**The Fundamental Flaws of European Monetary Union**

Evan Burns

Apart from the work of Philipp Bagus, economists of the Austrian school have been predominantly silent on the incredibly topical subject of the European Monetary Union. Due to this silence, there has been an unfortunate *de facto* lack of comparative discussion on the differences in opinions held by prominent thinkers within the Austrian school on the subject. Even more concerning, perhaps, is the lack of theoretical economic discussion of monetary unions in general. The dismissive attitudes toward these topics could possibly be attributed to the belief that elementary and less nuanced arguments will suffice to put the topics of monetary union in Europe and monetary union in general to rest. One such simplified argument might be that monetary union represents greater centralization of power, greater centralization of power leads to greater economic instability, and therefore the European Monetary Union ought to be opposed. However, there is much more to characterizing the economic and ethical dangers of the European Monetary Union. The European Monetary Union (henceforth referred to as the EMU) and other monetary unions similar in structure, ought to be opposed and abolished in favor of national monetary autonomy not only because it centralizes a dangerous amount of economic power, but also because it incentivizes an unstable downward spiral of increasing amounts of fiat money and credit creation and therefore reckless fiscal policies of its individual governments.

It is first important to note that the goal herein is not to offer a defense of autonomous national fiat monetary systems, such as those which existed in Eurozone nations prior to the EMU’s creation. Rather, the primary goal is to argue that the creation and existence of the EMU represents a greater distancing from the composition of money and banking which would come about in an unhampered market economy and must on these grounds be opposed. The final end is, therefore, the rejection of both in favor of a free market to which both systems are contrary.

**The Historical Background of the EMU**

To frame the discussion of monetary union in Europe and its affects, it is helpful to have an overview of some of the historical developments behind its inception. There have historically been two visions for the future of Europe, the classical liberal and the socialist. The former of these visions looks to abolish barriers to trade, dissolve government privileges, and allow free movement between the countries of Europe. Generally speaking, the classical liberal vision seeks to uphold to sovereignty of European nations and defend private property and a free market. The 1957 Treaty of Rome was an important milestone in bringing the classical liberal vision of Europe to fruition, guaranteeing such important liberties as free circulation of goods, free offering of services, free movement of financial capital, and free migration (Bagus, 2010b, p.1-3).[[1]](#footnote-1) The treaty represented a turning away from an age of socialism which had dominated socialism for so long and ultimately culminated in two world wars.

The socialist vision, on the other hand, seeks to centralize power under a single governing body until the individual governments of European nations have become irrelevant. Inherent to this vision for Europe is the intention of using the centralized governing body to favor and enrich the political class, government bureaucrats, special interest groups, and others through subsidies. And contrary to other efforts to establish a centralized government of Europe through the use military force, such as those of Charlemagne, Napoleon, Hitler, and Stalin, the socialist vision seeks rather to use coercive state power to push for greater centralization through more subtle, piecemeal steps (Bagus, 2010b, p. 3-5). These steps typically make use of crises, economic or otherwise.

Clearly then these two visions for Europe are at odds with each other and necessarily irreconcilable. Europe must tend toward one or the other. Over the latter half of the twentieth century Europe tends, regrettably, toward the socialist vision and continues to do so. The centralization of fiat currency and monetary policy through the introduction of monetary union represents an important step in the direction of the socialist vision being realized. When a fiat currency is mixed with fractional reserve and central banking, the state is given nearly limitless and complete control of the economy. Such is all the more true as the monetary autonomy of nations is abandoned in favor of greater centralization of the currency through monetary union. Despite being introduced as an economic necessity under various guises such as the most popular argument that is lowers transaction costs, the EMU is certainly an important step in the direction of creating a unified European state.

Monetary union has been a plan in the works in Europe long before the Maastrict Treaty. In 1970, the Werner Plan proposed three stages for the gradual integration of the European states into monetary union, adopting a common currency and fixed exchange rates by 1980. But unlike the Maastrict Treaty, the Werner Plan contained no provision for establishing a common central bank. Of course, only the first of the plan’s stages was ever implemented and for a variety of reasons including pressures from the United States, the monetary union never came to fruition (McNamara, 1998, p. 163). Then, by the mid-1980s, plans were already being drawn up for Europe’s current experiment in monetary union.

The EMU, furthermore, though not the first attempt to establish monetary union in Europe, was the first successful attempt in this regard. The Maastricht Treaty was signed in November of 1992 and established the European Union as it exists today. It laid plans for monetary union through the euro as a common currency and the European Central Bank (henceforth referred to as the ECB) as the architect of common monetary policy.

The treaty laid out criteria which members nations had to meet in order to join the union, prerequisites which would be fairly strict for most modern governments to meet. There were fiscal criteria such as the requirement that annual budget deficits were not to exceed three percent of GDP and the requirement that public debt was not to exceed sixty percent of GDP.[[2]](#footnote-2) Inflation rates in member nations were not to be higher than 1.5% above inflation rates in top-performing member nations. Nominal long-term interest rates were not to be more than two percent higher than those of top-performing member nations (Lane, 2006, p.48).

In the beginning of 1999, the euro and the ECB were launched. As per tradition of the state violating the rules it creates for itself, the fiscal criteria of the Maastrict treaty were not strictly enforced and countries such as Italy and Belgium were allowed to join despite significant levels of public debt (Lane, 2006, p. 48). By the beginning of 2002, notes and coins were put into circulation, replacing old currencies completely and putting an end to monetary autonomy in the Eurozone. Ever since, Europe continues to exist under the unstable system of the EMU.

**The Structure of the EMU**

For the sake of illustrating the extent of the centralization in the EMU, it is worth briefly analyzing the structure and operation of its most central body, the ECB. The stated primary goal of the ECB is to maintain price stability within the Eurozone. This goal is different from the Federal Reserve’s primary goal which is to both maintain price stability and to ensure economic ‘growth’. The ECB’s secondary goals are to define and implement monetary policy, to conduct foreign exchange operations, take care of foreign reserves of the European System of Central Banks, and to take care of the financial market infrastructure.

The ECB is composed of three different governing bodies, the Executive Board, the Governing Council, and the General Council. The Executive Board is responsible for the implementation of monetary policy and the everyday functioning of the bank. The Governing Council makes most of the final economic decisions for the Eurozone. The General Council handles the transition stages of nations in adopting the euro.

The ECB manipulate the supply of euros through a series of operations which are not unlike those traditionally employed in the “monetary policy” of central banks. Like the Federal Reserve, the ECB primarily engages in open market operations, however, unlike the Federal Reserve, the ECB typically does not buy and sell bonds outright. Rather, banks usually purchase government bonds and use them as collateral to back loans made to the ECB. Banks can continue to renew these loans made to the ECB until the bonds mature (Bagus, 2010b, p. 69-76). Once a bond matures, one of the EMU governments may issue a new bond to pay for the old one and then issue more bonds to pay off the interest.

The money supply is similarly manipulated to a lesser extent through deposit facilities and marginal lending facilities. In a deposit facility, banks may deposit money at the ECB overnight and collect interest on the deposited money. In marginal lending facilities, banks in desperate need of funds may borrow money from the ECB with penalty interest rates. But in order to for these loans to be made, there must be sufficient collateral provided in bonds with good credit ratings. If a given bond does not meet the ECB’s requirements for credit ratings, i.e., it is too risky, the ECB may apply a ‘haircut’ to the bond. This means that they will pay a reduced price for the bond to avoid losses in the case of the bond’s depreciation. The ECB’s typical standard of acceptance for credit ratings on bonds is A-, but it has lowered it all the way too BBB-. In fact, the ECB has at times completely disregarded the need for bonds to meet a certain credit rating at all (Bagus, 2010, p.70-74).

**A Critique of the EMU**

In his important article, “An Austrian Defense of the Euro,” Jesus Heurta de Soto relates an eloquent and thoroughgoing defense of the euro and the EMU. The basis of his defense rests upon the thesis that the euro essentially acts as a surrogate for the gold standard and that as long as the ideal monetary system remains unachieved, the EMU is preferable to monetary sovereignty in Europe (de Soto, 2012). There are, however, some major issues with de Soto’s thesis, as Phillip Bagus points out.

De Soto is right, of course, to point out the economic harms involved in flexible exchange rates. As he says:

[F]lexible exchange rates preclude an efficient allocation of resources on an international level, as they immediately hinder and distort real flows of consumption and investment. Moreover, they make it inevitable that the necessary real downward adjustments in costs take place via a rise in all other nominal prices, in a chaotic environment of competitive devaluations, credit expansion, and inflation, which also encourages and supports all sorts of irresponsible behaviors from unions by inciting continual wage and labor demands that can only be satisfied without increasing unemployment if inflation is pushed up even further (de Soto, 2012).

So, flexible exchange rates do exacerbate inflation and a sound monetary system would abandon them in favor of exchange rates fixed to gold, i.e., a gold standard. A gold standard prevents fiat money creation because it only allows for the creation of money provided that there is prior extraction through mining and manufacturing of commodity gold.

This line of reasoning that applies to a gold standard is not explicitly transferable to the euro and thus calls into question the validity of de Soto’s thesis. The first problem is that fiat currencies on fixed exchange rates simply do not work. Fiat currencies on fixed exchange rates are bound to be above or below the actual market valuation of the currency because those deciding the value of the currency unit will be unable to keep up with actual market fluctuations (Mayer, 2014). So, even if the euro did provide fixed exchange rates this would not necessarily be a good thing because the euro is still a fiat currency.

The other problem is that the EMU and monetary unions generally can only establish “fixed exchange rates” within the nations of the monetary union. Thus, the nations within the EMU have fixed exchange rates only relative to other nations within the EMU. Relative to other national currencies, the euro’s exchange rate is still very much so flexible.[[3]](#footnote-3) The euro thus may only act as a ‘proxy for the gold standard’ when considered within the confines of the EMU and ignoring the place of the euro within the context of the entire global economy. The bottom line is that the euro, unlike gold, may be created at the whim of those in control of the enormous centralized power scheme of the EMU.

De Soto moreover contends that the centralization of monetary policy in the EMU incentivizes conservative fiscal policies in the individual nations of the monetary union. A centralized monetary policy means that individual nations in monetary union do not have the option to use inflation as a remedy for national economic hardship and therefore the individual nations are forced to reduce their own spending (de Soto, 2012). This argument, however, proves to be even more fundamentally flawed than de Soto’s other.

The fatal flaws of de Soto’s austerity argument exist in the nature of central banking and fractional reserve banking. This counterargument is best espoused in the work of Philip Bagus and his argument that the EMU amounts to a tragedy of the commons. In order to understand his argument, it must first be pointed out that when property rights are not well defined of defended problems with negative externalities arise. In other words, a single privileged owner typically benefits from the lack of defense or definition of property rights and can therefore externalize the costs of a certain property’s use.

A tragedy of the commons occurs when multiple economic actors can exploit some property and externalize the costs of its use onto others. As an example of the tragedy of the commons, Bagus references a swarm of fish in the open ocean, where property rights are traditionally treated to not exist at all. Due to the lack of property rights, no one is incentivized to sustain the economic value of the ocean. Fishermen, for example, are incentivized to catch as many fish as they can before other fishermen seize upon the opportunity. This property rights composition leads to overfishing and therefore all consumers of fish bearing the costs of the depleted availability of fish (Bagus, 2010b, p. 81). Therefore, if property rights were defined for the ocean, property owners could limit the amount of fishing in their waters in order to avoid overfishing.

In the EMU, the way in which the different European governments can use the ECB to monetize their debt amounts to a tragedy of the commons. This process begins when governments sell their bonds to banks. As discussed above, banks will use these bonds, even in the cases of low credit ratings, as collateral to receive loans from the ECB. Banks then use this money from the ECB to add to their reserves, enabling them to pyramid credit on top of these reserves, at a two percent reserve ratio, by lending money in the form of credit to entrepreneurs and other commercial loan-seekers. As a result of this creation of money “out of thin air,” purchasing power begins to fall throughout the entire Eurozone as more money is lent and then spent.

To put it most plainly, the EMU actually incentivizes more reckless fiscal policies, making de Soto’s austerity argument all the more dubious. Governments may freely spend and run up budget deficits because they can easily monetize their debts by selling bonds to banks that will buy them almost without fail. Then as more and more euros are created through the process, all Eurozone countries will bear the cost of this wild credit creation in the form of lowered purchasing power. Therefore, the incentive for nations in the EMU is to run up debts and sell bonds at a rate faster than other nations. Nations that spend conservatively are actually punished for their austerity because they do not receive the benefits of spending yet bear the costs of lowered purchasing power. As Bagus puts it, “the incentives to run high deficits in the EMU are almost irresistible … only if a country runs higher deficits than the others can it benefit. You have to spin the printing press faster than your peers in order to profit from the resulting redistribution … These tragic incentives stem from the unique institutional setup in the EMU: one central bank” (Bagus, 2010b, p. 91-2). And therefore the perverse incentives amounting to a tragedy of the commons in the EMU is necessarily connected to the nature of a multi-national central bank and the centralized monetary policy that accompanies it. At best, it can be said that austerity may be encouraged for nations in the short run, but in the long run it pays to spend freely and externalize the costs to all nations of the EMU.

Likely the most prominent example of these flaws in action is in the case of Greece. In 2010, Greece’s budget deficit was 12.7% of its GDP and its gross government debt allotted to 113% of its GDP. Greece and other nations like it in the EMU, i.e., Portugal, Italy, and Spain, are able to get away with spending wildly and externalizing the costs of these spendthrift policies onto the more frugal nations of the EMU such as Germany (Bagus, 2010a). These irresponsible nations enjoy the benefits of low interest rates, the same interest rates paid by responsible nations, because the ECB has shown that it will accept even the riskiest of bonds.

**Rothbard’s Paradigm**

Perhaps the lack of discussion on the subject of the EMU can be attributed to Rothbard having shown beyond on the shadow of a doubt that as in the case of the Federal Reserve, central banking was created by and exists for the sake of a small group of economic elites. As he says, “The financial elites of this country … were responsible for putting through the Federal Reserve System, as a governmentally created and sanctioned cartel device to enable the nation’s banks to inflate the money supply in a coordinated fashion, without suffering quick retribution from depositors or noteholders demanding cash” (2009, p. 103). Thus, the centralization that necessarily comes with central banking ensures that the financial elites will benefit at the expense of everyone else. The extent of centralization is even greater in the case of monetary union like that of Europe. In the EMU, there are far more people subject to the power of only a select few than in the case of the central banks of other nations.

Furthermore, EMU not only came about after garnering the support of the economic elite, but also after it gained the support of ‘academics’ and ‘experts’ on the subject. Rothbard also noted that this was necessary in the case of the Federal Reserve. He says, “experts and academics, who were happy to lend the patina of their allegedly scientific expertise to the elites’ drive for a central bank. To achieve a regime of big government and government control, power elites cannot achieve their goal of privilege through statism without the vital legitimizing support of the supposedly disinterested

experts and the professoriat” (2009, p. 103). Indeed, monetary union became the call of the intellectuals for quite some time in Europe, under such claims as the need for lowered transaction costs.

**Money and Banking in a Free Market**

Although monetary sovereignty is certainly preferable both ethically and economically to monetary union, the ideal situation would be to allow the market to develop its own money and banking systems apart from the coercive state. Money comes about through spontaneous order on the free market to solve the problems associated with bartering such as the lack of double coincidence of wants, and existed long before the state saw to it to monopolize its production. Likewise, banking is a service which was offered on the market as a means of housing one’s gold long before fractional reserve and central banking were created as a means of creating the illusion that one’s money is being housed.

Market money means that money would no longer be fiduciary. The money itself would be made of gold, or some other durable and portable commodity, or would be in the form of money substitutes backed 100 percent by an amount of some commodity equal in price. Banks would have to ensure that they could honor all of their contracts by keeping 100 percent reserves. Since there would no longer be a central bank or ‘monetary policy’ money would no longer be able to be created at the whim of the central planners, whether by printing press or credit expansion. Indeed, money in a free market is only created when gold or some other commodity is produced for that purpose.

**Conclusion**

The EMU, therefore, must be rejected in favor of monetary sovereignty in Europe. The centralized monetary policy of the EMU creates the perverse incentive for nations to abandon conservative fiscal policy in favor of running up huge deficits. Nations may spend wildly and monetize their debt by sending government bonds to the ECB. The ECB then uses these bonds to create more and more credit, devaluing the currency and externalizing the costs of particular nation’s spendthrift fiscal policies in the form of lowered purchasing power of the euro. It would behoove Europe to not only abandon monetary union, but to abandon fiat currency and central and fractional reserve banking entirely in favor of the free market.

Bibliography

Bagus, Philipp. “The Bailout of Greece and the End of the Euro.” *Mises.org,* 11 February 2010. <https://mises.org/library/bailout-greece-and-end-euro>.

--. *The Tragedy of the Euro.* Auburn, AL: The Ludwig von Mises Institute, 2010.

De Soto, Jesus Huerta. “An Austrian Defense of the Euro.” *Mises.org,* 22 June 2012. <https://mises.org/library/austrian-defense-euro>.

--. *Money, Bank Credit, and Economic Cycles.* Auburn, AL: The Ludwig von Mises Institute, 1998.

Lane, Philip R. “The Real Effects of European Monetary Union.” *The Journal of Economic Perspectives,* Vol. 20, No. 4 (2006): 47-66.

Mayer, Christopher. “The Failure of Fixed Rates.” *Mises.org,* 20 August 2014. https://mises.org/library/failure-fixed-rates-0.

McNamara, Kathleen R. *The Currency of Ideas: Monetary Politics in the European Union.* Ithaca, NY: Cornell University Press, 1998.

Mises, Ludwig von. *The Theory of Money and Credit.* Indianapolis, IN: Liberty Fund, 1980.

Rothbard, Murray. *The Mystery of Banking.* Auburn, AL: The Ludwig von Mises Institute, 2008.

Zak, Paul J. Ed. *Currency Crises, Monetary Union, and the Conduct of Monetary Policy: A Debate among Leading Economists.* Northhampton, MA: Edward Elgar Publishing, Inc., 1999.

1. The status of free migration as a libertarian position has, of course, come into question and been a topic of much discussion in libertarian circles. To understand the opposing views on this issue, see Hoppe, “Natural Order, the State, and the Immigration Problem” and “The Case for Free Trade and Restricted Immigration,” and Block, “A Libertarian Case for Free Immigration.” [↑](#footnote-ref-1)
2. To put this into perspective, consider that as of 2014, the annual budget deficit in the United States has fallen to 2.9%, significantly lower than that of years prior, as reported by the Congressional Budget Office (https://www.cbo.gov/publication/45653). Also consider that as of 2014, total public debt as a percentage of GDP in the United States is 101.5% as reported by the Federal Reserve Bank of St. Louis (<http://research.stlouisfed.org/fred2/series/GFDEGDQ188S>). Of course, it is important to keep in mind that the fiscal policies of the United States are all but austere. [↑](#footnote-ref-2)
3. Remaining consistent with de Soto’s line of reasoning one would necessarily have to conclude that all nations ought better to be under one fiat monetary union, rather than under many national fiat currencies or separate monetary unions. Of course, the validity of this conclusion is outside this paper’s scope and best left unaddressed. [↑](#footnote-ref-3)