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Article (Accepted version)
(Refereed)

Original citation:
de Grauwe, Paul (2016) European monetary unification: a few lessons for East-Asia. Scottish Journal of Political Economy, 63 (1). pp. 7-17. ISSN 0036-9292
DOI: 10.1111/sjpe.12108

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Available in LSE Research Online: May 2016

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European Monetary Unification: A Few Lessons for East-Asia

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Abstract: In this paper I analyse the experience of European monetary and financial integration to shed some light on the question of the desirability and feasibility of monetary unification in East Asia. The experience of Europe shows that trying to fix the exchange rates when capital is freely moving is unsustainable and leads to frequent speculative crises. This leads to only two options: Either a monetary union or floating exchange rates. Monetary union requires very intrusive political unification. Given the complete absence of political unification in Asia, the only possible conclusion is that Asia will have to live with increasing exchange rate volatility.

November 2015

1. Introduction

In this paper I study the history, both old and new, of the attempts at monetary unification in Europe. I do this to shed some light on the question of the desirability and feasibility of monetary unification in East Asia. I will stress that even if the standard economic conditions for a successful monetary union are satisfied, much stronger conditions exist to make a monetary union successful. These come from the political sphere.

In section 2 I give a brief history of the monetary unification in Europe. In section 3 and 4 I ask the question of whether the economic conditions for a successful monetary union are satisfied in East-Asia. This analysis is based on the theory of optimal currency areas. In the subsequent sections I study the political conditions for making a monetary union successful and I conclude that these are certainly not satisfied in East Asia.

2. A brief history of monetary unification in Europe

Monetary cooperation started in Europe with the European Payments Union (EPU) in 1950. This was an arrangement among the eighteen members of the Organization for European Economic Cooperation (OEEC), the precursor of the OECD. The dollar shortage and the absence of convertibility within the OEEC had created the problem that each country would have to balance its payments against each of its trading partners. The EPU solved this problem by setting up a multilateral clearing system. This made it possible for European countries to accumulate deficits against some countries matched by surpluses against others. This greatly facilitated trade. The EPU became superfluous when the participating countries made their currencies convertible in 1959. Apart from facilitating trade, the EPU was also useful as the first postwar training ground for monetary cooperation in Europe.

During the 1960s the Bretton Woods system reigned. Monetary relations were centered on the dollar and the commitments of the European countries to maintain a peg with the dollar. This commitment collapsed in the early seventies. This started a series of attempts in Europe to set up fixed exchange rate systems among the members of the European Union (the European Community at that time). The first such attempt, which had already been announced in the Werner Plan of 1970, was an agreement among the EU-countries to peg their bilateral exchange rates. This agreement was seen as a first step towards full monetary union in 1980. It failed miserably under the onslaughts of the turbulences in the foreign exchange markets involving the dollar and the main currencies. Very soon, the UK, Italy and France withdrew. Exchange rate turbulences within the EU prevailed throughout the seventies.

The second attempt aimed at fixing exchange rates was made in 1979 with the institution of the European Monetary System (EMS). One feature of this system was a mechanism (the ERM) keeping the bilateral exchange rates within a band of +2.25% and –2.25% around the parities. The mechanism was maintained throughout the eighties, with many realignments though. It ultimately collapsed in 1992-93, when the UK withdrew (1992) and the bands of fluctuation were enlarged to +12% and -12%, transforming it into a system close to floating (for more institutional detail see De Grauwe (2012)).

The inability of the EU-countries to maintain fixed exchange rates forced them to make a choice between flexibility of the exchange rate or an irrevocably fixing within a monetary union. It was increasingly realized in Europe and elsewhere that in a world of capital mobility fixed exchange rates could not be maintained except by abandoning monetary sovereignty. In 1993, many EU-countries were willing to abandon monetary sovereignty in order to achieve exchange rate stability within the European Union. This willingness led to the next step, which was the organization of a monetary union. The rest of the 1990s would be dominated by the transition process towards monetary union. The latter was successfully launched on 1 January 1999.

From this brief historical overview two conclusions can be drawn. First, the overriding immediate objective of monetary cooperation in the EU was to

maintain exchange rate stability. Second, exchange rate pegging was most often seen as a preliminary step towards full monetary union. Although it can be said that all these attempts at pegging the exchange rates failed, it is also true that they were ultimately successful in guiding the European countries into a monetary union. The reason is that these attempts created new institutions and led to an intensified use of pre-existing supra-national institutions. Thus the success of these fixed exchange rate arrangements must be sought in the fact that they were institution-building devices. Even if it can be said that the attempt to peg the exchange rates failed, it succeeded in creating the embryonic institutional framework that could be used for the future monetary union.

3. East-Asia appears to be as much an optimal currency area as the Eurozone.

Is East-Asia an optimal currency area? In order to answer that question we compare the criteria of optimality for a monetary union in East-Asia and in the Eurozone.

The conditions that are needed to guarantee sustainability are well-known from the literature on optimal currency areas (OCA)[1]. They can be summarized by three concepts

- Symmetry (of shocks)
- Flexibility
- Integration

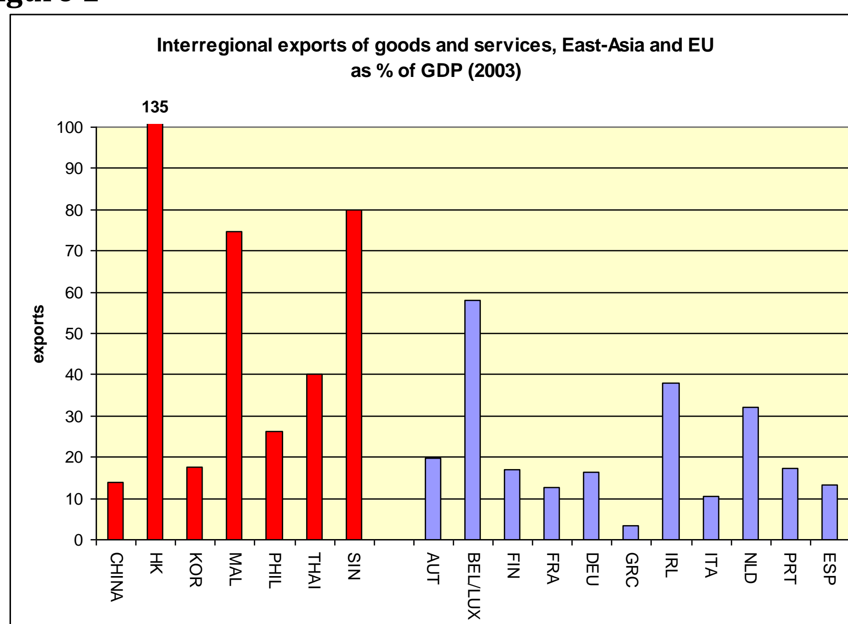
Countries in a monetary union should experience macroeconomic shocks that are sufficiently symmetric with those experienced in the rest of the union (*symmetry*). These countries should have sufficient *flexibility* in the labour markets to be able to adjust to asymmetric shocks once they are in the union. Finally they should have a sufficient degree of trade integration with the members of the union so as to generate benefits of using the same currency.

What is the evidence about the degree of trade integration? In figure 1 we present data on the degree of economic integration within East-Asia and within

[1] Mundell(1961), McKinnon(1963), Kenen(1969).

the Eurozone. We show the exports of East-Asian countries to the rest of East-Asia as a % of their GDP and compare these with the exports of Eurozone countries with the rest of the EU (also as a % of GDP). We observe that East-Asian countries have strong degrees of integration with the rest of East-Asia, very much like EU-countries have with the rest of the EU. Note also that some countries in East-Asia have extremely high integration ratios, in particular Hong Kong which has a ratio exceeding 100%. This is due to the fact that exports are production data (which include imports) while GDP are value added data (excluding imports). Hong Kong's export is to a large extent transit trade with little value added. As a result, it exceeds 100%.

Figure 1



Source: IMF, IFS

Note: the exports of the East-Asian countries is to ASEAN plus China, Korea and Japan. The data for China relate to 2001.

The second OCA criterion is the degree of asymmetry of shocks. This has been analysed in great detail during the last few years. The consensus today is that Asian countries do not experience more asymmetry in their shocks than the present Eurozone countries (see Bayoumi and Eichengreen (1999), Yin-Wong Cheung and Jude Yuen (2003), Xinpeng Xu (2004), Shin and Sohn(2006), and

Sato and Zhang(2006)).

We conclude that according to two of the OCA criteria, East-Asia seems to be close to an optimal currency area (assuming that the Eurozone is a good benchmark). In addition, since it appears that the flexibility of the labour markets in these countries is at least as high, if not more so, than in Europe, it is safe to conclude that East-Asia comes close to forming an optimal currency area.

The economic conditions for a monetary union in East-Asia appear to be in place, at least when we compare these to the Eurozone. So, why has monetary union not yet come about in Asia? The answer seems to be political. Compared to the European Union there is an almost total absence of supranational institutions in Asia to which nations have delegated part of their power. East-Asia has not developed such institutions for whatever reasons, political, historical and cultural.[2] The contrast with the European Union is great. The destruction of the Second World War led to a desire of political unification in Europe and a build-up of institutions like the European Commission, the European Court of Justice and the European Parliament that all embody some transfer of national sovereignty.

The recent experience with the sovereign debt crisis, however, shows that one has to go much farther into political union (i.e. transfer of sovereignty to an international body) than has been achieved until now in Europe. This, as will turn out is bears an important lesson for East-Asia.

4. New insights about conditions for monetary union

When the Eurozone was started a fundamental stabilizing force that existed at the level of the member-states was taken away from these countries. This is the lender of last resort function of the central bank. Suddenly, member countries of the monetary union had to issue debt in a currency they had no control over. As

[2] Regional integration in East Asia has been largely driven by market forces, with institutions designed primarily to harmonize rules and regulations, provide surveillance and financial safety nets, and facilitate the gradual opening of trade, investment, finance, and people mobility. In Europe, integration preceded crisis; in Asia, crisis spawned deeper integration (ADB, 2014).

a result, the governments of these countries could no longer guarantee that the cash would always be available to roll over the government debt. Prior to entry in the monetary union, these countries could, like all stand-alone countries, issue debt in their own currencies thereby give an implicit guarantee that the cash would always be there to pay out bondholders at maturity. The reason is that as stand-alone countries they had the power to force the central bank to provide liquidity in times of crisis.

What was not understood when the Eurozone was designed is that this lack of guarantee provided by Eurozone governments in turn could trigger self-fulfilling liquidity crises (a sudden stop) that would degenerate into solvency problems. This is exactly what happened in countries like Ireland, Spain and Portugal[3]. When investors lost confidence in these countries, they massively sold the government bonds of these countries, pushing interest rates to unsustainably high levels. In addition, the euros obtained from these sales were invested in "safe countries" like Germany. As a result, there was a massive outflow of liquidity from the problem countries, making it impossible for the governments of these countries to fund the rollover of their debt at reasonable interest rate.

This liquidity crisis in turn triggered another important phenomenon. It forced countries to switch-off the automatic stabilizers in the budget. The governments of the problem countries had to scramble for cash and were forced into instantaneous austerity programs, by cutting spending and raising taxes. A deep recession was the result. The recession in turn reduced government revenues even further, forcing these countries to intensify the austerity programs. Under pressure from the financial markets, fiscal policies became pro-cyclical pushing countries further into a deflationary cycle. As a result, what started as a liquidity crisis in a self-fulfilling way degenerated into a solvency crisis (De Grauwe and Ji, 2013).

The Eurozone crisis that we now witness is the result of a combination of the two design failures identified here. On the one hand booms and busts continued to

[3] Elsewhere I have argued that Greece does not fit this diagnosis. Greece was clearly insolvent way before the crisis started, but this was hidden to the outside world by a fraudulent policy of the Greek government of hiding the true nature of the Greek economic situation (see De Grauwe, 2011).

occur at the national level. In fact these were probably intensified by the very existence of a monetary union. On the other hand the stripping away of the lender of last resort support of the member state countries allowed liquidity crises to emerge when the booms turned into busts. These liquidity crises then forced countries to eliminate another stabilizing feature that had emerged after the Great Depression, i.e. the automatic stabilizers in the government budgets. As a result, some countries were forced into bad equilibria (De Grauwe, (2011) provides a theoretical model that generates multiple equilibria. See also Gros (2011)).

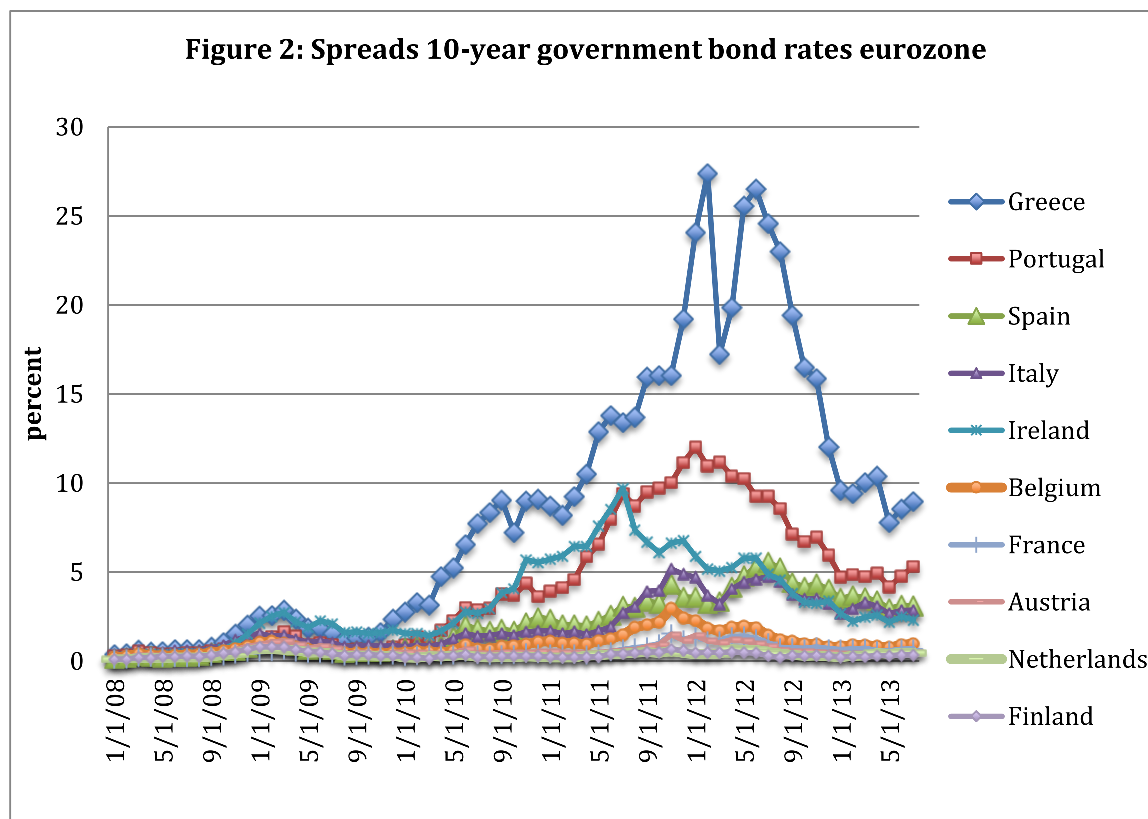
What are the policy implications of these insights? We analyze two of them. The first one relates to the role of the ECB; the second one relates to the long-run need to move into a fiscal and political union.

5. The ECB as a lender of last resort in the government bond markets

The ECB is the only institution that can prevent market sentiments of fear and panic in the sovereign bond markets from pushing countries into a bad equilibrium. As money creating institution it has an infinite capacity to buy government bonds. The European Stability Mechanism (ESM) that became operational in October 2012 has limited resources and cannot credibly commit to such an outcome. The fact that resources are infinite is key to be able to stabilize bond rates. It is the only way to gain credibility in the market.

On September 6, 2012 the ECB finally recognized this point and announced its "Outright Monetary Transactions" (OMT) program, which promises to buy unlimited amounts of sovereign bonds during crises. The ECB made the right decision to become a lender of last resort, not only for banks but also for sovereigns, thereby re-establishing a stabilizing force needed to protect the system from the booms and bust dynamics. In Figure 2 we show the evolution of the spreads before and after the OMT-announcement of 2012. It can be seen that since that announcement the spreads declined dramatically. By taking away the intense existential fears that the collapse of the Eurozone was imminent the

ECB's lender of last resort commitment pacified government bond markets and led to a strong decline in the spreads of the Eurozone countries.



Source: Datastream

However, the credibility of the program suffers because of continuing vehement criticism. This criticism reached its climax in early 2014 when the German Constitutional Court declared OMT illegal and referred the case to the European Court of Justice with the demand that conditions be imposed on the OMT-program that would make it ineffective and useless. The European Court of Justice ruled that the OMT-program is legal according to European Law.

The main argument made by the German judges is that the spreads reflect underlying economic fundamentals. Attempts by the ECB to reduce these spreads are attempts to counter the view of market participants. In doing so, the ECB is in fact pursuing economic policy, which is outside its mandate.

Implicit in this argument is the view that markets are efficient (see De Grauwe, 2014; Winkler, 2014). The surging spreads observed from 2010 to the middle of 2012 were the result of deteriorating fundamentals (e.g. domestic government debt, external debt, competitiveness, etc.). Thus, the market was just a

messenger of bad news. Its judgment should then be respected, also by the ECB. The implication of the efficient market theory is that the only way these spreads can go down is by improving the fundamentals, mainly by austerity programs aimed at reducing government budget deficits and debts. With its OMT program the ECB is in fact reducing the need to improve these fundamentals.

Another theory, while accepting that fundamentals matter, recognizes that collective movements of fear and panic can have dramatic effects on spreads. These movements can drive the spreads away from underlying fundamentals, very much like in the stock markets prices can be gripped by a bubble pushing them far away from underlying fundamentals. The implication of that theory is that while fundamentals cannot be ignored, there is a special role for the central bank that has to provide liquidity in times of market panic.

6. Completing the monetary union with political union

Even if the OMT program set up by the ECB can be salvaged from the onslaught of the German Constitutional Court, the institutional setup that has been created in the Eurozone is not sustainable and will have to be completed with steps towards a fiscal union. The latter implies a degree of political union that goes much farther than what has been achieved so far. Let us develop these points further.

The present institutional setup of the Eurozone is characterized by the fact that a number of bureaucratic institutions have acquired significant responsibilities without political accountability. Thus there has been a transfer of sovereignty without a concomitant democratic legitimacy.

6.1 The ECB and political union

The European Central Bank's power has increased significantly as a result of the sovereign debt crisis. With the announcement of the OMT program and given the success of this program it has become clear (at least outside Germany) that the ECB is the ultimate guarantor of the sovereign debt in the Eurozone. In this sense the ECB has become a central bank like the Federal Reserve and the Bank of

England. There is one important difference though. In the US and the UK there is a primacy of the government over the central bank, i.e. in times of crisis it is the government that will force the central bank to provide liquidity. When the sovereign in these countries is threatened it will prevail over the central bank. This is not the case in the Eurozone. In the latter, the governments depend on the goodwill of the ECB to provide liquidity. They have no power over the ECB and cannot force that institution, even in times of crisis, to provide liquidity. Thus, in the Eurozone today there is a primacy of the central bank over the sovereigns.

This is a model that cannot be sustained in democratic societies. The ECB consists of unelected officials, while governments are populated by elected officials. It is inconceivable that these governments (especially if they are large) will accept to be pushed into insolvency while unelected officials in Frankfurt have the power to prevent this but refuse to use this power. When tested such a model of the governance of the Eurozone will collapse and rightly so.

Thus we arrive at the following conundrum. The role of the ECB as a lender of last resort is essential to keep the Eurozone afloat. Yet at the same time the present governance of this crucial lender of last resort function is unsustainable because its use depends on the goodwill of the ECB, thereby making democratically legitimate governments' fate depend on the judgment of unelected officials. In order to sustain this role of the central bank as a lender of last resort it has to be made subordinate to the political power of elected officials, as it is in modern democracies such as the US, Sweden, the UK, etc. This can only be achieved by creating a Eurozone government that is backed by a European parliament and that has primacy over the central bank.

6.2 The European Commission and political union

We face a similar problem with the European Commission. The latter has seen its responsibilities increase. This has been motivated by the desire of the creditor nations to impose budgetary and macroeconomic discipline on the debtor nations. As a result, the Stability and Growth Pact has been strengthened, and the European Commission has been entrusted with the responsibility of monitoring

macroeconomic imbalances and to force debtor nations to change their macroeconomic policies.

The idea that macroeconomic imbalances should be monitored and controlled is a good one. As we have argued the emergence of such imbalances is at the heart of the emergence of the euro-crisis. Yet the way this idea has been implemented is unsustainable in the long run. The new responsibilities of the European Commission create a similar problem of democratic legitimacy as the one observed with the ECB. The European Commission can now force countries to raise taxes and reduce spending without, however, having to bear the political cost of these decisions. These costs are borne by national governments. This is a model that cannot work. Governments that face the political costs of spending and taxation will not continue to accept the decisions of unelected officials who do not face the cost of the decisions they try to impose on these governments. Sooner or later governments will go on strike, like the German and French governments did in 2003-04. Only the small countries (Portugal, Belgium, Ireland, etc.) will have to live with this governance. Large countries will not.

6.3 Bureaucratic versus political integration

Increasingly, European integration has taken the form of bureaucratic integration as a substitute for political integration. This process has started as soon as the European political elite became aware that further political integration would be very difficult. This process has become even stronger since the start of the sovereign debt crisis in the Eurozone. The outcome of this crisis has been that the European Commission and the European Central Bank have seen their powers increase significantly, without any increase in their accountability. More and more these two institutions impose decisions that affect millions of people's welfare, but the people who are affected by these decisions do not have the democratic means to express their disagreements.

Political scientists make a distinction between output and input legitimacy. Output legitimacy means that a particular decision is seen to be legitimate if it leads to an increase in general welfare. In this view a government that is

technocratic can still be legitimate if it is perceived to improve welfare. This view is very much influenced by the Platonic view of the perfect State. This is a State that is run by benevolent philosophers who know better than the population what is good for them and act to increase the country's welfare.

Input legitimacy means that political decisions, whatever their outcome, must be based on a process that involves the population, through elections that allow people to sack those who have made bad decisions.

Much of the integration process in Europe has been based on the idea of output legitimacy. The weak part of that kind of legitimacy becomes visible when the population is not convinced that what the philosophers at the top have decided, has improved welfare. That is the situation today in Europe. In many countries there is a perception that the decisions taken in Brussels and Frankfurt have harmed their welfare.

6.4 Towards a fiscal and political union?

The only governance that can be sustained in the Eurozone is one where a Eurozone government backed by a European parliament acquires the power to tax and to spend. This will then also be a government that will prevail over the central bank in times of crisis and not the other way around. This will also be a government that has the political legitimacy to impose macroeconomic and budgetary policies aimed at avoiding imbalances. Put differently, the Eurozone can only be sustained if it is embedded in a fiscal and political union.

A fiscal union involves two dimensions. First, it involves a (partial) consolidation of national government debts. Such a consolidation creates a common fiscal authority that can issue debt in a currency under the control of that authority. This protects the member states from being forced into default by financial markets. It also protects the monetary union from the centrifugal forces that financial markets can exert on the union. Finally, by creating a common fiscal authority (a government) we can create a governance structure in which the (European) sovereign prevails over the central bank and European bureaucracies rather than the other way around.

Second, by (partially) centralizing national government budgets into one central budget a mechanism of automatic transfers can be organized. Such a mechanism works as an insurance transferring resources to the country hit by a negative economic shock. Although there are limits to such an insurance that arise from moral hazard risk, it remains true that such a mechanism is essential for the survival of a monetary union, like it is for the survival of a nation state. Without a minimum of solidarity (that's what insurance is) no union can survive.

Conclusion: Lessons for East-Asia

The experience of Europe shows the following. First, trying to fix the exchange rates when capital is freely moving is unsustainable and leads to frequent speculative crises. This leads to only two options: Either a monetary union or floating exchange rates.

Monetary union requires very intrusive political unification. The Eurozone crisis has shown that the degree of political unification achieved in the Eurozone falls far short of what is required to make the Eurozone sustainable. Given the complete absence of political unification in Asia, the only possible conclusion is that Asia will have to live with increasing exchange rate volatility.

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