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THE OPTION OF LAST RESORT:

A TWO-CURRENCY EMU

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Abstract

This article, originally published at www.roubini.com on 7 February 2010, spells out our two-currency EMU proposal as a plan of last resort for resolving the present EMU sovereign-debt crisis. The key ingredients of our proposal involve a temporary split of the euro into two currencies, both run by the European Central Bank. The hard euro will be maintained by the core-EMU members whereas periphery EMU countries will adopt for a suitable period of time the weak euro. All existing debts will continue to be denominated in strong-euro terms. The plan involves a one-off devaluation of the weak euro versus the strong one, simultaneously with the introduction of far-reaching reforms and rapid fiscal consolidation in the periphery EMU countries. We argue that due to enhanced market credibility, our two-tier euro plan has a realistic chance of success in resolving the EMU crisis, if all other approaches fail.

Keywords: euro, two-currency EMU.

JEL codes: E44, F30, G01

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THE OPTION OF LAST RESORT: A TWO-CURRENCY EMU

by **Michael G. Arghyrou[1] and John Tsoukalas[2]**

First, we would like to clarify that we are strong supporters of the European monetary integration project. Our view is that the single currency involves significant potential economic and political benefits for all its participants which far outweigh its potential costs. We thus believe it is right to spare no effort to ensure the euro's continued stability and success.

Having said so, however, we cannot but admit that we are currently faced with hard facts that cannot be ignored by Europe's policy-makers. The present turmoil in the Greek sovereign bonds market, as well as the increasing pressure on Spanish and Portuguese bonds, is not coincidental but symptomatic of a fundamental truth. This is that the eurozone is not an optimum currency area. A significant body of academic research shows that since euro's introduction in 1999 the EMU periphery countries not only did not achieve real convergence towards the union's core countries but, on the contrary, have diverged further. Euro-participation provided periphery countries with a false sense of financial security preventing them from pursuing unpopular yet necessary fiscal and structural reforms. This caused substantial competitiveness losses leading to unsustainable public and external debts. One can write pages to analyse the latter's implications but the main point is simple. Debts provide the lender claims to future consumption the honouring of which implies either higher production or reduction of future consumption on behalf of the borrower. The increasingly loud market signal we receive in recent months is that the intra-EMU economic divergence has been allowed to reach such an extent as to render the servicing of existing debts from both sources quoted above increasingly unrealistic. To ignore this signal and blame the crisis on speculative attacks is to delude ourselves. What we observe is markets responding to unfavourable economic fundamentals rendering the euro's continued existence increasingly unsustainable.

Handling the crisis is not a straightforward proposition. Any successful solution must meet four prerequisites. First, preserve the credibility of the EMU as a low-inflation area and the euro as a strong currency. Second avoid intra-EMU tensions by benefiting one set of European taxpayers at the expense of others. Third, be regarded as credible by the markets. Last, but not least, allow the countries under pressure a realistic chance of completing successfully necessary structural reforms. This bill is hard to fit. Any plan based on an EU-based bail-out would validate long-standing moral-hazard fears and undermine euro's credibility. This is unacceptable to the core-EMU countries and would stretch the tolerance of their electorates to breaking point. Involving the IMF circumvents the fiscal spill-over problem but will signal weakness on behalf of the EMU to put its house in order. The risk of a weakened euro is hence not eliminated. Finally, allowing national defaults is inconceivable for two reasons. First, defaults will leave the credibility of euro-participation of the default countries in tatters. Second, they will cause substantial capital losses for many European banks

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and institutional investors with large investments in the bonds markets of periphery countries. By jeopardising the fragile European economic recovery, defaults at the periphery will cause EMU-wide costs the core countries can scarcely afford.

This leaves bold fiscal consolidation and far-reaching structural reforms in the periphery as the only way out. We totally support this course of action and sincerely hope it will be successful. There are good reasons, however, to regard its success as not entirely guaranteed. The problem with reforms is that they cause upfront output losses with potentially large welfare costs while their (undoubtedly higher) benefits follow later. This is why reforms are typically pursued gradually, allowing a reasonable margin of adjustment. But the enormity of the imbalances at the periphery economies makes the reforms' extensive and rapid implementation imperative to affect market expectations. This element of urgency and thoroughness raises doubts about the capacity of the periphery societies to bear the temporary yet substantial fall in living standards accompanying the necessary reforms. Hence, in the absence of a monetary competitiveness push, a reforms-based strategy may suffer from a deficit of credibility. This could compromise its success prospects and leave the EMU exposed to the same sustainability risks faced currently. As a result, we believe that in addition to determination for promoting reforms, the EMU also needs a self-preserving plan to be used if, and only if, everything else fails.

The plan we propose involves the temporary implementation of a two-currency EMU, with both currencies run by the Frankfurt-based ECB. The core-EMU countries will continue to use the present currency, the strong euro. The periphery countries on the other hand, will adopt, for a certain period of time, another currency, the weak euro. Crucially, the bonds and external debt of the periphery countries will stay in strong-euro terms. Upon its introduction, the ECB will devalue the weak euro by a percentage enough to restore the competitiveness losses periphery countries have suffered over the last decade against their main trading partners, the core-EMU countries. This will give the periphery a competitiveness boost while it introduces extensive structural reforms. The ECB will implement monetary policy for the whole of the EMU with its primary objective being price stability for all its members, strong- and weak-euro countries. It will do so in much the same way it does now, the only difference being that the ECB will be setting two rather than one reference rates. Periphery countries will be able to join the strong euro when they have achieved sustainable real convergence allowing them to co-exist with the core-EMU countries without fear of the present competitiveness divergence. To ensure this we propose that in addition to meeting the current criteria of nominal convergence, transition from the weak to the strong euro to be made conditional upon meeting a suitably defined criterion referring to the current account balance, a more accurate indicator of long-term competitiveness developments. A major benefit of the proposed plan is its enhanced ability to provide an effective commitment device for EMU members to undergo reforms and fiscal consolidation as opposed to the existing evidently weak, non-enforceable sanctions' mechanism of the Stability and Growth Pact.

We believe that our proposal meets all four criteria set above for a successful handling of the present crisis. By maintaining all debts in strong-euro terms there will be no bail-out and no loss of claims to future consumption. The reputation of the EMU as a low-inflation area and the credibility of the strong euro as a strong international currency will also be preserved. These elements are bound to be attractive to core-

EMU countries. As such, they will eliminate the basis for tensions within the two-currency EMU. They will also be beneficial to the European banking sector, whose substantial investments in periphery bonds markets will be shielded by the risk of default. Periphery EMU countries have plenty to gain too. As the weak euro will stay at the hands of the ECB there will be no return to the old bad days of high-inflation/devaluation vicious circles: the policy-credibility dividend of EMU participation will be maintained. At the same time, the devaluation of the weak euro will provide them a breathing space allowing their societies a much better chance of shouldering the necessary structural reforms. Thus, the chances of periphery governments to bring the latter to successful conclusion will be significantly enhanced and the door to returning to the strong euro will be open. Furthermore, as our proposal respects the “red lines” of both core and periphery EMU countries, there is every reason to believe that it will meet the approval of the markets. Finally, our proposal will be beneficial for EMU’s enlargement: In the present circumstances, the young democracies of Central and Eastern Europe cannot realistically expect to join the EMU in the foreseeable future. A two-currency EMU will provide them a chance of joining the EMU at a reasonably close date, initially as members of the weak euro, thus maintaining internal popular support and the momentum of enlargement.

In short, we believe that our proposal has something good to offer to all interested parties. Above all, if worse came to worst, it would preserve the EMU project to whose long-term economic and political benefits we strongly believe. We very much hope that in future months the Eurozone’s outlook will improve to such an extent as to render our proposal redundant. But if they do not, we hope that our proposal will be noted and considered as what is intended to be, that is an option of last resort.