# The Impending Collapse of the European Monetary Union

*Charles W. Calomiris*

European monetary union will centralize control over European currency. Some have argued that the scale of this new currency area will cause a leap in demand for European currency as a numeraire and store of value. Furthermore, reductions in transactions and hedging costs from currency homogeneity within Europe could increase European wealth and income.

It is argued that this change would be beneficial to the world economy, not just to Europe. Giving other countries the ability to peg their currencies to a basket of hard currencies (say, a mix of the dollar and the euro), rather than just to the dollar, might stabilize fixed exchange rate regimes. For example, pegging to a bundle of currencies could take the form of a currency board that redeems a fixed bundle of "hard" currencies in exchange for the domestic one. A bundle of currencies is potentially superior as an anchor because its value is more stable. A productivity shock in the United States that produces a real exchange rate appreciation for the dollar won't produce as large an imbalance with emerging market countries if the hard-currency bundle includes the currencies of countries other than the United States which are not experiencing that productivity shock. So a stable European currency could contribute to overall financial stability.

Furthermore, the introduction of the euro could produce a one-time depreciation of the dollar, which immediately could take some pressure off emerging market countries pegged to the dollar.

## The Problem of Credibility

Is this rosy scenario plausible? It depends on whether Europe will produce, or be expected to produce, a truly "hard" currency to com-

---

*Cato Journal*, Vol. 18, No. 3 (Winter 1999). 

Charles W. Calomiris is the Paul M. Montrone Professor of Finance and Economics at Columbia Business School and Co-Director of the American Enterprise Institute Project on Financial Deregulation.

pete with the dollar as a numeraire and a store of value, within and outside Europe. The fiasco produced by France over the management of the new central bank, and the willingness of the Germans to cede to those demands, raises strong doubts about any immediate use of the euro as a competing international store of value. The long-run prospects for the euro to become a hard currency are unclear, and I am rather pessimistic, both because of the apparent weakness of Germany in opposing French pushiness, and because credible policy rules to insulate the euro from fiscal shocks in member countries have not been laid out, and likely will not be in the future.

Euro-optimists should bear in mind that currency unions not only can begin, but also can collapse. The United States (a currency union mandated by its Constitution, and defensible by force of arms, if necessary) is the successful historical exception among history's attempts to create a common numeraire from a variety of local ones. Unlike the case of the United States, European members of the monetary union will retain the option to exit. That not only means that the monetary union may fall apart; it also means that the (implicit or explicit) threat of exit will be used by member countries to influence monetary policy, and thus keep the currency from becoming a reliable international anchor.

My concerns about member countries' meddling into central bank policy go beyond the occasional fudging of medium-run targets because of differences in unemployment rates across countries. I am concerned primarily about the absence of credible constraints that would limit the long-run monetization of deficits, and the way cross-country differences in the taste for the long-run level of inflation will undermine the currency union.

## Structural Weaknesses

As the rules currently stand, there remains some uncertainty regarding the amounts of each country's government securities that will be purchased by the central bank, and the formula for how the seignorage (the profits from holding those securities) will be distributed among member countries. Let's assume (as is likely) that securities will be purchased and revenues will be shared on an equal (proportionate to GDP) basis.

This arrangement leaves a lot of room for inflationary mischief resulting from the monetization of deficits. Monetary union will encourage countries whose tastes lean more toward monetizing deficits to press harder for monetization. Soft-money members will recognize that the costs to inflating are now lower because their neighbors are

also forced to inflate alongside them. Inflation will no longer be one of the competitive tools used by governments to compete in attracting multinational enterprises. Why will hard-money members agree to inflate? The threat of exit by soft-money countries will be used successfully (for a time) to gain acquiescence by hard-money members of the union for higher inflation.

The amount of deficit monetization that is likely to occur in the future is greater than one would estimate from current levels of European deficits, for three reasons. First, because monetary union will reduce the costs to a fiscally irresponsible government of monetizing its deficit, monetary union will encourage larger deficits in the future.

Second, running larger deficits increases the bargaining power over inflationary policy of soft-money countries by making their exit threats more credible. Soft-money countries can use large deficits to bolster their threats to exit—pointing to the possibility that they will "have to" exit from the European Monetary Union to monetize those deficits unilaterally unless hard-money countries agree to joint monetization. The threat of exit is more credible if a member country's present value of tax revenues net of expenditures (which, they will argue, are constrained by domestic politics) is inadequate to repay its future debt service costs. Thus running higher deficits makes the threat of exit more credible, and makes it easier for soft-money countries to push for monetization.

Third, large contingent liabilities of soft-money members are already looming on the horizon. What expenditures are most likely to produce the enormous fiscal deficits that will weaken, and ultimately undermine, the euro? The two most important categories of off–balance sheet fiscal risk are pension systems and banking systems.

As Jonathan Gruber and David Wise (1998) show, the pension systems of some of Europe's economic giants are heading for disaster in the not-too-distant future. High retirement benefits are encouraging declining labor participation, which is adding to the fiscal problems the pension funds face. The unused labor capacity of workers between the ages of 55 and 65 is 67 percent in Belgium, 60 percent in France, 59 percent in Italy, and 58 percent in Netherlands, compared to 48 percent in Germany and 37 percent in the United States. The potential for a massive fiscal expenditure to bail out insolvent pension systems poses a severe threat, and the threat is larger in some countries than in others.

Potential bank bailouts are another source of large deficits. Here, too, Italy and France are among the most vulnerable. The banking sectors of France and Italy are among the weakest in Europe, and

they will come under increasing pressure from the competing Dutch, Spanish, German, and British banks. Large and growing bank bailouts (following the examples of Credit Lyonnais and Banco di Napoli) are a distinct possibility over the next few years.

Thus, big declines in the euro against the dollar, and the eventual collapse of the euro, will most likely coincide with ballooning fiscal problems from off–balance sheet government liabilities, not changes in on–balance sheet taxation and expenditure which receive so much attention from many macroeconomists and the press. The need to redefine fundamentals to include off–balance sheet fiscal risks is one of the primary lessons of the exchange rate collapses in Asia, Mexico, and many other countries over the past two decades. It is a lesson that remains to be learned in Europe (and by some influential macroeconomists in the United States, as discussed in Calomiris 1998).

Eventually, one or more hard-money members will tire of suffering the costs of inflation. The intolerance for continuing inflation in the hard-money members will lead them to exit the system. While the (implicit or explicit) threats to exit will come mainly from soft-money members in the early years of the European Monetary Union, it will ultimately be the hard-money members who force its dissolution.

## Can Reform Help?

Can anything be done to address the structural weaknesses I have described? Realistically, probably not much. I can imagine three reforms that could conceivably help to forestall problems, and make it more likely that the euro would become a hard currency—but two of these possible reforms are very unlikely, and the third is positively far-fetched. The unlikely ones are (1) implementing immediate credible solutions to pension system insolvency and (2) bringing market discipline into Europe's banking regulation. Market discipline would require, minimally, a credible subordinated debt requirement as a part of bank capital standards. (For details, see Calomiris 1997). Weak banks, of course, do not like the idea of market discipline, so this is not a policy likely to be greeted enthusiastically by Europe's powerful bankers. And the anticipated cross-subsidization coming from monetary union removes the incentives of the fiscally weak to undertake the costly process of banking or pension reform.

The third (and most far-fetched) reform would be to implement credible rules for open market operations and seignorage sharing that would discourage fiscal profligacy and the monetization of deficits by the union. It would be logically feasible (see the appendix for details) to set a rule that would link the fiscal risk created by a member

country to its share of seignorage from the euro. That is, suppose that higher fiscal risk (defined as an increased possibility that future taxes will not pay future government debt service costs) led automatically to a dumping of some portion of that government's bonds by the central bank, and a reduced share for that country in the seignorage created by the central bank. It is even conceivable that the creation of fiscal risk could be penalized by fees in addition to losses of seignorage revenue.

Such a rule might discourage fiscal profligacy and thereby make deficits, and their monetization, less likely. But this proposed rule for sharing seignorage and penalizing fiscal risk, while interesting to think about and possibly effective in principle, is politically almost unimaginable. The conflicting goals of the governments within the union, and the weak political will of Germany to demand concessions from France and others, would be an insurmountable hurdle to imposing a rule for "incentivized" seignorage sharing (especially since such a rule would require amending the Maastricht agreement). The union would be very unlikely to establish a rule that would discourage soft-money countries from running deficits, or to enforce such a rule if somehow it were established.

## Conclusion

I predict that the euro will be a weak currency (one that will not retain its value against the dollar), and that it will not be a permanent currency. Ultimately, the euro will most likely be remembered neither as a textbook example of the social gains of properly defining the optimal currency area nor as the harbinger of global exchange rate stability, but rather as an illustration of the importance of fiscal discipline for monetary credibility, and as a monetary example of the tragedy of the commons.

European union will likely strengthen the attraction of the dollar as a numeraire and a store of value. Countries outside of Europe will continue to peg their exchange rates to the dollar. And when the European Monetary Union ultimately collapses, it will itself provide a positive shock to the real dollar exchange rate that will hurt countries that have pegged to the dollar. All of this is unfortunate from the standpoint of global macroeconomic stability—an example of how political constraints that limit rational policy and encourage public profligacy make the global economy less stable than it otherwise would be.

What could Europe do to promote its own interests and improve global financial market efficiency? Rather than focus on risky attempts

at reforming monetary policy—ironically, an area where there is probably relatively little to be gained from reform—more emphasis should be placed on a fundamental redesigning of Europe's inefficient core institutions of commercial law, corporate governance, and banking. Reforms that would strengthen the rights of shareholders and debtholders (including bankruptcy reforms) should be a top priority. Here France and Italy especially have much to learn from Great Britain (for details see La Porta et al. 1997). Allowing European-based companies to choose which country's securities, banking, and commercial laws apply to them (a proposal akin to Romano's [1998] recent proposal for promoting regulatory competition within the United States) would be a wonderful first step toward spurring the reform of core economic institutions. That kind of economic integration would really make a difference for Europe, and provide an example of the constructive role of institution building to be imitated by emerging market countries.

## Appendix

This appendix outlines a means for limiting the risk of deficit monetization within a monetary union by linking the seignorage earned by a member country to the amount of fiscal risk it creates.

Fiscal "insolvency" risk for a member country is defined as the probability that the member country will be unable to meet future debt service obligations from its net future taxes and "normal seignorage" (the amount earned if all members follow a noninflationary monetary policy rule).

A member that is perceived as fiscally insolvent must either change its tax and expenditure policies to become fiscally solvent, exit the monetary union and inflate unilaterally (raise new inflation taxes from unilateral seignorage), or remain in the monetary union by convincing other countries to jointly inflate.

Assume that with probability $p$ an insolvent member will be able to convince other members to jointly inflate (through higher euro money growth) in order to keep it in the union.

Initially, at the onset of the monetary union assume that all countries are fiscally solvent. The objective is to make countries react to an initial deficit shock with an increase in direct taxation by penalizing a member country (through a reduction in seignorage share from operating the European Central Bank, and possibly an additional fee) if it does not respond to a deficit shock with sufficient taxation.

This policy will only work for some, perhaps unrealistic, parameter values. If initial $p$ is large (sufficiently close to 1) the rule will be useless, since ultimately the coalition will likely absorb members'

deficits. But if a member's $p$ is sufficiently small initially, if the first derivative of $p$ with respect to that country's deficits is not too large and positive, if fiscal imbalances develop sufficiently slowly and persistently over time (so that the costs of current forgone seignorage are large compared to the gains of future monetization), and if feasible penalties can be sufficiently large, then the cost imposed on members that increase fiscal risk could provide adequate incentives to limit fiscal risk.

How will fiscal risk be measured, and how will seignorage shares be reduced (or fees assessed) as a function of that risk? One simple approach would be to use market measures of fiscal risk as a basis for varying seignorage shares and penalties. For example, in a two-country model (for simplicity) where penalties are limited only to lost seignorage, the seignorage share of country 1 (bounded by zero and one, and equal to one minus the seignorage share of country 2) would be a function of the relative yields of 30-year ''legal tender'' bonds issued by the two countries. As the relative bond yield of a country rises, its seignorage share falls. If additional penalties are feasible, that implies that the feasible range of seignorage shares would include negative values.

''Legal tender bonds'' rather than euro-denominated bonds would be used here to measure fiscal risk because doing so would maximize the responsiveness of market yields to market perceptions of fiscal risk. All member countries would be required to issue a fixed percentage (say, 10 percent) of their government debt in the form of legal tender bonds. A legal tender bond has the following structure: it pays in whatever currency is the legal tender of the country at the time of the delivery of the bond coupon or principal payment. If the country switches from the euro to some other currency at some point in the future, *all* future bond payments would be converted into that currency at the currency conversion ratio prevailing *at the time of the currency change.* Thus bond payments would *not* be indexed. If a member country exited the system in order to inflate its currency (after suffering a fiscal insolvency and being unable to convince other members to monetize it within the currency union), then the real value of the promised payments on the bond would fall. For a discussion of the use of legal tender bonds in United States history, see Garber (1986) and Calomiris (1991).

That structure ensures that the ex ante yield on the bond will provide information about market perceptions of the member country's fiscal affairs. Of course, this plan can work only if there is a sufficiently large probability that soft-money countries will be forced to exit the monetary union. Yields on these bonds would not reflect fiscal risk

if $p = 1$, since in that case countries would never have to exit as the result of insolvency.

The usefulness of simple yield differentials to provide information about the relative fiscal risks of countries requires that countries suffer similar risks of being forced to exit the monetary union as the result of fiscal insolvency. For example, if the union were more likely to bail out France than to bail out Spain, then French yields would rise less than Spanish yields for any given change in fiscal risk. Thus a seignorage sharing rule that treats all countries equally may unfairly discriminate against smaller countries (whose bargaining power is weaker because their membership is not vital to the perpetuation of the union).

As noted in the text, in practice this plan is far-fetched. Initial values of $p$ may be too large (at least for some countries—like France and Italy) to make seignorage penalties effective deterrents. Second, the rule is unlikely to pass, since some countries would probably oppose it. Germany and Netherlands would gain from its passage more than others, while France and Italy might lose on net if the rule were passed. Furthermore, it is hard to construct rules that ensure enforcement by the central bank (one should not underestimate the creativity of bureaucrats when defining the meaning of inconvenient statutes).

## References

Calomiris, C. (1991) "The Motives of U.S. Debt-Management Policy, 1790–1880: Efficient Discrimination and Time Consistency." *Research in Economic History* 13: 67–105.

Calomiris, C. (1997) *The Postmodern Bank Safety Net.* Washington, D.C.: American Enterprise Institute.

Calomiris, C. (1998) "The IMF's Imprudent Role As Lender of Last Resort." *Cato Journal* 17(3): 275–94.

Garber, P. (1986) "Nominal Contracts in a Bimetallic Standard." *American Economic Review* 76 (December): 1012–30.

Gruber, J., and Wise, D. (eds.) (1998) *Social Security Programs and Retirement Around the World.* Chicago: University of Chicago Press.

La Porta, R.; Lopez de Silanes, F.; Shleifer, A.; and Vishny, R.W. (1997) "Legal Determinants of External Finance." *Journal of Finance* 52 (July): 1131–50.

Romano, R. (1998) "Empowering Investors: A Market Approach to Securities Regulation." Working Paper. Yale Law School.