The Euro: Spectator or Player in the World's Financial Imbalance?

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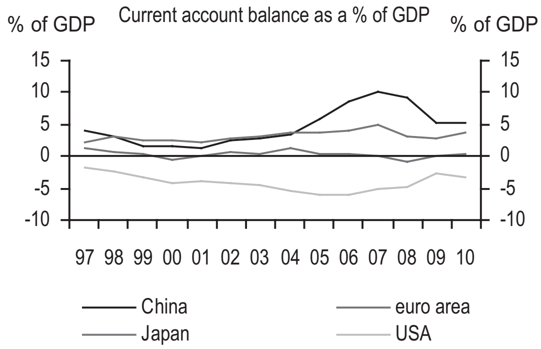
The creation of the euro limited world financial imbalances by increasing the financial stability of members of the Eurozone and also by triggering reworking of the international monetary system, which was added to the G20 agenda by France, during its presidency. Indeed, the Eurozone generated a current balance in equilibrium, unlike in the United States and China. But, above all, the single currency encouraged financial integration. It improved the liquidity and depth of financial markets and thus acted as a brake on deterioration of world financial imbalances. The euro cannot be blamed for current imbalances in Eurozone Member States and the European sovereign crisis. These are the result of the failure of the economic and monetary Union to channel strong growth in credits and to coordinate budgetary policies.

The euro: a player in the world financial equilibrium

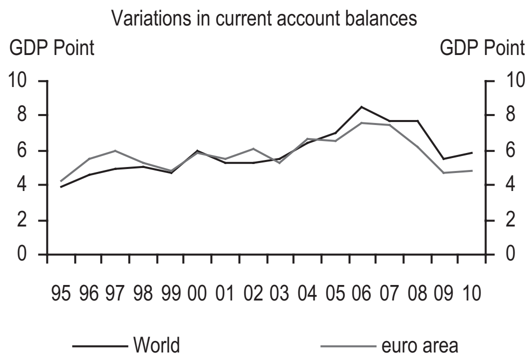
The 2007 crisis revealed the defects in financial regulation and the unsustainable nature of world imbalances. This revelation has led to a fierce debate on the true causes of these current surpluses and deficits. Two main theories confronted each other, the theory making the American monetary policy of the years 2000 mainly responsible for the banking and financial crisis, and the theory which considers that it was the inflow of Asian, particularly Chinese, capital to the United States which engendered the biggest recession since 1929. According to the first theory, the Central Bank of America (Fed) undertook a monetary policy that was far to expansionist after the events of 11th September, using major reductions in its base rate. The result was a strong increase in the American debt and a reduction in savings rates, which encouraged the development of a real estate bubble. Between 2001 and 2007 the mortgage debt increased by an average of 12% per year, to reach over $10 000 billion. As a consequence, the deficit in the American current account balance reached 6% in 2007 and investors' share of assets in dollars doubled. The other theory puts the accent on the responsibility of emerging countries, particularly China. In seeking to accumulate foreign currency reserves to defend their own currency in case of attack by speculators and by failing to liberalise their financial systems, emerging governments had to invest abroad. They therefore sought the safest assets, which financed the American debt. The Chinese current account surplus represented up to 10% of the Chinese GDP in 2007!



Whatever the theory, Europe has not been accused of any responsibility in the increased worldwide imbalances because its own current account balance has always been stable and close to equilibrium. The euro's external position was deemed strong. It resulted from the commercial strength of Europe, which exports almost twice as much as the United States, and from financial integration which has enabled the development of debt instruments. Over the past ten years, the bonds market in the Eurozone has also reached the size of the American market. The euro thus represents 32% of international bonds held, excluding national issues, as well as 40% of foreign currency transactions (of 200%), 28% of foreign currency reserves and 16% of current international banking loans, excluding cross-border European loans.

Also, although the euro does not yet have the status of reserve currency, monetary stability in the zone is now defined in terms of an internal reference, managed jointly, and no longer in terms of the dollar, a fact that has limited the volatility of financial markets.

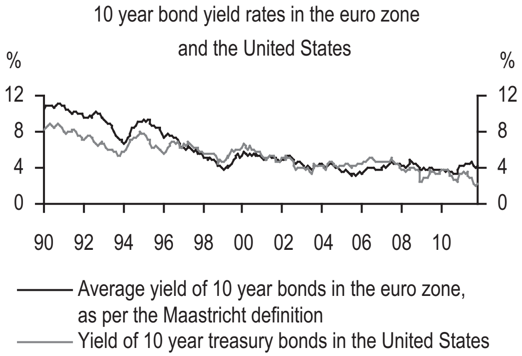
Finally, thanks to more exchanges of assets and liabilities between countries in the Eurozone, the single currency has enabled better diversification of risks and has increased the possibility of international sharing of risks. The years 2000 were therefore the years during which a new international monetary system was established.



The creation of the euro was therefore the foundation stone in the new world monetary system, the definition of which was added to the G20 agenda by France during its presidency. In this respect the single currency has been a player in world equilibrium.

The positive role played by the European Central Bank in the international monetary concert

The European Central Bank (ECB) has played a very important role in the international monetary concert and for increasing the role of euro. The ECB rapidly made its mark as the Federal Reserve's equal. It has also established a credible monetary policy which guarantees price stability whilst identifying the problems caused by the weakness of risk premiums. Jean-Claude Trichet was one of the first central bankers to voice his concern publicly with regard to the excessively low level of these risk premiums and the major imbalances that it risked causing. The ECB also stood out during the 2008 crisis by granting emergency loans and currency exchanges to central banks which needed them, from outside the Eurozone. In this way it assumed its role as issuer of a recognised international currency, in a position to provide emergency liquidities[1].



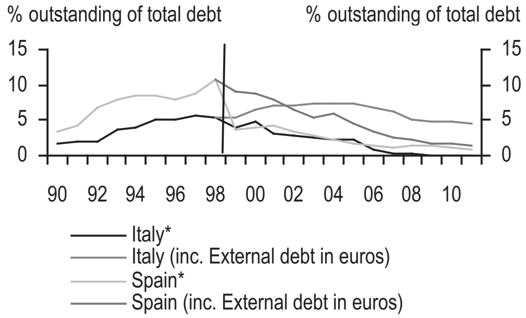
This analysis may appear paradoxical, at a time when the sovereign crisis in the Eurozone has reached a peak. The single currency is indeed considered to be responsible for the deterioration in current account imbalances between member countries of the European monetary union and, consequently, for the massive increase in public bond yields of peripheral countries. Creation of the euro did indeed mean easier, cheaper access to external finance and a reduction in nominal and actual interest rates. The apparent disappearance of the external constraint delayed the moment of rebalancing of current accounts. However, it has always been clear that the sanction would come from an increase in interest rates which would force "clandestine" Member States, that is to say those not complying with Stability and Growth Pact criteria, to get back in line, even though the euro was postponing the date of the sanction.

Further, it is not the creation of a single currency as such which accentuated the current account imbalances in each country, but the way in which public and private authorities used this sudden influx of capital. Indeed, the increase in the current account surpluses and deficits in Member States dates only from 2004, that is to say

1. Barry Eichengreen, Un privilège exorbitant, Paris, Odile Jacob, 2011, p.167 and following.

from the time when credits in the private sector increased rapidly worldwide and which was known as the "*global credit boom*"[2]. Yet this acceleration was the result of a demand for bonds higher than the offer, the deleveraging of States, statutory developments, the flattening of the curve of interest rates and, above all, the development of *collateralised debt obligations* (CDO). In fact these structured products increased by 75% between 2003 and 2004 according to the Bank of France, a consequence of abandonment by the banks of balance sheet CDO in favour of synthetic arbitrage CDO[3].

Share of the debt in foreign currency



The euro is thus neither responsible for, nor guilty of the size of current imbalances within the zone. It is the incomplete nature of European construction that does not allow for budgetary and economic coordination which has limited the stabilising function of the single currency. In other words it is not financial integration accentuated by the euro which has caused the crisis in public debt and destabilised the world financial system, but the lack of federalism or, at least, the lack of economic, social and financial integration.

Completing progress made under the effect of the crisis: the need for economic and financial integration

Recent progress will significantly improve the functioning of the economic and monetary union because it deepens economic integration and provides the euro zone with institutional structures. The "6 pack" added a preventive aspect to the Stability and Growth Pact and makes sanctions less dependent on political haggling. The "Euro Plus Pact" increases the coordination of economic policies and the creation of a "Euro summit" is the foundation stone for specific governance of the Eurozone. However, this progress is not sufficient to make the Eurozone a first rank player in the reduction of world imbalances.

2. Philip R. Lane, International financial integration and the external positions of euro area countries, OECD Working papers n°830, Dec 2010.

3. In fact, although the regulations introduced by Basel II no longer enable banks with low equity levels to outsource their risk by securitisation, as was the case under the 1998 Basel agreement, it gives them the possibility of provisioning the economic risk actually transferred. If the risk is judged to be low, securitisation again enables outsourcing of debt. In parallel to this, the tightening of credit spreads encouraged recourse to underlying more complex or more liquid instruments, which offer greater profitability. For further information see Mathilde Lemoine, "Le marché de la dette américain soutenu par les ménages et la titrisation", *Annuaire des Professions financières*, 2008.

The first limit of institutional evolutions over these past few months has been to exonerate States from considerations regarding continued construction of the single European market. Indeed, economic theory, particularly that of R. Mundell, clearly shows that it is possible to create a joint currency, even if the monetary zone is not optimal, that is to say even if reactions to external impacts are not symmetrical. In this case, workers and investments must be able to move from one country to another without hindrance or develop transfer mechanisms between countries in the zone thanks to a federal budget. Continued European economic integration, thanks to elimination of obstacles to trade, harmonisation of regulations segmenting the markets and increased worker and capital mobility would have enabled us to bring the prices of factors closer together, along with economic structures and growth rates. Member country economies would not have diverged in the way they have done recently, but would have seen their economies draw closer to one another.

The second limit on European progress observed over these past few months is the importance of "inter-governmental" decisions. This method of decision-making, where discussions between States are given priority, exacerbates both national interests and conflicts. Which Member State can most legitimately give advice or directives to another?

Further, the Eurozone does not yet speak with one voice in international bodies such as the IMF or the G7/G8/G20. This means that there is no defence of any joint European position in monetary terms. The euro is thus hindered in its progress towards becoming a heavyweight player in international financial stability.

Making the Eurozone a player in world balances calls not only for greater mutual supervision of national budgetary developments, but also better coordination of economic policy choices. After the failures of the main economic policy orientations and the Lisbon Strategy, "Europe 2020" and the "Euro Plus Pact" risk encountering the same lack of success if the European Commission cannot control the attainment of objectives and the sustainability of public finances. Moreover, since in the end the only source of growth is technical progress, a major step towards federalism could be taken by allowing the European Stability Mechanism (ESM) to borrow in order to finance investments aimed at achieving the objectives detailed in the "Europe 2020" programme. It is also urgent to facilitate the movements of workers amongst the various countries in the Eurozone. The creation of a European work contract, with rights for the employee financed by a European fund paid for by Member States could be one way of getting around national reticence. Finally, to ensure that the euro becomes an essential player in the new international monetary system, one Member State could represent its partners in the Eurozone at international bodies debating monetary and financial matters.

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The Eurozone sovereign crisis is not a euro crisis. The euro has contributed to world stability and growth by improving financial integration, as well as permitting the formation of a leading regional zone. The euro has also been a pioneer in the reform of the international monetary system. The sovereign crisis is not a crisis for the euro as a currency but rather the reflection of a lack of economic and budgetary integration and of the failure of the functioning of economic and monetary Union. Considerable progress has been made recently. This should be supplemented in order to "*make the European Union the world's most competitive and dynamic economy*", as pronounced by the late Lisbon Strategy and reduce regional specialisation. It is by creating the conditions for strong, sustainable growth that Eurozone Member States will complete their work of positioning the euro as a reserve currency and will become essential players in world financial stability.