its reach to the Mediterranean.

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