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WE NEED TO BE PART OF A BORN-AGAIN EURO

By Marcello Minenna

January 1st, 1999: the exchange rates between the Euro and the national currencies are established. The enthusiasm outstripped the economic studies, which stated that fixed exchange regimes among different states tend to not last long. However, there was strong regulatory support in spite of the risks. The member countries' government bonds (the Govies) were all equal (risk-free) for the financial system's stakeholders, especially with regard to the ECB. The concept of risk-sharing permeated the new European structure. The free circulation of goods and services sought to level the playing field (no obstacles to competition), with the goal of making production factors (capital and labor) equally accessible to the Eurozone's bank-centric production system.

As far as labor is concerned, there were varying elements that derived from regulatory designations, linguistic differences, and geographic particulars; making the Govies risk-free was an excellent precondition for accessing capital. With 4 years of arbitration operations (the convergency trades), the fiscal police had, in fact, led to the 'Germanization' of taxes in the Eurozone: the paradigm that a monetary area must have a single price of money was therefore respected, and thus they could finally launch.

Obviously there were some imperfections, including the ECB's inability to monetize the public debts and functionality being focused on the goal of 2% inflation. However, the ECB wasn't compelled to reach this goal punctually in all of the member states; the agreement was decidedly optional, and unfortunately it still is. And though it's well-known that the inflation differentials among different states are naturally adjusted by the exchange rate, this was no longer provided for among the Eurozone countries. The lack of these adjustments isn't so much a detail as it is an advantage towards the financial cost of industrial production for the states with lower inflation. German manufacturing already had this advantage before the crisis; in comparison with Italian manufacturing, for example, it was by more than 5%. Because of the spread, this competitive advantage grew to more than 20% after the crisis. Therefore, in the medium-to-long term, the competition between the two economies gets compromised. And the depreciation of labor costs at the expense of the treasury, as seen recently with the Jobs Act, cannot normalize the unfair competition caused by the spread.

Competition, the cornerstone of the Treaties, isn't enough to bring the European institutions to reflect on resolving these aberrant factors. This explains one of the determining factors behind the German trade surplus; a second can be gleaned through analyzing their geographic composition over time. Before the height of the sovereign debt crisis, this surplus was largely fueled by the countries on the periphery of the Eurozone, according to a typical vendor financing strategy: the German banks financed buyers in order to buy German-made goods which, thanks to the single currency, had become more accessible. When the distributed credits became excessively risky, the ECB supplied the banks in the periphery countries with enough liquidity to honor their debts (through the Long Term Refinancing Options). Subsequently, the German surplus was substantially fueled from outside the Eurozone, aided by the Euro's exchange rate (which was price-controlled through Quantitative Easing), since the internal demand among the periphery states had been exhausted by then. In short, combining the violations of the Treaties (which the persistent German trade surplus exclusively represents) with the metaphor of the ‘German locomotive,' rather than these associated dysfunctions is, at the very least, simplistic.

The spread problem isn't just limited to the real economy. In the financial economy—which is ten times larger—the spread in fact creates some shadow currencies, since it discriminates the relationship between the member countries' banks and the ECB.

Therefore, the spread is a disease that tampers with competition in the Eurozone—instead of a 'physiological element,' as can be read between the lines from the relationship between the 5 presidents of the European institutions in "Completing Europe's Economic and Monetary Union." Yet the relationship benefited from the Eurozone's less-than-encouraging economic statistics (not including Germany's) for the 2008-2014 period, as well as the awareness that these figures resulted from numerous decisions that the German-driven Eurobureaucracy had made following the crisis, which ended up isolating the respective member states' private and public debt risks.

In this new structure—in which even the Eurozone began to doubt itself by abdicating risk sharing, even though in the Treaties it seemed like a founding and consequential value to the unity of the Euro's interest rate curve—the financial markets started betting on the breakup of the single currency. This led to the negative rates for the Bunds which, in reality, assess the potential for reimbursing the German public debt with a revaluated Deutsche Mark (in comparison with the old Euro), and the spreads, for example, of the long-term treasury bonds, which assess the risk of reimbursement in devalued lira. The divergency trades have substituted the convergency trades whereas, in the Eurozone, they celebrate J.M. Keynes' paradox of thrift.

The Euro isn't, therefore, the root of all problems, but the policy choices that were taken in the Eurozone are. Not to mention examples of national recklessness; in countries like Italy, for example, the precious years when the single currency was launched, when interest rates were Germanized, are gone; the country should have bolstered itself, both from a public finance viewpoint as well as a reforms viewpoint.

The problem is that there's no change of direction in sight. It displeases me to confirm that before the crisis the Eurozone's key institutions were aiming for a European public debt, a federal budget, basically an honest-to-goodness 'United States of Europe' project, whereas now the most they can muster is securitizing part of the member states' public debts (the ESBies)—according to participatory dynamics that disregard any mutuality criteria—in the hopes of creating a 'Top Tier' and 'Second Tier' Euro in the markets. And in spite of the fact that it's clear that the Euro has been behaving like a system of fixed exchanges over recent years, it has become a magnet through which finance has conveyed wealth to the core countries (in particular, Germany). A tactical change is needed to restart the convergency trades: it's not impossible. All that's needed is for the anti-spread shield (the outright monetary transactions) to become activated and enforced on the "zero spread" value. Finance wouldn't bet against the Central Bank, as it can envision the risk-free earnings that can be derived from a new ruling on the Govies. A reborn Euro that, in order to avoid the mistakes of the past, would be flanked by a tightly-managed course of fiscal policies and reforms, as well as relaunching investments; in short, creating the opportunity for the "Eurozone's resilience" (to borrow an expression that was recently used by President Draghi) before the excessive collateral damage causes a few member states—which might be influenced by social tensions and the results of lines of questioning aimed precisely at the voters' guts—to decide to break the current, delicate balance. It would be a real shame.

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