

# FUTURE OF THE EUROZONE

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**IMK**

Institut für Makroökonomie  
und Konjunkturforschung

## Diverging or Uniting Europe?

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We asked each of the speakers of the Workshop 3 questions about their statements. The answers can be found below. The Workshop was to discuss the situation and future of the EU and especially the Euro Area in the middle of a deep crisis. It is highly controversial among politicians as well as academics which way or ways out should be sought. Against this backdrop IMK organized its "Future of Europe" workshop bringing together academic scholars of economics and political science to discuss the relevant issues. The debate addressed several fundamental questions on a future Europe. A critical assessment was made of the economic policies implemented so far, because measures taken have deepened the rift among member countries rather than bridging it. This immediately leads to the question whether the Euro can be saved as a common currency. The structural heterogeneity of the Euro area with respect to wage and price formation as well as economic policy approaches speaks against it. It is difficult in the absence of convergence-promoting policies to preserve monetary stability under these circumstances. On the other hand, the growth potential of a joint currency and the undisputed high costs of a break up were seen as arguments in favour of keeping the Euro.

All this happens in a situation where uncertainty is significantly enhanced. Financial investors are desperately seeking safe assets they cannot find anymore. The reason is that government bonds can no longer play this role under new default rules. While some scholars find this appropriate to avoid moral hazard problems that might encourage national governments to get over indebted, others see it as a source of increased uncertainty that hampers investment and growth.

This issue is a special case of more general question of utmost importance: Should European politics be re-nationalised or must it become more integrated to preserve a stable Europe, given that the status quo is not sustainable. The former provides a chance to reconcile diverging national interests with at least a reduced form of a European community. The latter would establish a new kind of European stability which results from a truly European perspective beyond national interests.

A crisis in its original meaning is a situation where decisions have to be taken that will lead one way or the other. Presently it is still far from obvious which way should be taken. This suggests that the crisis will continue.



## SHOULD THE EURO BE SAVED?

Andreas Nölke, Professor at the University of Frankfurt

### 1. *You strongly argue in favour of giving up the Euro. Why?*

Although the Euro is very helpful for the performance of German export sector companies, it has led to a lot of economic misery in other parts of the Eurozone. A progressive reform of the Eurozone is conceivable, but the necessary reforms – such as a decade of over-proportional wage increases in Germany, transnational wage coordination and strongly increased fiscal redistribution via the EU – are politically extremely unlikely. Neither are German firms and work councils willing to give away their competitiveness, nor do we have European structures for wage negotiations, particularly on the employers' side. And there currently is neither sufficient pan-European solidarity for massively increased permanent fiscal transfers, nor for the jump in European integration that necessarily would need to go along.

### 2. *Don't you fear major currency crises in the aftermath of a Euro abolishment?*

Indeed a disorderly break-up of the Eurozone would certainly lead to major currency crises. In order to prevent both long-term economic stagnation (with the Euro) and major currency crises (with a disorderly break-up), we need to develop progressive alternatives to the Eurosystem, such as a reformed European Monetary System (EMS). The old EMS worked much better than the current Eurosystem and a reformed system would even overcome some of the old EMS' weaknesses, such as the overly strong position of the Bundesbank. The latter could be replaced by a European Monetary Fund, based on the existing institutions of the European Central Bank and the European Stability Mechanism. The Euro could be kept as an external currency, like the old ECU. In order to soften the turbulent transition phase, the introduction of a reformed EMS would need to be accompanied by capital controls and a one-off European Marshall Plan.

### 3. *Is a Europe without a Euro a better Europe?*

Given the institutional heterogeneity of the Eurozone member economies, Europe needs a somewhat more flexible currency arrangement. If we do not go ahead with a radical reform of the Eurosystem, we are risking continuing economic misery and increasing political unrest in large parts of Europe. Moving in the direction of even more powerful European integration – such as increased EU-level fiscal redistribution – is no option at the moment, since this would further strengthen right-wing populist parties in many Northern economies. The latter parties would be able to exploit the uneasiness of many citizens with a European super-state. Correspondingly, a Europe without the current Eurosystem would indeed be a better Europe.



## SHOULD THE EURO BE SAVED?

Gustav A. Horn, apl. Professor University of Duisburg-Essen, Director IMK (Macroeconomic Policy Institute)

### 1. *You strongly argue in favour of keeping the Euro. Why?*

Dissolving the Euro area in the present situation would impose severe economic harm on all member states. The most important impact would occur by the uncertainty triggered already by the decision to do so. Financial markets would dive and investment would stall. A deep recession with high unemployment would be inevitable. This all, just to end up in currency regime with a probably pegged or managed exchange rates that recreates the uncertainties we have already seen in the early nineties. At the end of the day a new but less dynamic Europe would emerge. Low growth, higher interest rates and lower employment compared to a situation where we would have a properly managed currency union is the result.

### 2. *But do you think the Euro is properly managed? Don't you fear that present instabilities may destroy the Euro area?*

Indeed the Euro area is not properly managed. And there is a real danger of breaking-up. But in this case you have two possibilities. Either you try to improve economic policy of the Euro area in order to achieve a properly currency area. That is what I recommend. Or you give up hope. Then it is better to dissolve the joint currency. But you should not assume that policy makers who failed to run a currency union properly could nevertheless succeed in managing an exchange regime in an optimal way. They have failed in the nineties, they have failed during the currency union and they will fail thereafter again. What you need is a better economic policy and I prefer to achieve that inside a currency union and not outside.

### 3. *Would a Europe without a Euro not be more stable?*

A joint currency creating an economically huge domestic market is a protection against all sorts of external shocks, notably exchange rate turbulences. In addition to that, trade between member states becomes cheaper and domestic trade gets a higher share of trade. Moreover the effectiveness of economic policy is enhanced taking place with only one currency. So already in principle a currency union is more stable. Given the policy failures to be expected in a pegged currency regime it seems obvious to me that a more instable situation is waiting for Europe if the Euro is gone.