The Crisis and Possible Future of Euro as an Institution

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Abstract - The institution of the single euro was born as the countries affected by global economic crisis were not able to operate any other institution for the efficient coordination of their currencies. It always operated as a ranking institution, generating competition among the currencies, and increasing the level of uncertainty. In the beginning, euro eliminated most of such uncertainty. However, it cannot be maintained as a coordinating institution in the long-run as there are very big institutional differences among the member-States besides the non-the availability of a quick balancing mechanism. The price of keeping the euro is to transform it, either directly or indirectly, into a ranking institution by openly focusing on the responsibility of individual member-States and by the weighted distribution of costs and benefits. The most probable option involves the introduction of a new euro in Germany and in the best performing member-States and the maintenance of the old one in the remaining member-States. In the final analysis, the new euro will become the old (coordinating) institution, whereas the old euro will be the new (ranking) institution

Index Terms: cost benefit analysis, economic forecasting, governmental factors, and macroeconomics

I. INTRODUCTION

Basically, the crisis of euro is not the result of slack public budget discipline in the member states. The roots actually go much deeper than this. Euro itself is the product of a certain kind of fleeing forward: Germany, France and their first companions simply were not satisfied anymore with their currencies and the related institutions of exchange rate coordination. Their plans promised long-term relative wealth for them from euro, the single currency. Great Britain represented a different view already at the beginning. It did not wish to enter into a currency union with member states that had not even been able to achieve proper results with their own currencies. The reduction of uncertainty caused by the gradual expansion of the euro area and the EU was enough to temporarily produce relative wealth, although in the case of less competitive member states it was limited mostly to the exhaustion of the otherwise greater volume of loan and credit sources. The global economic crises only brought forward the disappearance of this relative wealth and the noticeable rise in the level of scarcity that finally led to the crisis of euro. As we will see, the members of the currency union and the major

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differences in their basic institution combinations foreshadowed the onset of lean years already at the start.

II. UNCERTAINTY AND SCARCITY

When it comes to studying the institutions, it is already evident that great emphasis should be laid on uncertainty and on the management of uncertainty. It is well-known that, by default, an institution related to a given situation will reduce the uncertainty of the players involved. In this sense uncertainty means, with reference to Knight, [1] that a player is unable to clearly determine whether his ex ante mathematical calculations or statistical estimates regarding the probability of occurrence of the alternatives he has to face in a given action scenario are correct. The smaller is the player's uncertainty, the more correct he sees his calculations for the purpose of helping him choose an alternative that is considered satisfactory ex post. [2] In turn, choosing and implementing the right alternative increases the player's chance to achieve the desired situation. At reduced uncertainty, the players will be more capable of choosing and implementing strategies that help them better realise their targets. [3]

However, the existence, operation and changes of institutions are related not only to uncertainty but, with a close and fundamental link, also to scarcity. The player's need to reduce uncertainty is actually based on the player's intention to reduce scarcity. What happens is that the player keeps coming up against bottlenecks and barriers when he wants to meet his demands and input requirements. In general, scarcity means that the assets in question can be obtained at considerable expense and that, after a certain volume, this expense will further rise. In today's economic systems it is the limitation of his financial means that stops the player after a certain volume at the given price. [4] The perceived scarcity means that the player is not able to fully realise his targets. However, if by reducing the level of uncertainty he manages to choose and implement a more appropriate alternative, he will be more successful in realising his targets and thus the scarcity perceived by him will be smaller. But when the player cannot fully realise his targets through the implemented alternative, he will perceive a higher level of scarcity increasing, in turn, also the level of his uncertainty. The reason is that he must see ex post that he wrongly judged the available alternatives or strategies in the past and failed to choose the right one. We might say that uncertainty is interlinked with scarcity, causing them to grow or decrease together. Yet, it is often not the case due to the so-called distorting effect of the institutions.

III. CLASSIFICATION OF INSTITUTIONS AND CONTINOUSLY GROWING SCARCITY

Although there is no overall consensus, there are no major conceptual differences either among professionals in the assessment of the definition of institutions. Institutions are classified in various ways. [5]-[12] As compared to the already known classification systems, the parallel consideration of uncertainty and scarcity for classification purposes is, in my opinion, a more constructive approach for assessing the operation and for forecasting the potential transformation of institutions.

The institutional system of a community is based on a relatively stable web-like institutional structure. The intersections of this web contain certain action scenarios that are linked to each other in a certain order. Thus each community can be characterised both by the type and the interconnection of action scenarios used for meeting the community's demands. In practical terms, this institutional level corresponds to the base level proposed by Williamson. [9] Yet, it is better to call it strategic target web as in most cases these institutions provide only frameworks instead of prescribing specific modes of action. It is obvious that, when looking around in the world, only such communities can bee found where this strategic target web represented a sound basis for survival and prosperity. All other communities vanished, dissolved or terminated.

It means that the community receives a combination of action scenarios from the strategic target web. When focusing on one of these, we will see that the pure existence of an action scenario does not necessarily mean that the community is able to study one or two alternatives that can be implemented successfully. It is something great in the life of a community if it manages to choose one from countless alternatives or, just the opposite, if it manages to create a real alternative instead of non-existent ones. Except for organisations seen as institutions, the finding of a solution always takes place at the individual level of a player. The institutions providing a workable alternative will be referred to as problem-solving institutions here. These will reduce the player's uncertainty as the excelling alternative continuously proves its workability. At the same time, the level of scarcity will also decrease as the excelling alternative is exactly the one that has given a solution for the level of scarcity experienced formerly in the relevant action scenario. The community will not necessarily find such a problem-solving institution.

Based on human history, the community's growing acceptance of the problem-solving institution that helps individual prosperity will sooner or later lead to a time when the players perceive again a rising level of scarcity as the growth reserves revealed by the problem-solving institution start to wane. This, of course, leads to a rising level of uncertainty as the costs and benefits of the implemented alternative are less evident than before. If, in terms of a given action scenario, the realisation of individual targets does not rule out their successful joint implementation, it may give rise to an institution that will coordinate the joint use of the problem-solving institution in a

manner to ensure acceptable costs and benefits for each player. It will be called coordinating institution in this paper. As it is clear from the foregoing, this institution will reduce both uncertainty and scarcity.

Again, sooner or later there comes a point where the level of reserves revealed by the coordinating institution will noticeably drop. At this point it will not be possible anymore to realise the targets of all players jointly and successfully. In a lucky case the community will identify a set of conditions that can be met, in theory, by any player through additional costs or more efficient implementation. As a result, the realisation of individual targets will be ranked in line with these conditions. The players who can best meet the conditions are the same players who can successfully realise their targets. This institution will be called ranking institution in this paper. It is almost the same as the notion of fair competition. The interesting thing here is that although in many cases greater efficiency can reduce at least the perceived level of scarcity, the level of uncertainty will increase all the same. Such increase is the result of a drop in the homogeneous behaviour of the players.

When there is a rising level of scarcity within the problemsolving institutions, circumstances are not always available for the establishment of coordinating or ranking institutions. Either there is a high level of scarcity or the community simply lacks the knowledge or has no time for it. However, even less knowledge, shorter time and greater scarcity may give rise to an institution that allows the players, within limits, to directly inhibit each other in the realisation of their individual targets. If such limits are not strict enough, the rising level of uncertainty may lead to the disintegration of the community. It is also not clear whether such institutions can actually help to reduce scarcity at community level. These will be called devolving institutions in this paper.

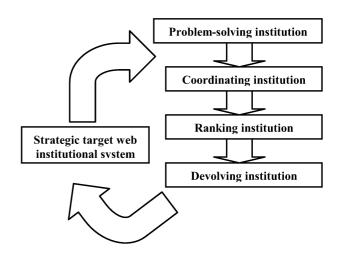


Fig. 1 Classification of institutions in terms of scarcity and uncertainty

The above classification prompts us to draw three main logical conclusions. Firstly, the devolving institutions cannot be transformed into ranking or ranking-coordinating institutions as these latter are less able to manage the given level of

scarcity. Such transformation is conceivable only when outside reserves can be made available from the wealth of other action scenarios. It would create relative wealth and allow the replacement of a devolving institution with a ranking institution. Secondly, if – accepting a growth in the level of scarcity – the institutions were transformed "backwards", that is for example from ranking institutions into coordinating institutions, the level of scarcity should decrease in terms of other action scenarios. The final balance of such transformation may be beneficial for the individual players only in this case. Thirdly, the rising level of scarcity may be settled through a change in the strategic target web: the relevant action scenario may move to a position of lower expectations or may even exit from the strategic target web.

IV. EURO AS AN INSTITUTION

As far as sales and settlement transactions are concerned. money has been present for generations in the strategic target web of the communities of today's developed countries. [13] Nevertheless, modern money is not equivalent to formerly used commodity money such as salt, seeds or cattle. Furthermore, it is not equivalent to gold coins or to the money used in gold standard systems in the past. The currencies are also not identical with other currencies in institutional terms. It means that different alternatives were developed as problemsolving institutions (money) for the action scenarios determined by money functions – present in the strategic target web. As a result of the Bretton Woods Conference, the exchange rates of (among others) Western European currencies were fixed to the US dollar from 1944 until 1971. In 1972, in order to avoid great exchange rate fluctuations, the then six member states of the European Economic Community (West Germany, France, Italy, Belgium, Netherlands and Luxembourg) fixed their currencies to each other. In 1978, France and West Germany agreed on the establishment of the European Monetary System in Bremen. Six other countries joined the agreement later. The eight parties - Great Britain, Ireland and Denmark joined and Luxembourg quit later admittedly wanted to gradually transform the problem-solving institution (separate currency zones) into a coordinating institution in order to reduce their perceived level of uncertainty and scarcity. They wanted to achieve stability and economic growth at the same time. [14] As part of the European Monetary System, they created a new currency conversion system under the name of Exchange Rate Mechanism (ERM) and a trade-weighted currency basket called European Currency Unit (ECU). By 1989, Greece, Portugal and Spain joined the system 3 years after their respective accession to the European Union, and Luxembourg also gave up its separate ways. In 1992, the Maastricht Treaty was the first time for the EU member states to agree on the replacement of their national currencies with euro, a new single currency. Through the setup and operation of the European Central Bank, euro has admittedly become a typical coordinating institution. [15] As, following the onset of scarcity, this coordinating institution is unable to turn into a ranking institution showing an increased focus on individual

responsibility, the emerging scarcity and growing uncertainty could be addressed only by improving its efficiency as an institution. In lack of such efficiency improvement, the members of the community may continue to benefit from the use of this institution (from being part of the euro area) if, as a form of compensation, it can still lead to relative wealth and reduced uncertainty/scarcity with regard to other action scenarios. Yet, this compensation is not always and not necessarily enough for the members. [16] It is well illustrated by the example of Great Britain and Denmark. Both countries were members of the European Monetary System, using ERM and ECU, from 1979 until 1999. However, following the success of the first few years, this coordinating institute could produce only partial successes, which necessitated the introduction of euro, a new and stronger coordinating institution. In other words, after a certain period of time, ERM and ECU were unable to properly manage the newly emerging levels of uncertainty and scarcity. The introduction of euro i.e. a new coordinating institution was not the right answer for Great Britain and Denmark: they realised that, on one hand, the institution of euro alone could no longer sufficiently reduce the uncertainty and scarcity of the participants and that, on the other hand, the various economic or social institutions related to euro could not provide sufficient compensation for each euro area member. It took 20 years for Great Britain and Denmark to draw this conclusion, whereas Sweden seems to have simply learnt from the experiences of these two countries.

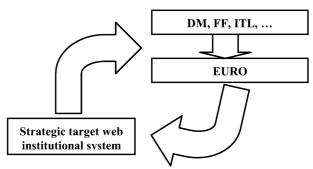


Fig. 2 The progress of euro as a coordinating institution at times of increasing scarcity and uncertainty

Yet, there is another major lesson learnt from the history of euro as an institution. To understand this lesson, it is enough to examine the process of community formation and the member states' order of accession. The group consisting of the French-German axis, the Benelux states and Great Britain has always been more competitive than the other member states from Southern and Eastern Europe. The members of this group were always the first to coordinate their institutions resulting in relative wealth. Once this wealth started to wane, this group enlarged the community. When the newly created wealth began to shrink again, this group set up a new institution and specified the conditions for joining it. No stowaways are tolerated but those meeting the conditions must absolutely join. Now we are in the euro era – assisted by Great Britain in a special way – but it is evident that this is not yet the end of

the institutional changes of this currency in the European Union.

V. THE CRISISOF EURO AS AN INSTITUTION

A coordinating institution will be more capable of coordinating the realisation of the targets of the relevant players if the action scenario combinations displayed in the strategic target web of the individual players better resemble or complement (i.e. show less conflicts with) each other. When these action scenario combinations sufficiently resemble or complement each other, the successful coordination of individual problem-solving institutions will lead to relative wealth and smaller uncertainty for the players, but only for a certain period. However, once the relative wealth produced by the coordination is used up, we feel as if the coordination of the players' strategic target web institutions had not led to lower levels of scarcity and uncertainty: only the relative wealth from other action scenarios can compensate for the rising levels of uncertainty and scarcity caused by the maintenance of the coordinating institution attached to the relevant action scenario. In lack of such compensation, the solution may be provided only by ranking and devolving institutions that place greater emphasis on individual or member state responsibility. However, this latter is ruled out by the current institution of euro. Due to the strict antiinflationary policy of the European Central Bank, no major inflation - acting as a devolving institution of money - may gain ground. This way countries with net borrowings like Greece cannot gain advantage at the expense of countries with net savings like Germany and the surrounding hard core states. Only the option of compensation is left or otherwise the Community will disintegrate. Obviously, disintegration would have already taken place if the compensation to Germany and France – as well as to the hard core states – were not regular and satisfactory. It means that they have other institutions that, receiving significant relative wealth from the institution of euro, can operate more efficiently. These include, among others, the tax system, the pension system and the business organisations as institutions. Thus the problem must emerge elsewhere: for example, the years of relative wealth following the introduction of euro ended quickly for Greece. The strategic target web of Greece - dominated, among others, by tourism and high wages in comparison with actual performance - markedly differed from that of the most competitive EU member states already before the launch of euro. [17] As a result, the introduction of euro could not have led to real and noticeable relative wealth for a significantly long period of time either directly through the institution of euro or indirectly through compensation from other institutions. Compensation for Greece came from another place: from the loan markets. As in comparison with previous periods, the weak economic performance of the Greek economy caused only minor problems in the loan markets, Greece was able to become indebted in the new currency to a much higher extent than back in the era of its ERM membership. However, the resulting general relative wealth had a great impact also on the Greek institutional system. It

became possible for the country to transform the former ranking and devolving institutions (that increased competition) into coordinating institutions. [18] Yet, the debt crisis put an end to the period of wealth and suddenly increased the levels of scarcity and uncertainty.

If the institution of euro were not a seemingly robust coordinating institution, the "invisible institutional hand" would automatically start to transform it at least into a ranking institution. In this case the member states would receive automatic and guaranteed benefits from their euro area membership but would have to take greater responsibility for their own future. This process has actually started already, with the "invisible institutional hand" doing its job, as despite the single currency and the safety provided through its EU membership, Greece could obtain loans from the money market only at high surcharge during recent years. Yet, these difficulties did not prevent it from maintaining its disadvantageous strategic target web and other institutions. It means that the euro area is still a coordinating institution as the community assumes the main responsibility. In other words, the recipients and the extent of the euro-related direct benefits do not depend on actual member state efforts. Nevertheless, right because of the status played by euro as a coordinating institution, the behaviour and activities of Greece represent negative externalities and thus affect the economic management of the other member states. This negative effect keeps increasing the level of uncertainty and scarcity in countries (considered winner states so far) where the adverse impacts of the ailing institution of euro have been offset by the relative wealth arising from the currency union's beneficial impacts on the institutions of other action scenarios. [19] If the debt crisis generated by Greece and similar member states remains unresolved, it is only a question of time until the current form of euro becomes ultimately burdensome for the hard core states of the European Union.

VI. POSSIBLE PROSPECTS FOR EURO

The current form of euro as a coordinating institution will become unsustainable if the relative wealth provided by other financial and economic institutions for the institution of euro ceases to exist in a permanent and overall manner. It greatly depends on the conditions and trends of the global economy. Until that time the relative wealth supporting the institution of euro should be ensured, both at home and abroad, by the prospering members of the Community either through forgiving Greek and other debts and then financing the bank losses or through issuing common European government bonds and then bearing the related losses. However, this could mean only a temporary solution for the simple reason that the resulting transitional period of relative wealth will not probably be long enough for Greece to adjust the combination of its social and public institutions in the strategic target web to something that is similar to the German arrangement. [20] Furthermore, a relative wealth could push the relevant Greek institutions up to the right place only if they were, in general, devolving institutions that could be transformed into ranking institutions. According to experiences, these latter would

generate more efficient solutions through competition in the economy and also in terms of the strategic target web institutions. However, the Greek system consists mostly of coordinating or ranking institutions that – probably due to the basic institutions of the strategic target web – operate with low efficiency. Thus the reappearance of relative wealth cannot lead to a more efficiently functioning institutional system, even if the financial support is coupled with strict financial and institutional conditions set by Germany.

A long-term solution could be produced by three types of changes, provided that the coordinating institution ensuring stable euro – at least for the hard core states – were left intact:

- Adjustment of the Greek strategic target web to an improved position: time-consuming process. Endogenous restructuring should be used to reduce the time demand and to achieve a combination that better matches the unchanged institutions. The question is whether Greece has the required community knowledge for this effort. Least probable option.
- 2) The transformation of euro into a ranking institution through flexible admission and discharge. This would create an automatic, transparent and predictable mechanism for the withdrawal of a member state whose operation generates scarcity. If the scarcity-generating institutional system of such member state were transformed successfully, a similar automatic mechanism would allow the admission of the member state (e.g. Greece) in the currency union.
- The division of member states into two groups: the good performers could step higher up on the ladder, whereas the poor performers would be left in the old system. Germany and other states ensuring the strength and stability of euro would introduce a new euro (both Germany and the EU are experienced in this regard). In this case the non-euro area countries holding the "old" euro in central bank reserves should be offered a non-recurring compensation (both Germany and France are experienced in this regard). This is the most probable option. It is not by chance that capital keeps flowing into Germany even when its government bonds are traded at negative real yields (e.g. in January 2012). The remaining "old" euro area would not be in great trouble either as its members would finally get a chance of reshaping the institution of euro to match their needs. Actually, the two euros would represent much smaller uncertainty than the eventual presence of 17 separate currencies.

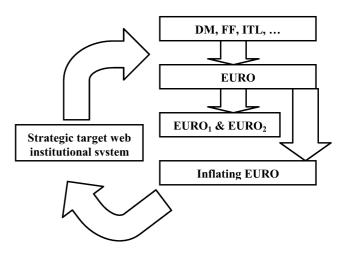


Fig. 3 A possible transformation of euro as coordinating institution into ranking or devolving institution at times of increasing scarcity and uncertainty.

The quick solution would require, in addition to the new euro of Germany and the hard core states, a generous but strictly regulated assistance for the scarcity-generating countries, although – as shown above – it will reproduce the problem and force Germany and the hard core states to follow a slower track of growth as a result of the burdens. Yet, this track may become faster if the global economy speeds up again.

VII. SUMMARY

The crisis of euro cannot be examined as a stand-alone issue because there are also troubles with the institutional system to which it belongs. In the case of a long-standing institution such as money, it can only be very rarely expected that a groundbreaking solution manages to generate sufficient surplus to avoid the crisis. Today, we have no such things on the horizon as the scriptural money, banknotes, gold standard or the omission of gold standard were in the past. The currently available tools are unable to maintain the institution of euro in unchanged form because – as discussed above – the remaining institutions are not capable of generating a wealth that could preserve the stable euro in the form of compensations. In lack of such capacity, we may reach wellfounded conclusions as to the future of euro, euro area and member states through the study of the underlying institutional logics. When it becomes unsustainable as a result of the rising level of scarcity, the coordinating institution should be transformed into a ranking institution or a devolving institution. A ranking institution – i.e. two euros – would offer a relief for the current difficulties with much less uncertainties and losses than a devolving institution. The latter would involve the European Central Bank having to issue common government bonds instead of the member states, or to perform under-priced purchases of the member states' own government bonds, or simply to use monetary instruments in order to permanently increase the value loss of euro. In each of these cases some member states would suffer permanent losses, whereas other member states would obtain permanent gains. The winners would be the member states that actually generate

scarcity, instead of reducing it through their other institutions. Therefore, the devolving institutions would represent a basic threat to the Community's survival, leading to an end sooner or later. Then, after the end, a new currency or currencies should come again.

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