The euro and its future[1]

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The euro, created in 1999, has weathered almost a quarter of a century of crises and storms without sinking. It is used by 340 million people in 19 countries of the euro zone[2]. It is, after the dollar, the second most widely used international currency.

And yet the euro was faced with a challenge: to make a common currency prosper in an area where the various member countries are masters of their own budgetary policies.

Has this challenge been met?

In part yes and in part no.

1. The specific aspects of the euro area: a common currency in a disparate environment

1.1 Firstly, it should be noted that the heterogeneity of economic policies in the euro area increased during the first ten years of this history (2000 to 2009)

Inflation rates have diverged – higher in the "South" than in the North of the zone.

And since monetary policy is unique, the result was that inflation in the South was encouraged by a monetary policy that was too liberal on average – which could not be adapted to the heterogeneity of the specific situations. To combat this contradiction, macroeconomic cooperation should have been intensified and more restrictive fiscal policies implemented in the South. This was not done. Hence the sovereign crisis of the euro from 2010 onwards.

1.2 The "sovereign" euro crisis (2010-2012) could only be overcome by the resolve shown by the ECB ("we will do whatever it takes")

The ECB's response was a systematic policy of stimulating demand and the LTRO: "Long Term Refinancing Operations" launched at the end of 2008, which made it possible to distribute more than 1000 billion to European banks. This policy was accompanied by a fall in interest rates which converged towards zero.

From January 2015, the ECB launched a programme of qualitative easing (QE) which involved the purchase by the Issuing Institute of the sovereign bonds of all the countries in the zone at a rate of 60 billion euros per month. The programme was increased several times and extended (2016-2017).

From the time of the pandemic crisis (2020), the ECB set up a vast additional programme of asset purchases: the Pandemic Emergency Purchasing Program (PEPP) to the tune of 1350 billion.

All these purchases swelled the ECB's balance sheet to 70% of GDP (compared to 21% in 2008).

This strong stimulative reaction of the ECB to the sovereign debt shocks (2010) and to the pandemic (2020-2022) made it possible to "save the euro" by reducing the spreads on the different signatures and thus preserving the unity of the financial market and the cohesion of the Union.

1.3 But the question must be asked: "at what cost?

The question – which goes beyond the borders of the euro – of the cost of these rescue measures and their long-term consequences must be examined if the sustainability of the euro is to be assessed.

The monetary easing measures have had three main negative effects:

- **The excessive increase in liquidity and money creation.**
  The liquidity created by QE has continued to accumulate since 2020 despite the increase in demand and the revival of inflation (which had exceeded its target level of 2% since 2019).
  The ECB's balance sheet grew by almost 5 trillion euros from 2014 to 2022.
- **This highly stimulative policy has weakened the financial market.**
  Economic agents have taken on massive amounts of debt, which has increased the number of overexposed credit areas and therefore the probability of defaults and a financial crisis in the event of cyclical difficulties. At the same time, the quality of credit ("search for yield") has deteriorated with the expansion of loans to poorly rated companies (below investment grade).
- **With the fall in interest rates, it has been noticed that productive investment has tended to decrease (-2.5% of world GDP over the last 20 years).**
  The "liquidity trap", Keynes' fear, has occurred: savers have abandoned long-term, non-interest-bearing investments in favour of holding liquid, risk-free portfolios.
  The ECB's ultra-stimulative policy has thus contributed to the decline in productive investment and thus, in the medium term, to hampering our future growth.

1. Speech delivered Speech delivered on May 30, 2022 at a conference organized in Paris by the European League for Economic Cooperation (ELEC)
2. The banknotes in circulation represent about €1.5 trillion.

2. The place of the euro in the international monetary system

The history of exchange rate relations between the euro and the dollar is marked by a fairly high degree of volatility, as well as by the resilience of the dollar as the main international currency.

2.1 The relatively high volatility of the exchange rate relationship between the euro and the dollar

When the euro was launched in January 1999, it was close to the parity of 1 euro to 1.1 dollar.

Then, the euro went on a very steep downward slope for two years (from 1999 to 2001): it lost more than 25% of its initial value against the dollar.

This was followed by a contrasting phase (between January 2001 and May 2003) where the euro regained ground and returned to its launch level.

This was followed by alternating phases of volatility with no clear link to the 'fundamentals', particularly the level of inflation.

- From 2003 to 2008, the euro appreciated steadily against the dollar (weakened by the fall in US rates and the external deficit). In April 2008, the euro reached its high point (1.60). That is to say 35% appreciation compared to its entry point.
- From 2008 to 2014 it was a yo-yo game. The 2008 crisis strengthened the dollar but the US QE limited this appreciation.
  Despite the euro sovereign crisis and the fear of an implosion of the euro in 2010, the "whatever it takes" of 2012 stabilized the euro around 1.30.
- In 2015, with the ECB's QE, the euro fell by 13% against the dollar (1.10) and then normalized at 1.15-1.20. And the pandemic has little effect on the exchange rate, which remains at 1.20.
- With the war in Ukraine and the deterioration of Europe's economic forecasts, the euro has fallen significantly. It has been between 1.035 and 1.04 since May 13th.
- The uncertainty maintained by the ECB on the evolution of interest rates encourages this depreciation of the euro (since 2020, the euro has lost 14% of its value against the US dollar).

2.2 The dollar remains THE international currency

It remains the most widely used reserve currency (65% of total reserves are denominated in dollars).

Although the dollar shares the denomination of commercial transactions with the euro, it is nonetheless true that the dollar is still the world's currency, in particular because of the size of its public securities market and its liquidity.

The Commission's latest report on the euro area shows that in the event of a crisis, it is the Fed that appears to be the only lender of last resort – in 2008, the Fed provided the dollar liquidity required by the most affected countries, while the liquid assets issued by the ECB decreased.

For the euro to benefit from the dollar's "exorbitant privilege" and become a true international currency, a bulwark of liquidity and stability in the event of a crisis, it would be necessary:

- That budgetary and fiscal cooperation and convergence between EU members becomes an operational reality,
- That the banking union is completed, (today the forces of fragmentation are at work),
- And that the unified capital market is achieved, which is far from being the case (the surplus of capital movements is exported outside the euro zone).

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It is not excluded that the currency sanctions against Russia will encourage a trend towards fractional use of international currencies (with clearing platforms developing around the renminbi, for example). But the euro is not necessarily the currency that will emerge as the winner from these changes.

If monetary policies were to diverge sharply in the coming months on both sides of the Atlantic, with a less pronounced rise in rates in Europe than in the US, we could expect a stronger depreciation of the euro against the dollar.

But this depreciation would probably remain limited because, unlike the US, the euro zone still has a current account surplus and exports its capital outside the Union.

Conclusion

But a major uncertainty remains for the long-term future of the euro: debt sustainability.

The fiscal stimulus, amplified by the pandemic, has led to a considerable deterioration in the euro area's public finances.

The public debt ratio of the area jumped by 13 percentage points of GDP in 2020 alone to 92%.

The public debt ratio of the six most vulnerable countries (Belgium, Greece, Spain, France, Italy, Portugal) remains above 100% of their GDP.

The planned increase in military spending, following the Ukraine War, will worsen these figures.

But it is important to understand that as public debt ratios worsen, the problem of debt sustainability becomes more acute.

Historically, a negative "r-g" ratio (where $r \equiv$ *interest rate*, $g \equiv$ *economic growth rate*) does not eliminate sustainability problems. Indeed, the growth rate and the interest rate are not independent of the level of indebtedness. The higher the level of indebtedness, the more market interest rates tend to rise and the more fragile the economy becomes. Hence the extreme caution that must be attached to the question of risks to debt sustainability in Europe. It must be understood that money creation and the purchase of public securities will not always be able to solve this problem. The Maastricht Treaty contains limits on the monetary financing of the Treasury and opinions on this issue are far from unified.

Ultimately, the fate of the euro will depend on the political will to achieve genuine cooperation within the zone.