CHAPTER 16

Thirty years on, new frontiers for Europe's monetary cooperation

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At 30 years since the ERM crisis, the single most important observation we can make is to note how diametrically opposed the situation is from the 20th anniversary of that event. A decade ago, euro area countries were only just coming out of the second of three waves of runs on some members' sovereign debt, which quite plausibly could have torn the construct apart, or at least prompted the policy and political choices to allow it to unravel. Thankfully that didn't happen. But the key difference this time around is how much the integrity of the euro has been a non-issue.

The euro/ERM-2 countries' economies have been hammered by three new crises in as many years (actually a bit less): the pandemic, the energy and commodity price spike brought on by Vladimir Putin (as well as all the other instability caused by his crime of aggression against Ukraine), and the greatest inflationary challenge to monetary policy since the 1970s. None of these has caused any serious doubt about the euro's future. ERM-2 has held up to the point where a new country – Croatia – has adopted the euro, and another – Bulgaria – is likely to do so soon.

What this shows is that Europe's currency union is now an uncontested acquis. A big reason for this is that the single currency has acquired new mechanisms for risk-sharing (the European Stability Mechanism fund for emergency lending to member governments) and macroeconomic stabilisation in the presence of asymmetric shocks (the SURE reinsurance mechanism for national unemployment benefit systems). Another is that the ECB has become a 'normal' central bank, the central actor responsible for financial stability which of course includes preventing disorderly movements in sovereign bond markets. And after EU governments' Rubicon-crossing decision to engage in joint borrowing for the post-pandemic Resilience and Recovery Fund, the euro now has a sizeable safe asset.

Above all, the political unity around the commitment to keep the euro together has been put beyond doubt. The future of the euro is safe. No members will leave. More will join.

Instead, three other issues relating to European monetary cooperation remain contested, sometimes deeply and some would say irreconcilably.

The first is the actual conduct of the common monetary policy. While the ECB manages to set joint policy for a multi-country currency area with an impressive degree of harmony, monetary policy is very much in flux. There are several open questions that will in the next few years have to be given answers – and those answers are bound to lead to significant change in how monetary policy is carried out. This includes the core of that mandate – how to secure price stability – where a thorough strategy review seems to have become obsolescent barely a year after it was concluded. Inflation and growth developments in 2023–24 will shape perceptions about the wisdom of the ECB's choice to tighten policy strongly into a supply-side-driven recession – and therefore whether the inflation-targeting regime is seen as fit for purpose.

At a time of very high investment needs (for the energy, climate and digital transitions), it will also be necessary to devise forms for fiscal-monetary cooperation, which Europe's current institutional set-up makes almost impossible. Finally, how (if at all) monetary policy should take into account climate change and the EU's goal of decarbonising its economy by 2050 is a debate that could profoundly change the way monetary policy is done.

This set of contested issues is one Europe's monetary union shares with other currency areas. That is not true of the second set of issues, which relate to the performance of the euro area economy.

The euro is here to stay, but it is quite a different matter whether its economy is doing as well as it could. In fact, much criticism of 'the euro' and many of the accusations supposedly showing how bad an idea monetary unification was really reflect shortcomings in the real economy and the governing institutions that shape its functioning. One excuse for this conflation – blaming real economy problems on the currency – is that these shortcomings are largely coextensive with the currency union itself, given the degree of regulatory harmonisation both of the EU as a whole and in some cases especially in the euro area.

They include insufficient integration of banking markets that remain too national (especially at retail level, but also at wholesale level when interbank lending even within groups is preferred to full cross-border corporate integration). They also include the underdeveloped capital markets, for equity and venture capital above all. And they included the continued incompleteness of the single market for goods and services. There is a good case to be made that the full potential benefit of a common currency has been blunted because other barriers to trade are currently a greater brake on the dynamic gains from trade than what exchange rate volatility would entail. In economic jargon, the binding constraints on euro area economic performance are non-monetary and non-currency-related.

There are, certainly, valiant efforts underway to remedy these shortcomings, such as the banking union and capital markets union projects. But the sluggish progress, to put it mildly, achieved on these fronts is testimony to how disputed the required steps are.

The third contested policy area is the boosting international role of the euro. The policy objective, formally adopted although with only weak political capital behind it, will surely only be strengthened by the current geopolitical environment. Financial sanctions, dependence on US price and monetary developments, and vulnerability to US pressure on such political decisions as whether and how to decouple from China all increase the salience of the US dollar's domination of the global economy and financial system. So, there is all reason to think that greater monetary autonomy will be something Europe's leaders will find increasingly important.

But can they achieve it? Measures have been taken, although for unrelated reasons, that are necessary steps on the way to raising the euro's international use. One is the euro-denominated safe asset (the once-dreaded 'eurobond') that finances the Resilience and Recovery Fund. Another is a more serious effort at energy price benchmarking that works in Europe's interest.

But the real game changer will be a central bank digital currency (CBDC). The ECB has vaulted the euro area into the lead among major economies preparing CBDCs. The technical preparations are underway, and just as important, the political backing is nearing a point of no return. If a digital euro is launched – which could conceivably happen well within five years – it will make it easier to encourage use of the euro as an international transaction currency. It would help overcome banking fragmentation domestically. And it could help financial deepening and greater sophistication by enabling a leading European fintech industry developing smart contracts using safe programmable money. The first and the third of these probably come with important first-mover advantages. All three would make the euro a more attractive reserve currency.

Thirty years on from a crisis, then, the European monetary system is in rude health. With existential fears rightly buried, the policy questions that now have to be addressed are ones which, if the right solutions are chosen, could take it from safety to strength.

ABOUT THE AUTHOR

Martin Sandbu is the *Financial Times*'s European economics commentator. He also writes Free Lunch, the FT's weekly newsletter on the global economic policy debate. He has been writing for the FT since 2009, when he joined the paper as economics leader writer. Before joining the FT, he worked in academia and policy consulting. He is the author of three books, on business ethics, the euro, and on the economics of belonging.