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IS THE EUROZONE AN OPTIMUM CURRENCY AREA?

MAREK LOUZEK

Abstract:

The objective of this paper is to find out the past, the present and the future of the euro. The first part presents the euro as an edifying currency experiment. The second part analyses the economic performance of the euro area. The third part points out the internal conflicts inside the eurozone. The fourth part explains why the eurozone is not an optimum currency area. The fifth part outlines the controversy around the purchase of bonds by the ECB. The sixth part poses the question whether it is still possible to save the euro.

The eurozone is not an optimum currency area. In theory, it could become one, provided that high mobility of labour is achieved, wages are flexible downwards, asymmetrical shocks do not occur and there is a stable system of national finances, supplemented by an effective system of fiscal compensations. Since these conditions are not met, the euro has become a trap for the member states. The euro has not had the effect of converging economic development in the eurozone; quite the opposite, it has had a diverging effect.

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1 Introduction

When the single European currency was born 25 years ago, it raised great expectations. The euro was expected to boost economic growth, employment and overall prosperity. And in the beginning, it seemed that a future full of prosperity was becoming a reality. 25 years have passed, and nothing could be further from reality than a stable and healthy economic development of the eurozone. The euro did not provide stability. Quite the opposite, the euro itself became a source of instability.

The objective of this paper is to analyse the past, the present and the future of the euro. The first part presents the euro as an edifying currency experiment. The second part analyses the economic performance of the euro area. The third part points out the internal conflicts inside the eurozone. The fourth part explains why the eurozone is not an optimum currency area. The fifth part outlines the controversy around the purchase of bonds by the ECB. The sixth part poses the question whether it is still possible to save euro.

2 The Euro as a Currency Experiment

For economists, the euro is an amazing experiment (Wallace 2016). Economists do not carry out trials in laboratories. They test their ideas in experiments, which come up naturally or which are prepared by politicians. The euro taught us a lot. It originated from a combination of an unfortunate economic theory and ideology (Dornbusch 1996). The European currency project fulfilled neither the economic ambition, i.e. the ambition to bring prosperity, nor the ambition to bring the individual countries together politically.

The euro is a magnificent building standing on a precarious foundation (Stiglitz 2016). The economic arguments in favour of the euro are not convincing. The transaction cost savings are not that significant. Disparities among regions may not decrease but may conversely grow. Undeniable modest benefits are overshadowed by crisis-induced problems, which appear when the real exchange rate is significantly out of balance (Feldstein 2012).

The euro was not only an economic project, which was supposed to increase the standard of living, to boost competitiveness, to take advantage of the economies of scale and to ensure economic stability. It was also a political project (Eichengreen 1993). It was supposed to reinforce the political integration of Europe, to bring together European inhabitants and to ensure peaceful co-existence within Europe. The euro accomplished none of these goals. These goals are now more distant than before the eurozone was created.

The euro exacerbated inequality among European countries: weak countries are now even weaker and strong countries are even stronger. For example, between the years 2007 and 2019, the German GDP as compared to the Greek GDP increased from being ten times greater to being eighteen times greater. Inequality also increased in the individual eurozone countries, particularly in the countries facing a crisis. The situation in Greece, Spain, Portugal and Italy was worse than during the economic crisis in the 1930s (King 2016, Stiglitz 2016).

Instead of peace and harmony, European countries view each other with mistrust and animosity. Old resentments are revived because northern Europe perceives the southern countries as lazy and unreliable while, vice versa, the hegemony of Germany during the world wars is reminded. Most European countries will probably never achieve the standard of living they could have had, if the euro crisis had not come or if more resolute action had been taken against the euro crisis (Kuhn, Stockel 2014).

Monetary orders come and go. The Bretton Woods system of fixed exchange rates, which prevailed after World War II, lasted less than three decades. At first, everyone welcomed it enthusiastically because it replaced the gold standard. However, disillusion came in the 1970s. The euro's moment of glory was even more short-lived and even during the brief period when it seemed to be working, there were imbalances occurring, which eventually resulted in the euro crisis (Baldwin, Wyplosz 2015).

The founders of the euro fixed the exchange rates and centralised interest rates. They created new rules for managing budget deficits and the banking system. They bought into the illusion that they understood the workings of an economy and that they can intelligently intervene in it and improve its performance. In spite of the best intentions, Europe has a less stable and more diverging economic system, in which the rich countries are getting richer and the poor countries are getting poorer (Nellis, Alexiou 2012).

The founders of the euro were visionaries who tried to create a new Europe. Never before had anyone established a currency zone among countries, which are so different. Therefore, it cannot come as a surprise that the actual events deviated from the original intention very much. Regardless of how well designed the euro would have been, the benefit of a single currency could never be what its advocates believed. The impact of the euro on economic integration is inconsistent. The euro divides more than it unites (Sinn 2014).

Advocates of the euro noticed that large successful countries such as USA have a single currency. It seemed that if Europe wished to play a role similar to that of the USA on the global stage, it must also have a single currency. However, having a common currency can become a curse for heterogeneous countries. A currency compromise may not be advantageous for anyone: an unacceptable inflation rate in one country combined with an unacceptable unemployment rate in another country (Marsh 2009).

For example, when Nevada experiences an unpleasant recession and its unemployment rate increases, people will move to other states of the USA. Migration is relatively easy there because English is the national language. Things are different in Europe: even though there is formally free movement of labour force in Europe, there are still considerable language and cultural barriers. While it is common to move from state to state for Americans, this is not the case for Europeans (Stiglitz 2016).

Today, the eurozone consists of twenty EU countries: Germany, France, Italy, Spain, Luxembourg, Netherlands, Belgium, Austria, Finland, Portugal, Greece, Ireland, Slovenia, Lithuania, Latvia, Estonia, Slovakia, Cyprus, Malta and Croatia. The euro was originally introduced in eleven member states in 1999 for non-cash payments; euro banknotes and coins have been in circulation since 2002.

Advocates of the euro believe that the euro will bounce back and will return in full strength. Such an assurance might have sounded convincing twenty years ago. But today, the stagnation in the eurozone has been dragging on while economies elsewhere are getting healthier and, on top of that, are growing faster. The eurozone is experiencing two lost decades like Japan did.

The currency experiment has adverse social and political consequences, including the growth of political radicalism.

The creation of a single currency twenty years ago was perceived as a triumph of European integrationists over nationalist reactionaries (Wallace 2016). But the euro was born prematurely and politics triumphed over economics. The most painful paradox of the euro as a common currency is that in spite of the expectation that it would consolidate the European project, it actually brought about animosity and instability.

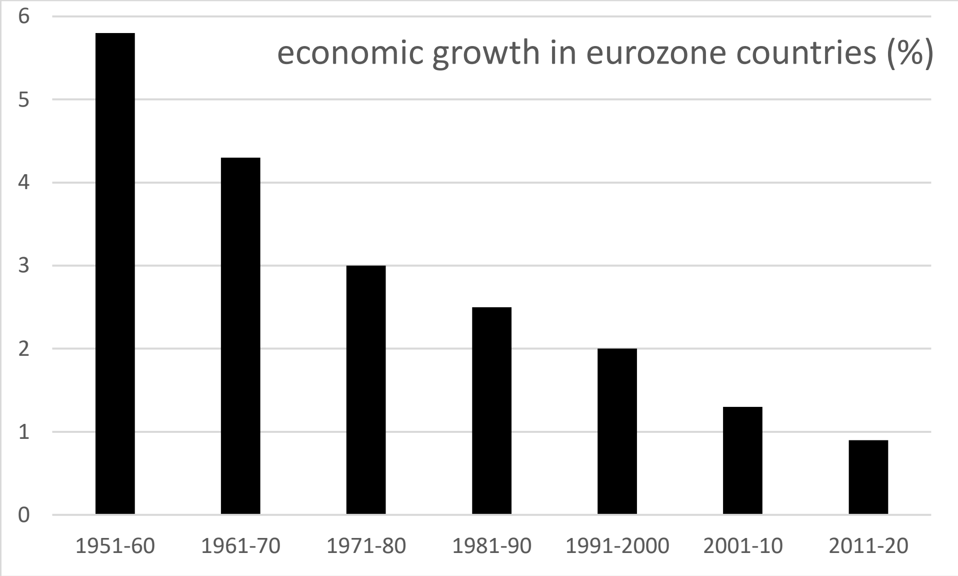
3 Economic Performance of the Euro Area

Monetary policy in the eurozone is implemented by the European Central Bank, which respects the established rules of central banking applied in the recent decades, for example, by targeting an inflation rate (Fandl 2018). The fundamental goal of the ECB is price stability. Without its main goal being affected, the ECB is supposed to support the general economic policy in the EU, i.e. to support a balanced economic growth respecting the environment, a high employment rate, social protection systems, etc. And it is exactly in this second sphere where the EU is not very successful.

The fact that economic growth in eurozone countries did not accelerate but conversely slowed down was not a coincidence. Since its creation, the eurozone grew substantially more slowly than, for example, the USA as well as more slowly than those “old” EU countries, which refused the euro for the time being. According to the ECB, the long-term potential growth rate of the eurozone is merely around 1 %. That is no miraculous growth pace; it’s more like a snail’s pace (Chorafas 2013).

Chart 1 shows the economic growth of the continuously integrating European Union. Eurostat reconstructed the data for fifteen countries of the future eurozone for a period from the 1950s. The average economic growth in West European countries was 5.8 % in the 1950s, 4.3 % in the 1960s, 3 % in the 1970s, 2.5 % in the 1980s, 1.3 % in the first decade of the 21st century and a mere 0.9 % in the years 2011-2020. The decline of economic dynamics is obvious.

Chart 1. The economic growth in the continuously integrating EU



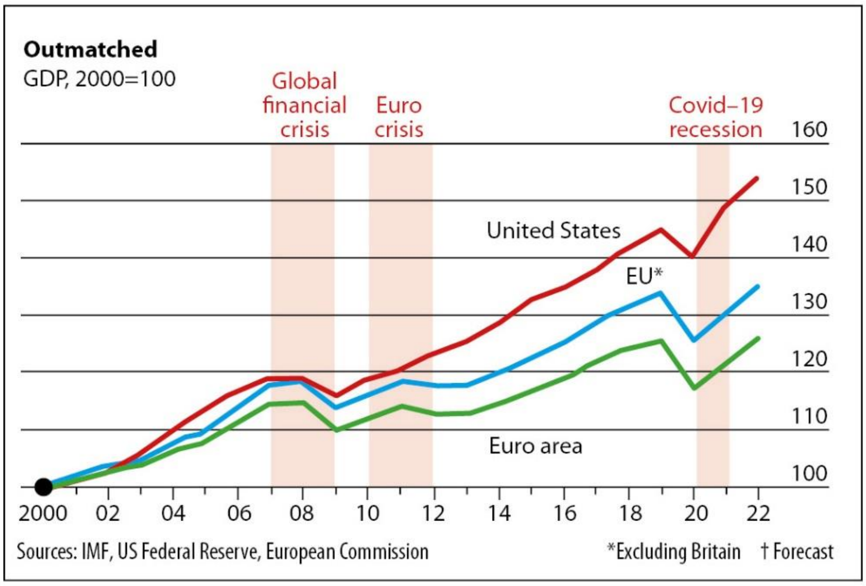
Source: Adapted from Eurostat, 2023

The coronavirus crisis will make the EU lag behind even more. In 2020, the global economy experienced the biggest drop since the Great Depression in the 1930s. The US economy contracted by 3.5% in 2020, the worst decline since 1946. The euro area contracted by 7% in 2020. According to the estimates of the OECD, the economies of France, Italy and Spain should even drop by 12 %. Conversely, economies should grow in 2021. EU is likely to grow 3.7% in 2021; America, by contrast, is now projected to grow 6-7% in 2021.

It has long been true that during crises, the US economy falls faster but also recovers faster. During the last ten years, the economic growth of the EU was half of that of the USA. However, the coronavirus crisis has had a harder impact on Europe than on the US because the quarantine measures were stricter in the EU than in the USA. There is a risk that the European economy will remain in depression for a longer time.

Chart 2 compares the economic development of the US, the EU and the euro area over the euro period 2000-2021. While the US economy grew by 50% over this period, the EU economy grew by 30% and the euro area by merely 20% over the same period. The biggest adverse shocks were the 2007-2009 global financial crisis, the 2010-2012 euro crisis and the 2020 Covid-19 recession.

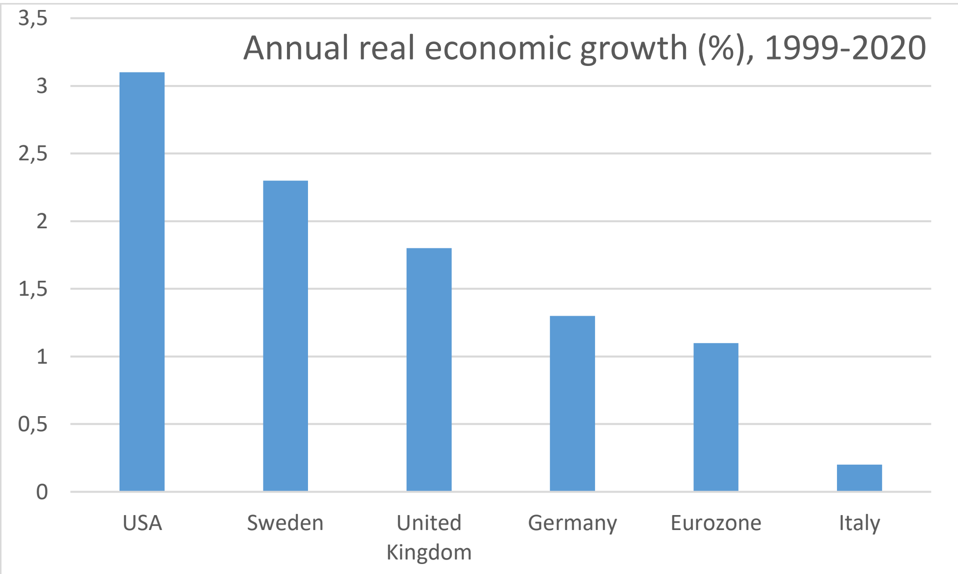
Chart 2. The economic growth rates of the US, EU and the euro area, 2000-2021.



Source: Adapted from The Economist, April 3rd 2021.

Chart 3 shows the average annual growth of the real GDP in selected EU countries in the years 1999-2020. Countries outside of the eurozone, such as the United Kingdom or Sweden, grow substantially faster than the eurozone as a whole or Germany, not to mention unfortunate Italy, which does not grow nearly at all. From this point of view, the decision of countries such as the United Kingdom, Sweden or Denmark not to join the common currency appears to be quite rational.

Chart 3. Annual real growth in countries inside and outside of the eurozone



Source: Adapted from Eurostat, 2022

The inflation rate in the eurozone (just as in other Western economies) was successfully kept low (deflation appeared to be more of a problem). The credit for the decrease of inflation is not due to the ECB because, for example, the USA or Japan experienced the same decrease of inflation. It was a global trend. The ECB acquired substantial controlling power but remained a unique body – a central bank without a country. The eurozone does not have any budget of its own, any fiscal authority or any joint representation at the IMF or the World Bank (Coenen, Straub, Trabant 2012). Inflation gripped the world economy in 2022, but the ECB was in no hurry to raise interest rates.

The eurozone crisis deprived the affected countries of their competitiveness. While the bubble was being inflated, prices and wages grew above the level that would allow for sustainable development without dependence on the inflow of loans. For a number of years, the current-account deficits of southern European countries constantly grew and so did their need for foreign loans to finance these deficits. It was all going smoothly while the markets dazzled by the euro were willing to finance these deficits. When they stopped this financing in summer 2007, a crisis arose (Sinn 2014).

The different real interest rates resulted in widening the gap among the trends in the balance-of-payments current accounts of the eurozone members. Considerable deficits or surpluses in balance-of-payments current accounts (Target 2 system) gradually accumulated inside the monetary union, which resulted in splitting the eurozone countries into debtors and creditors. Excessive loan expansion and misallocation of capital occurred in the debtor countries. This could have previously been observed in Greece, Spain, Portugal or Ireland (Gros 2013).

The euro has turned into a trap for the European states that adopted it. The southern states are trapped because the inflationary credit bubble brought about by the euro deprived them of their competitiveness, and the northern states are trapped in a liability spiral… Unfortunately, the sequence of measures to combat the crisis is not planned, and no one has a notion of where this all will lead. Instead Europe is left stumbling from one crisis to the next. (Sinn 2014: p.257)

4 The Weight of Contradictions

The European economic and monetary union is more differentiated than any other imaginable monetary union. The eurozone is more heterogeneous than other monetary unions, including those, which had previously existed in Europe, such as the Latin Union and the Scandinavian Monetary Union. Failures of experiments with the monetary unions of various states in the past are a memento for the current monetary experiment in Europe (Marco 2014).

The euro is not the first monetary zone on the European continent; it is actually the fourth one (Chorafas 2013). The first three predecessors existed in the 19th and 20th centuries. The German Monetary Union was formed by Prussia, Bavaria and the Austrian-Hungarian monarchy and lasted for 78 years (1838-1914). The Latin Monetary Union (1865-1926) was created by Belgium, France, Greece, Italy and Switzerland and lasted for 61 years. The Scandinavian Monetary Union (1872-1914) fixed exchange rates between the currencies of Denmark, Sweden and Norway. All these monetary unions eventually disintegrated.

The dissolution of the Bretton Woods monetary system fifty years ago as well as the dissolution of the European monetary system of fixed exchange rates in 1992 should have served as a warning that systems of fixed exchange rates are fragile. It is only a matter of time before a set system of fixed exchange rates deviates from economic fundamentals. The European currency is another example of a system, which believes that it is capable of fixing exchange rates on a long-term basis (Nikas, Stoupos, Kihos 2019).

A monetary union works similarly to a gold standard in many respects (Baldwin, Wyplosz, 2015). Gold has been replaced by the euro. In both cases, sovereign states share a single currency – formerly gold, currently the euro – and are no longer able to use an exchange rate to eliminate imbalances. If a country in the eurozone achieves a balance-of-payments surplus, there will be an inflow of euros to that country and, vice versa, if a deficit arises, there will be an outflow of euros from that country. A country with a deficit cannot use an exchange rate to restore its competitiveness.

Good monetary systems cannot ensure prosperity, but bad ones can cause unnecessary recessions and depressions (Pisani, Ferry 2011). The euro met the expectations only partially: on one hand, it became recognised as the second global reserve currency, and even a more important currency than the US dollar on some markets. Technically, it was a success. But in economic terms, it worked as the most powerful amplifier of the business cycle since the classical gold standard.

Since 1999 when the European currency was created, eurozone countries have constantly been lagging behind other centres of global economy (Buti, Carnot 2012). The eurozone has been suffering from a low economic growth on a long-term basis. This disadvantage has been affecting the eurozone throughout the past two decades and was caused by the very nature of the common European currency, the initially hesitant monetary and budgetary policy after the financial crisis and the errors made in addressing the eurozone crisis during the years 2009-2014.

Critics – both insiders and outsiders – have long warned that the economic benefits of the euro would be meagre, if any. Instead of creating good will and solidarity among the member countries, the euro generated grievance and antagonism. Not only did the German and French compromises adopted in the process of creating the European currency cause damage to large parts of Europe but the euro also drove a wedge between the two largest European nations (Schelkle 2017).

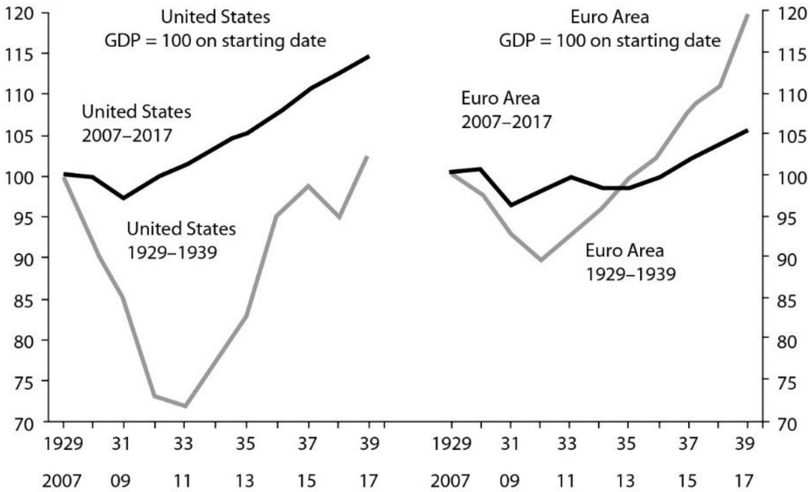
German chancellor Helmut Kohl believed that a single currency would contribute to stability and peace in Europe. However, when advocating this idea, he did not take important circumstances into account. He rejected warnings from both national officials and international economists and also did not listen to the wisdom of popular opinion because the German public had initially refused the euro. Kohl created an ideology of stability, which concealed the destabilising nature of the eurozone’s policies and institutional structure (Sarrazin 2012).

France maybe always belonged to the south and its former northern status was only an illusion. However, the founders of the eurozone assumed that Germany and France, acting as equals, would push the European integration forward. But France has had a weak economy for a long time. Government spending grew from 50 % of the GDP to 57 % of the GDP during the years 1980-2017. The French are spending too much money and are spending it on the wrong things. Fiscal expansion is weakening the competitiveness of France (Mody 2018).

Since the beginning of the 2007 financial crisis, eurozone countries have been following a trajectory similar to that of Japan after the “lost decade”. The eurozone crisis affected particularly the southern countries – Greece, Italy, Portugal, Spain and currently France, too (Mody 2018). The belief that countries in crisis such as Greece or Portugal would be in an even worse situation without the euro does not stand up to scrutiny. Spain was plagued by a high unemployment rate, but its hardships never reached such intensity as during the euro crisis. Before the euro, the unemployment rate in Greece had never reached 27 %.

While the US economy recovered from the economic recession quite quickly, the European economy is reeling from one crisis to another (Chart 4). The USA dealt with the economic crisis in the years 2007-2009 substantially better than the EU and even substantially better than the USA itself had dealt with the economic crisis in the 1930s. It is true that the eurozone declined less during the latest financial crisis than during the Great Depression but the more slowly it recovered. The coronavirus crisis is continuing this trend.

Chart 4. Economic trends in the USA and Europe during the Great Depression and the Great Recession



Source: Adapted from Mody (2018)

The higher sensitivity of the unemployment rate to the business cycle is related to the higher flexibility of the US labour market. The fact that it is much more simple to lay off an employee in the US results in a greater increase of unemployment during a recession but also in its rapid decrease during recovery. In view of the higher flexibility of the labour market and wages, it can be expected that the increase of the unemployment rate in the US will be temporary (Čermáková, Kašová, 2019). The coronavirus crisis will hit the EU harder because more extensive restrictions were implemented in Europe in response to the pandemic and their duration was longer than in the US.

Jean-Claude Juncker, the ex-President of the European Commission, in his State of the Union speech from September 2016 said: “Being European, for most of us, also means the euro. The euro stayed strong and protected us from an even worse instability.” In Juncker’s opinion, Europeans will find out that the benefits of the euro are enormous. And he concluded his speech with a grandiose statement: “We can be united even though we are diverse.” (Juncker quoted in Mody 2018: 434). However, the narrative of “unity in diversity” is in contrast with the reality of the widening economic and political gap inside the eurozone.

The economic differences between the north and the south of the eurozone were not reduced but, conversely, exacerbated. There was no economic convergence but quite the opposite happened: divergence occurred (De Grauwe 2014). During the crisis, the north acted as the source of finances for the south. The political tension between the leaders of these two groups of countries grew. This tension between the north and the south persisted and limited the prospects of finding joint solutions to European problems.

The idea that the euro will act as an external anchor proved to be completely erroneous. The southern countries – Greece, Portugal, Spain and Italy – did not become more resistant to economic shocks and did not move to a hopeful growth trajectory. During the crisis years, the euro caused the biggest damage in the weakest eurozone countries and widened the income disparities among member countries (Clausen, Schlösser, Thiem 2019).

Other Western democracies share similar problems with the eurozone. But the eurozone faces the highest risk of an economic downturn. Low growth, a high tax burden and weak banks are leaving the southern countries in a vulnerable position. A new crisis – and the coronavirus pandemic is just another example of this – will be a challenging test for the eurozone, especially if Italy should become the epicentre of the crisis (Mody 2018).

If Italy remained outside of the eurozone, its central bank would lower interest rates faster than the ECB did. Lira would devaluate and Italian exports and GDP would experience a short-term recovery. Lower interest rates and weaker lira would certainly not resolve the long-term problems of the Italian economy, but they would prevent the Italian economy from sinking into an ever deeper economic and financial black hole.

The tragedy is that inside the eurozone, Italy experienced the worst of all worlds. The euro and its governance structures did not create a positive impulse for change, and neither did they provide a jolt to shake Italians out of their sense of creeping normalcy. The eurozone’s financial support systems created a safety net, which helped the country survive in near-crisis conditions. Italy did not undergo a much-needed economic and political catharsis. (Mody 2018: 386).

5 Suboptimal Currency Area

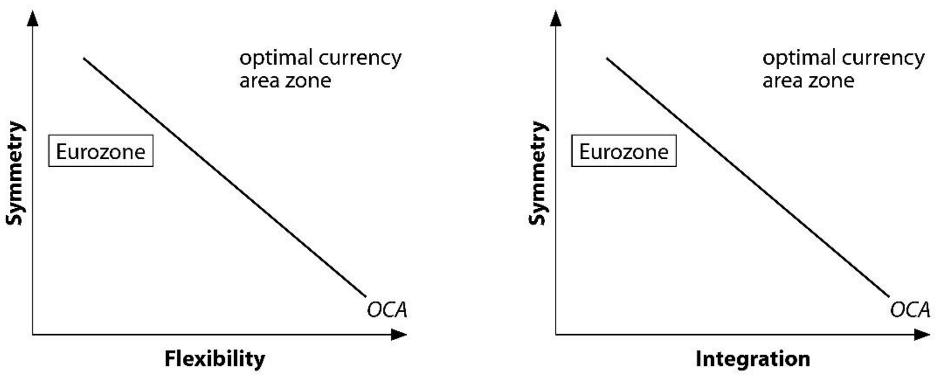
In the opinion of Robert Mundell (1961), separate states could form an optimum currency area if the following conditions were met: 1) high mutual mobility of labour; 2) wages flexible downwards; 3) intensive mutual trade; 4) symmetry of exogenous positive and negative shocks; and 5) the existence of a reasonable fiscal compensation mechanism (Jager, Hafner 2013).

The debate about whether the eurozone represents the optimal currency zone has been conducted for a long time but the predominating opinion is that these conditions are not met in Europe today. The mobility of labour force is relatively low in Europe and the necessary downward flexibility of wages and prices is virtually non-existent. The rigidity of the European labour market is well known. Asymmetrical positive and negative shocks keep occurring in Europe, which is not surprising because eurozone countries are indeed different (Klaus 2004).

The level of budgetary transfers at the eurozone level is very small. There may be a certain degree of international solidarity among EU member states, but its extent is incomparable to the degree of solidarity inside national states. The share of the EU budget in GDP is 1 % while the share of government spending in GDP is 30 %, 40 % or even 50 % of GDP at the national level. European solidarity is negligible in comparison with the national one. The eurozone does not even have its own budget (Schelkle 2017).

It is a paradox that Robert Mundell was celebrated as one of the fathers of the European monetary union when the euro was created. This is rather surprising because his ground-breaking article from 1961 and his subsequent cost-benefit analysis of a monetary union were fairly sceptical about the possibility of a successful monetary union in Europe. Mundell's later works (such as Mundell 1998) were more optimistic with regard to the benefits of a monetary union.

Chart 5. Optimal and suboptimal currency zone



Source: Adapted from De Grauwe (2014).

Chart 5 shows why the eurozone is not an optimal currency area. The charts show that the eurozone does not reach the necessary level of flexibility or integration. In the upper right section, there are countries forming an optimal currency area, for which the benefits of a monetary union exceed the costs. In the bottom left section, there is the eurozone, for which the costs probably exceed the benefits. This makes the eurozone unsustainable in the long run (De Grauwe 2014).

A common currency brings certain benefits. The benefits of currency integration are usually thought to include the lowering of transaction costs, the reduction of speculative capital flows, the restraining of exchange rate fluctuation, the simplification of consolidated statements of supranational corporations, the boost of mutual trade or the decrease of interest rates. Citizens and businesses do not need to hold that many foreign currencies. Excessive exchange rate movements resulted in certain macroeconomic disturbances in the past (Lorca-Susino, 2010).

However, the existence of a common currency also comes with risks: the loss of an exchange rate as an economic-political tool, the loss of autonomy of monetary policy or perhaps the loss of fiscal autonomy (Friedman 1970). The loss of an exchange rate is manifested in that the economy can no longer rely on the exchange rate as the means of adaptation when an external imbalance occurs. The loss of autonomy of monetary policy means that no member country can independently decide on whether and when to implement expansive or restrictive monetary policy. The loss of fiscal autonomy is rooted in the fact that a certain degree of fiscal redistribution or fiscal integration or coordination is necessary in a monetary union.

As soon as a country becomes a part of a monetary union, it loses one of its two key macroeconomic tools –monetary policy, while the second tool –fiscal policy – still remains within its purview. However, it is not at all certain that fiscal policy would be a good substitute for monetary policy. Budgetary policy measures can be used for other purposes when governments ignore the need for maintaining a balanced budget. Fiscal policy is like a tanker, which changes its position very slowly (Baldwin, Wyplosz, 2015).

The most significant cost of a monetary union is undoubtedly the loss of autonomy in monetary and exchange rate policy (Gilchrist, Mojon 2018). A country, which surrenders its own currency and accepts the euro, loses the exchange rate as a unique tool for balancing the flows of money between the domestic economy and the foreign economies. If there is a risk of occurrence of asymmetrical shocks and if there is an absence of sufficient adaptation mechanisms that would substitute for utilisation of an exchange rate, it is not advisable for a candidate country to rush into a monetary union.

It made sense for the small and open economies of northern and western Europe such as Belgium or the Netherlands to join the single currency controlled by Germany. Adoption of the euro by the southern countries such as Italy, Spain, Portugal or Greece was highly ill-conceived. And adoption of the euro by France was not well thought through. The French economy is relatively closed and has a particularly inflexible labour market (Wallace 2016).

Sober analyses of the European monetary union (e.g. by De Grauwe 2014) suggest that it is improbable that the EU as a whole could become an optimum currency area. Not all EU countries have the same interest in abandoning their national currencies and joining the European monetary union. Even countries, which are net beneficiaries of the monetary union, bear a risk due to unpredictable external shocks. Enlarging the eurozone to include 27 countries would create enormous problems because joining the monetary union would not be advantageous for all countries, far from it.

After Brexit, the ex-President of the European Commission Jean-Claude Juncker called for swiftly enlarging the eurozone and making sure that all EU member states paid in euro. From among the 27 EU countries, Poland, the Czech Republic, Bulgaria, Denmark, Croatia, Hungary, Romania and Sweden are the only ones that still have their own currencies. Bulgaria and Croatia wish to join the majority. This is a surprising change of attitude on the part of European institutions because the ECB tended to discourage non-eurozone countries from joining the eurozone in previous years.

If the European Commission wishes to enlarge the eurozone, it should thoroughly reform the eurozone to make it interesting for the Central and East European countries (Sinn 2014). The euro of today divides more than it unites. The larger the eurozone will be, the more heterogeneous it will be and the lower the likelihood that it will be an optimal currency area. The eurozone should make the euro more flexible and should establish a mechanism for an orderly exit from the eurozone.

6 Controversy about Purchases of Bonds

By adopting the euro, states lost more than just the ability to change their exchange rates and set interest rates according to the needs of their domestic economies. They also started to issue bonds in a currency, which was effectively a new currency to them. During the first decade of the euro's existence, this gave an advantage to the economies in southern Europe, which had been previously distrusted, because their borrowing costs were reduced by this. But these economies were left in the lurch when the bond holders started to worry too much (Wallace 2016).

Those who demand unlimited purchase of bonds from the ECB in order to save the euro can only see one side of the coin, which is the risk that insufficient trust in the public finance of the eurozone will lead to a collapse of the bond market, and the insolvency of euro countries will become a self-fulfilling prophecy (Sarrazin 2012). They like to disregard the other side of the coin, which is that a bailout, eurobonds or other forms of joint guarantee for bonds may not motivate national efforts to implement the necessary consolidation policy but may conversely tend to paralyze such efforts.

The coronavirus eurobonds, which a part of the financial markets sees as the right solution, are associated with serious pitfalls. Even if the EU wanted to build a federal state, it would not be meaningful to introduce a joint liability for the government debts of the eurozone member countries. Even in the USA, which forms a single nation, no member state is held liable for the financial management of other states. The absence of collective liability for the state-level debts of individual states is the very reason why federalism works in the US (Muellbauer 2013).

Eurobonds will probably lead to even more extensive borrowing since the countries, which borrow excessive amounts, know that they can no longer be punished by capital markets demanding higher yields from them. The inability of certain parts of the EU to pay their debts will result in a situation where reeling from one wave of crisis to another by doing just enough to avert a catastrophe will inevitably lead to the need to transform the eurozone into a transfer union (Sinn 2014).

By purchasing government bonds of the southern part of the eurozone (with many doubting whether this is in accordance with the European law at all), the ECB supports the moral hazard of the governments. The ECB justifies printing new money by the need to provide liquidity for the market. However, the eurozone's financial problem is insolvency in time, not insufficient liquidity. The interventions by the ECB reinforce the governments' incentives to incur debt. There is a real risk of private loans being crowded out by government loans (Gilchrist, Mojon 2019).

If eurobonds are introduced to collectivise the past, present and future public debts, they will become the manna from heaven to sanction claims even if they are unpayable and unsustainable. Eurobonds can become a boomerang even if the national central banks of the euroland and the ECB act honestly. By accepting toxic government bonds as a collateral, the ECB and the member countries are causing self-inflicted damage (Chorafas 2013).

The quantitative easing, which the ECB was doing in the years 2015-2019, was only seemingly a solution to the economic difficulties of the eurozone. Under the Public Sector Purchase Programme (PSPP), the ECB purchased bonds in the volume of more than two trillion euro. With quantitative easing, there is a risk that currency wars will break out. If quantitative easing is done successively by the American, European and Japanese central banks, which results in the weakening of all three currencies, the outcome is the same as if they did nothing, with the only difference that their balance sheet totals will increase.

In spring 2020, the German Federal Constitutional Court issued a ground-breaking ruling, according to which the purchases of government bonds, with which the ECB is trying to support the economy of the eurozone, are in violation of the German constitution. The Constitutional Court in Karlsruhe ruled that the ECB had failed to respect the proportionality principle when purchasing the bonds and suggested that the ECB had exceeded its mandate (Buiter 2020).

According to the German Constitutional Court, the ECB's purchase of bonds is not a violation of the ban on monetary financing of the governments of member states laid down in Article 123 of the Treaty on the Functioning of the European Union but the ECB's actions are still partially in violation of the German constitution. This violation is rooted in the fact that the ECB failed to prove conclusively that the tools, which it had used to achieve its goals, had been proportional. According to the German Constitutional Court, the ECB should justify these massive purchases of government debt, otherwise it will have to continue this programme without the Bundesbank.

In late 2018, the Court of Justice of the EU ruled that the programme for purchasing bonds was in accordance with EU law and did not exceed the mandate of the ECB. In the opinion of German constitutional judges, the Court of Justice of the EU exceeded its power, and therefore its opinion is not binding on them. Although the ruling of the German Constitutional Court formally concerns the purchase of bonds in the years 2015-2019 and not the purchases, which the ECB launched during the coronavirus crisis, it will never again be possible to ignore the proportionality principle.

The Karlsruhe ruling is ground-breaking in legal and economic terms because it significantly reduces the ECB's room for manoeuvre (Buiter 2020). While Mario Draghi, the ECB's President, assured markets during the financial crisis and the eurozone crisis that he would do whatever it takes to save the euro, Christine Lagarde, the new ECB's President cannot declare something like this.

The Karlsruhe ruling represents the moment of truth for the common currency. The German Federal Constitutional Court articulated the thoughts of many economists and citizens. If the German Federal Constitutional Court used the same arguments for the purchase of bonds during the coronavirus crisis, it could make matters very difficult for the ECB. In spring 2020, the ECB introduced a special programme for the purchase of assets (PSPP) worth a total of 1.3 trillion euro in response to the coronavirus crisis.

The coronavirus crisis generated higher pressure on fiscal stability in the euro area than the financial crisis, which resulted in the eurozone crisis. The public debt-to-GDP ratio may increase to 200 % in Greece, 160 % in Italy, 130 % in Portugal and as high as 120 % in France and Spain (Financial Times, 27 May 2020). The coronavirus depression in the EU will probably last longer than in the USA and will further widen the economic gap between Europe and the USA (Jašová, Kadeřábková 2021).

Special monetary policies, if they are implemented over an excessively long period of time, reduce the effectiveness of interest rates, which are normally a meaningful instrument to influence production and employment (Subacchi 2020). The actions of central banks after the coronavirus, however desirable at first, may exacerbate the vulnerabilities threatening the global economy, namely accumulation of debt and misallocation of loans.

Relying on monetary policy in situations where fiscal policy would be more appropriate creates the risk that investors' excessive preference for liquidity will worsen the liquidity trap. Extreme monetary policies may have extreme and unexpected consequences. Although an unconventional monetary policy has become the norm, its effectiveness is inevitably reduced with each next intervention (Subacchi 2020).

The coronavirus crisis changed the environment, in which the central banks have operated for decades. While the previous crises – such as the global inflation in the 1970s and 1980s – reinforced arguments for the independence of central banks, the coronavirus crisis has led to closer coordination between governments and central banks. And it will perhaps bring even more – it may put central banks – including the FED and the ECB – under open political control. But that is a different political-economic system than the one, which we have recognised up until now.

As short-term interest rates fall to zero or even below zero, the effectiveness of monetary policy implemented by central banks is ever lower. Quantitative easing may continue but its marginal utility is decreasing. As a result of the pandemic, macroeconomic authorities may eventually revert to direct monetary financing, which was previously prohibited and which will merge monetary and fiscal policy into a new model (Subacchi 2020).

7 Is it still possible to save the euro?

The European Monetary Union is the most ambitious project undertaken in monetary history (King 2016). There is no successful example of a monetary union among independent states without a political union. The EU put the cart before the horse. All political decisions, of course, are associated with risks. But not all the decisions that are made lead to progress. The tragedy of the eurozone is not that it could collapse but that it could, since it is a political project, continue and drag the entirety of Europe into economic stagnation and consequently hinder the recovery of the global economy.

The euro crisis caused damage to European democracy (Rodrik 2018). It undermined trust in the European project, weakened centrist political parties and strengthened the more extreme political parties. Trust in the European Union has been declining since the early 1990s. While trust in the EC grew in the 1980s, trust in the Union among its citizens is dwindling three decades after the adoption of the Maastricht Treaty. The euro has played a significant part in this trend. The idea of an ever tighter union, of which the euro is a symbol, has its substantial national economic costs.

On one hand, the euro was an extraordinary feat. The fact that it survived its maladies in the form of the eurozone crisis or the debt crisis indicates certain resilience (Minenna 2016). But the episode of the acute crisis weakened the euro and the measures taken in response to this crisis largely represented desperate attempts to restore the spirit of the original plan in spite of its horrible failure. It is obvious that it was unwise to first create a single currency and only then to try to create a more reliable system of common institutions, if not a downright federal state (Wallace 2016).

Mody (2018) presents two scenarios of further development of the eurozone. The first is “more of the same” where there are glimmers and periods of occasional optimism (like in the years 2004-2007) but otherwise we will continue along the wrong path and crises will recur. European authorities believe that they are treading the right path towards a bright European future. But the economic and social results call this vision into question. European decline will continue and problems will cumulate over time.

In the second scenario, European authorities will admit the important truth that “more Europe” will not resolve the pressing economic and social problems of the EU. They will realise that fine-tuning European institutions will not help achieve major improvement unless a more radical change is made: national states will restore their sovereignty and the fragmentation of Europe will become not a source of concern but a source of creative energy. The EU will come to understand that the euro is not vital for the future of Europe.

The euro was a mistake from the very beginning (Stiglitz 2016, Bagus 2011). Europe does not need a common currency for its economic and political collaboration. The end of a common currency would not be the end of the European project. A friendly divorce and a flexible euro with a stronger northern euro and a softer southern euro would solve a lot of problems. Europe will maybe have to abandon the current form of the euro in order to save the European project. Such a solution may appear to be dangerous and hardly imaginable from a political viewpoint but there is deep economic logic behind it.

The eurozone is facing four versions of future development (Chorafas 2013): 1) the current system will be maintained where things are left to rot but at an enormous cost; 2) one of the countries will leave the eurozone but the eurozone as a whole will survive; 3) a certain group of countries will leave; for instance, the euro will split into a northern euro and a southern euro; 4) the eurozone as a whole will disintegrate so the euro will completely cease to exist.

Maintaining the current system is possible but enormously costly (Sinn 2014). The eurozone created a currency structure where divergence, not convergence, is the main characteristic and where crises are the rule rather than the exception. And the interests and ideologies of the dominant powers created an economic policy, which is particularly painful for the inhabitants of the countries most affected by crises. And since eurozone countries are firmly attached to the euro, they will drag down even the best functioning economies.

Exiting the eurozone is a big change. But the present strategy where problems are left to rot away is very expensive and costs the eurozone trillions of euro. For Greece and Italy, which both got trapped in an economic crisis lasting many years, the current losses are just a fraction of the future ones. We need to compare the current losses, which are growing, and the risks associated with a divorce. Even if the beginning after the divorce will not be without difficulties, at least there will be the future prospect that the economic crisis will end and the economy will start to grow in real terms once again (Whelan 2013).

A flexible euro represents a system, in which different countries (or groups of countries) will have their own euro. Instead of a single currency for the eurozone as a whole, there would be several groups, each with its own currency. Just as it is necessary to cooperate if a friendly divorce is to take place, Europe must cooperate in order to make sure that a flexible euro works smoothly. A flexible euro is certainly not perfect. But it is definitely better than the current system, which made a lot of people in the eurozone incur such high costs (Stiglitz 2016).

A lot of people in Europe will be saddened by the death of the euro. To those who regarded the euro as another major phase of European integration, its death is synonymous with failure, resignation. However, the European project is not based and should not be based on a shared single currency (Ferguson, Kotlikoff 2000). The end of the euro would not be the end of the world because currencies are created and terminated. The euro is just an ill-designed project without a functioning setup.

The euro is a manmade construction. Its contours are not the result of inexorable laws of nature. Europe's monetary arrangements can be reconfigured; the euro can even be abandoned if necessary. In Europe as well as elsewhere, we can reset our compass, we can rewrite the rules of our economy and our policy, to achieve an economy with more and better-shared prosperity, with a strengthened democracy and stronger social cohesion. (Stiglitz 2016: xxi).

8 Summary

The eurozone is not an optimum currency area. In theory, it could become one, provided that high mobility of labour is achieved, wages are flexible downwards, asymmetrical shocks do not occur and there is a stable system of national finances, supplemented by an effective system of fiscal compensations. Since these conditions are not met, the euro has become a trap for the member states. The euro has not had the effect of converging economic development in the eurozone; quite the opposite, it has had a diverging effect.

European economic collaboration has deeper foundations than a common currency. It builds on the free movement of goods, services, people and capital. Europe does not need the euro to function. In spite of that, the common currency has substantial political momentum. The existence of the euro will continue at an enormous cost, which will be paid by the citizens of the eurozone in the form of a meagre economic growth or stagnation.

Judging by the economic performance and political cohesion, the euro experiment failed. But judging by its mere survival, it succeeded to a considerable degree, however precarious the position of the southern countries in the monetary union remains. If deglobalisation and regionalisation prevail as the new norm in international relations, the European Union should consider a more effective monetary arrangement, which would make the common currency more flexible and efficient and would open it to new possibilities.

Declarations

The author declares that he has no conflict of interests.

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