

# EUROPEAN HOUSE OF CARDS



New  
Direction

the foundation for european reform

WINTER 2016/2017



Alberto Bagnai  
**THE EURO  
BREAK-UP:  
MANAGING THE  
INEVITABLE**

Jens Nordvig  
**THE EURO AS  
A SOURCE OF  
DIVISION RATHER  
THAN UNITY**

Stefan Kawalec  
**THE EUROZONE  
IMBALANCES AND  
GLOBAL TRADE  
CONFLICTS**

Desmond Lachman  
**THE REAL  
SOLUTION TO  
GERMANY'S  
EXTERNAL  
IMBALANCE**

# New Direction



A Brussels-based free market, euro-realist think-tank and publisher,  
established in 2010 under the patronage of Baroness Thatcher.

We have satellite offices in London, Rome and Warsaw.



**Tomasz Poreba** is a Member of the European Parliament and President of New Direction – The Foundation for European Reform.

The foundations of the post-WWII Western international order are being shaken in unprecedented ways. State of the global economy is the root cause of the wave of populism and isolationism, which has swept across Europe and the United States. For too long, too many people have lived with economic misery from global imbalances, and the political consequences have, inevitably, shown up on the both sides of Atlantic.

Bad economics have consequences. The single currency was supposed to usher in a period of prosperity, but instead turned out to be a destabilizing force for both the European and global economies. The decision by British voters to leave the European Union came in the context of eight years of economic crisis in Europe. In contrast to the eurozone, the United Kingdom managed to return to the road of recovery soon after the financial crisis.

When Britain entered the European Economic Community in 1973, the European project was an arrangement aimed at improving the economic well being of all Europeans. At present, economic success is not an idea commonly associated

with the EU. Indeed, the entire enterprise has undergone profound, disfiguring changes during Britain's membership. Abandoning the principle of subsidiarity and interfering too deeply in the affairs of sovereign states, the actions of EU leaders have provoked political backlash. Support for the European project is now fading away in the countries of the eurozone. Despite all this, federalist tendencies still run strong in Brussels. The call for more Europe will not strengthen the EU, and will instead have the opposite effect by alienating more voters.

The scale of economic misery caused by the European Monetary Union in Southern Europe has been accentuated by the deteriorating condition of European banks. Healthy banking systems are essential for economic growth, but well-performing banks also depend on functioning economies. The euro has choked off the engine of the European economy. It is true that the euro is not Europe's only problem, but without a new monetary regime in Europe the situation will remain bleak. The lessons emerging from the eurozone crisis are clear: there is no economic justification for a federal Europe or a single currency. ■



**Hans-Olaf Henkel** is a former CEO of IBM Europe and a former head of the German Federation of Industries (BDI). He is a member of the European Parliament and a Vice-President of New Direction.



“ **The limits of my language are the limits of my world.** ”

Ludwig Wittgenstein's famous dictum helps illuminate the state of affairs in Europe. The quality of thinking on economic matters is reflected by the language and policy debates among elites. Public discourse driven by policy makers is heavy on discussion of taxes, regulation and the role of the state in the economy, but virtually absent on monetary arrangements and economic imbalances.

The consequences of the eurozone crisis and the euro-rescue policy now reach far beyond the borders of the monetary union. The eurozone, now with a higher current account surplus than even China, has contributed significantly to global imbalances. This situation is neither good for the world nor for eurozone countries, and has profound political consequences, as it has contributed to the rise of isolationism in Europe and the U.S. Undoing global economic imbalances in a responsible manner is now essential for the health of the global economy. Globalization is now under heavy fire in Europe. But it should not be blamed for problems arising from the European Monetary Union.

The European project and the transatlantic alliance have had strong backing from both Europe's elite and broader society. Massive unemployment and economic depression have eroded this understanding. Rising public debt and the European banking system are not separate factors but are part of a wider story. Only when the larger picture is in focus can we appreciate the economic and political problems facing Europe. This is the aim of this New Direction magazine. Only through changing the language of the debate, can the limits of our world be redefined. ■



8

**Desmond Lachman**  
THE REAL SOLUTION TO GERMANY'S EXTERNAL IMBALANCE



10

**Jens Nordvig**  
THE EURO AS A SOURCE OF DIVISION RATHER THAN UNITY



13

**Alberto Bagnai**  
THE EURO BREAK-UP:  
MANAGING THE INEVITABLE



16

**Kamil Kamiński**  
THE EURO AND THE UNMAKING OF THE EUROPEAN PROJECT



20

**Brigitte Granville**  
LESSONS FROM DISMANTLING THE RUBLE ZONE FOR A EUROZONE BREAK UP



34

**Antoni Soy**  
THE CASE OF THE SPANISH ECONOMY



26

**Mojmír Hampl**  
INSIDE AND OUTSIDE THE EUROZONE  
A BACK-OF-THE-ENVELOPE CALCULATION



30

**Zdzisław Krasnodębski**  
THE EURO AS UTOPIA



33

**Jacques Sapir**  
THE ILLUSIONS OF THE 'FIVE PRESIDENT'S REPORT'



36

**Hans-Olaf Henkel**  
THE EURO AND THE GERMAN MINDSET



40

**Jean-Pierre Vesperini**  
THE TRAGEDY OF THE EMU AND A CALL FOR A NEW FRENCH PARADIGM



42

**Joachim Starbatty**  
A TRUE KEYNESIAN PERSPECTIVE ON THE EUROZONE CRISIS



44

**David Liebers**  
UKRAINE: THE UNNAMED VICTIM OF THE EUROZONE CRISIS



48

**Pieter Cleppe**  
BREXIT: THE EURO'S FIRST MAJOR BLOW TO THE EUROPEAN UNION?



52

**Stefan Kawalec**  
THE EUROZONE IMBALANCES AND GLOBAL TRADE CONFLICTS

The magazine was edited by Kamil Kamiński and Hans-Olaf Henkel.

*Desmond Lachman*

# THE REAL SOLUTION TO GERMANY'S EXTERNAL IMBALANCE

**A**welcome debate seems to have started in the United States as to what should be done about Germany's inordinately large external current account surplus. However, it is to be regretted that in this debate little attention is being focused on the free ride that Germany continues to get from tying itself to a weak euro. Since without a basic change in German exchange rate policy, there is every prospect that the German current account surplus will only get even larger in the period ahead.

The fact that Germany is running a disturbingly large external imbalance is hardly open to question. According to the most recent official balance of payments data, it now appears that Germany will have a current account surplus of more than US\$ 300 billion in 2016 or close to 9 percent of GDP, which would be more than twice China's current account surplus. Making this

surplus all the more troubling is the fact that it is occurring at a time when the German economy is cyclically in a very much stronger position than its European partners.

Germany's maintenance of a current account surplus as large as it has now would be damaging to both the global and the European economies. From a global perspective, at a time that there is insufficient global aggregate demand, a large German current account surplus would constitute a drain on aggregate demand in the rest of the world. Similarly, from a European perspective, at a time that countries in the European periphery are being required to balance their economies, the maintenance of a large German current account surplus would make that rebalancing all the more difficult.

While US analysts are now coming to focus their attention

on Germany's large external imbalance, as is the US Treasury in its latest currency report to Congress, the solutions that they are proposing to redress this imbalance are partial at best. As an example, Greg Ip of the Wall Street Journal proposes that the problem might best be addressed by having Germany somehow engineer a rise in its domestic wage level. He makes this proposal on the grounds that the German imbalance problem has its roots in excessive savings in the private sector. For his part, Brad Setser of the Council of Foreign Relations proposes that the German government take advantage of currently very low interest rates to finance a major boost to infrastructure spending.

The truth of the matter is that the very size of the German external imbalance makes it necessary to contemplate a comprehensive approach if a substantial reduction is to be made in that imbalance.

**SADLY, SO LONG AS GERMANY REMAINS TIED TO THE EURO, THERE IS LITTLE PROSPECT THAT IT WILL BE FACED WITH A STRONGER CURRENCY ANYTIME SOON.**

Indeed, in much the same manner as the IMF would prescribe a comprehensive approach for a country to redress a large external current account deficit, so too would a comprehensive approach, albeit in reverse, be indicated for a country with a very large external current account surplus.

Two key elements would be required in such an approach. The first would be to require a substantial appreciation of the currency facing German exporters and importers. Such an appreciation would be needed both to switch resources away from Germany's traded good sector as well as to reduce domestic savings

by effectively increasing the real wage level through lowering the price of imports. The second element would be to substantially loosen German domestic fiscal and monetary policies to boost domestic demand to make up for the reduced support to the domestic economy from the external sector.

Sadly, so long as Germany remains tied to the euro, there is little prospect that it will be faced with a stronger currency anytime soon. Indeed, with US and European monetary policies now out of sync and with the European economy still struggling, there is every prospect that the euro will continue to depreciate. If that were to occur, there is every likelihood that Germany's external imbalance would only increase.

It would seem that the only way that Germany can get a very much more appreciated currency would be if it were to exit the euro. To be sure, such a move would represent

a fundamental departure from current policy. However, if that move is not undertaken, the world should reconcile itself to a large German external imbalance for a protracted period of time while the European periphery should brace itself for continued tough sledding in its efforts to reduce its economic imbalances. ■



Desmond Lachman is a resident fellow at the American Enterprise Institute. He was formerly a Deputy Director in the International Monetary Fund's Policy Development and Review Department and the chief emerging market economic strategist at Salomon Smith Barney.

Jens Nordvig

## VISION VERSUS REALITY

# THE EURO AS A SOURCE OF DIVISION RATHER THAN UNITY

Money derives its value from the common belief that people can always convert it into goods and services at will. It is the universal acceptance of the idea that money can be exchanged for

something else at some time in the future that gives it value. Government actions underpin this acceptance. Certain laws, such as those that allow people to use money to pay taxes, help define the role of money in our society. Meanwhile, government

control of the supply of money helps to ensure trust in the value of the currency. As a society, we have entered into this social contract.

Each country has its version of money. In the United States, money

is called dollars. In the eurozone, it is euros. In each case, the currency has value because it can be used to facilitate transactions (buying and selling of goods) and to store wealth for the future.

But currencies serve a purpose beyond providing the ability to buy a carton of milk, sell a house, and accumulate savings conveniently. Governments that have control of their own currency have a powerful tool at their disposal. Having an independent currency allows a country to tailor its monetary and exchange-rate policy to meet the specific needs of the economy. For this reason, currencies are often symbols of national power.

During the nineteenth century, for example, at the peak of the British Empire, the pound sterling was the

dominant international currency. The relative values of currencies are determined in foreign exchange markets. For most major currencies today, market forces are allowed to determine exchange rates.

The supply of and demand for a currency will dictate its price in accordance with economic and political developments at home and abroad. But the success of a currency cannot be judged from its nominal strength or weakness alone.

For example, the strong Japanese Yen in the period after the Global Financial Crisis was often seen as evidence of economic failure, rather than success.

A currency's success should ultimately be evaluated based on its ability to deliver on the core objectives of the country's citizens.

In many countries, this isn't limited to economic prosperity, but also includes basic values such as democracy, equal opportunity, and political stability.

The euro was created with such fundamental values in mind. Therefore, it should follow naturally that judgment on the euro's success should not be based solely on its value against the dollar, or against any other currency. Rather, the euro's success should be based on the currency's ability to deliver prosperity for all European citizens and its ability to reinforce the most treasured European values.

The euro was born out of a political desire for European integration. It was a noble idea, but it lacked a sound and resilient underlying structure.



**THE EURO WAS BORN OUT OF A POLITICAL DESIRE FOR EUROPEAN INTEGRATION. IT WAS A NOBLE IDEA, BUT IT LACKED A SOUND AND RESILIENT UNDERLYING STRUCTURE. THE IDEA WAS THAT COUNTRIES THAT ADOPTED THE EURO WOULD BE UNITED THROUGH THE COMMON CURRENCY AND A COMMON MONETARY POLICY SET BY THE EUROPEAN CENTRAL BANK.**

The idea was that countries that adopted the euro would be united through the common currency and a common monetary policy set by the European Central Bank. Each individual country that was part of the eurozone surrendered its ability to make its own monetary decisions, even in a time of crisis. Unified monetary policy implied that tools that could help save an individual economy during periods of severe stress were no longer available to the individual countries. Meanwhile, there was no centralized fiscal policy to provide an offset. Unlike the United States, the European currency union had no backing from a common federal government that was able to transfer funds between weak and strong regions. What's more, no European institution had any real ability to control an individual country's budget or spending habits. The monetary union was handcuffed in the event of a catastrophe and also lacked mechanism to deal with business cycle management and growth policies.

These fundamental flaws have caused severe economic and financial stress in the eurozone since 2010. Instead of being a source of increased cohesion and unity, the euro – through its constraints on economic policy – has become a source of division. Economic growth has diverged in the North and in the South, and

this divergence is persisting much longer than the euro-optimists expected. It is now almost ten years since the Global Financial Crisis. Germany is growing fast, and Italy is still barely growing. Greece and Portugal still cannot engineer sustainable growth, even after years of internal devaluation, and those countries continue to struggle with an overhang of debts, even after the world's largest sovereign debt restructuring in Greece.

The euro is a cause of internal inequality in the eurozone, and a cause of political instability too, as opposition towards the European project is growing as a function of increasing dissatisfaction with the status quo of permanently lackluster economic performance in large parts of the eurozone. The idea was to spur European integration and cohesion and to create a special bond of tolerance and cooperation between different European cultures. But the euro's inflexibility as an economic system is pushing many dynamics in a negative direction. From a long-term perspective, the euro is a source of division rather than unity, and it has the potential to destroy the positive aspects of increased European integration achieved over the last sixty years. ■



Jens Nordvig - founder and CEO at Exante Data. He headed currency strategy and fixed income research for Nomura Securities. He is the author of "The Fall of the Euro: Reinventing the Eurozone and the Future of Global Investing"



*Alberto Bagnai*

# THE EURO BREAK-UP MANAGING THE INEVITABLE

Seventy-one years ago, the Axis powers lost WWII, leaving the US with the demanding task of managing its victory and defining a new global architecture. The US did this by setting up ambitious institutions, such as the Bretton Woods system and NATO, and by supporting the European integration project. Institutions have much inertia, which while favoring stability, may prevent vital change in response to evolving situations. This explains both the success of many political projects, and their ultimate failure. The same applies to European integration.

NATO and European integration shared the strategic goal of creating a cohesive alliance that could withstand what was at the time perceived as a credible threat: the Soviet Union. They were successful. NATO (not the EU) secured almost six decades of peace in Europe, while economic integration was a key to prosperity in the former world leader, Europe.

Then something happened. The Soviet system collapsed, which among many other things, brought back to the fore what had for centuries been the root cause of much suffering: the difficult relationship between France and Germany. Berlin-wall panic suggested the nonsensical and

impossible goal of European political union. The worst possible way was chosen to pursue it, namely by forcing it through the establishment of a European monetary union. No democratic or even meaningful political process can take place in an area which does not share a language or national identity. Yet, despite advice to the contrary from prominent US economists (ranging from Feldstein to Krugman), a hasty marriage of convenience between France and Germany, with the single currency as a wedding ring,

**NO MATTER HOW MUCH POLITICAL CAPITAL IS INVESTED IN IT, THE EURO WILL FALL, AS TOP US ECONOMISTS PREDICTED. THE MOST LIKELY CAUSE WILL BE A COLLAPSE OF THE ITALIAN BANKING SYSTEM, WHICH WILL TAKE THE GERMAN ONE WITH IT.**

was seen as necessary in Europe in order to avoid intra-European conflict. Much has been written about whether building a political house starting from a monetary roof was actually a mistake. Like any economic choice, the euro affected the distribution of income, creating losers and winners. The latter of course cannot bring themselves to consider it a mistake. While opinions on this point may differ, everybody agrees that as of today the euro is failing. The reason for its failure is the same that put the Bretton Woods system out of its misery: both

institutions fostered external imbalances, though for different reasons. The original sin of the Bretton Woods system was to adopt the currency of a state as the world currency. The euro's original sin was to adopt the currency of no state as a regional currency. Their common flaw is fixed exchange rates, that prevent balance-of-payments adjustment. If, for whatever reason, this mechanism is hindered, it must be replaced by something else. The relatively long life of the Bretton Woods system was secured by financial market regulation and by the vision of its leader, the US. These two things are missing in the eurozone, where unfettered capital movement is fostered in the absence of any regional supervising institution, and where the regional leader,

Germany, is patently obsessed by the very short-sighted aim of increasing its external surplus as much as possible.

This Wille zur Macht is now backfiring. Keynes's proposal at the Bretton Woods conference gives us good insights into what is happening. Keynes proposed to settle international trade in a supranational currency, the Bancor, issued by a world bank, which would charge an interest rate on negative and positive Bancor balances. The rationale for this apparently unfair symmetry

(why force a creditor to pay interest, rather than earning it?) is that international debtors and creditors both benefit from international finance: thanks to international lending, the former can buy goods they otherwise could not afford, while the latter are able to sell goods that would otherwise remain in stock. By proposing such perishable money, a currency that by design could not be a store of value, Keynes aimed to discourage mercantilism, i.e. the temptation to hoard international assets rather than reinvesting them in the world economy, thus mitigating the potentially destabilizing properties of fixed exchange rates. The euro obtained the opposite result. Its rigidity fostered mercantilism both by helping redirect trade to the benefit of core countries, whose currency is undervalued in real terms, and by preserving the value of their net foreign assets.

But the supposed winner of the euro game, Germany, is now at a dead end. If it wants to keep the eurozone alive, Germany must accept the very loose monetary policies run by the ECB. Ironically, Keynes's negative rates are coming back in disguise, putting strain on the eurozone banking and pension systems, especially in Germany. On the other hand, a tighter monetary policy would give relief to the creditors, but for the very same reason would lead the debtor countries to immediate collapse by making it difficult to service the debt. Any

illusion that fiscal expansion could solve this conundrum must reckon with the fact that the countries needing fiscal stimulus, i.e. the eurozone peripheral countries, are the very same countries where an increase in income would bring about external deficits, again fostering the imbalances that caused the crisis.

Germany romped to victory by manipulating the forex market (as the US Treasury recently recognised), but must now choose between losing everything at once (through the collapse of its debtors) or little by little (through zero or negative interest rates). In the long run, irrational economic choices have no winners: bad economics cannot be good politics. What should have united Europe is now dividing it. The United Kingdom is going, and continental Europe must now choose between increasing confrontation or surrender to German hegemony. The US, like any global player, must reckon with the evidence that the euro has unnecessarily revived the German question, which it was meant to prevent.

If the US decides that it is in its best interest to deal with a politically divided, economically failing, socially unstable Europe, then supporting the euro is the best option. After all, the divide et impera (divide and rule) principle secured a former Empire some five centuries of existence. If instead the US feels that a politically and

economically healthy Europe could be a key partner on the global stage, then it should promote a controlled end to the euro. Undoing the euro will be costly, though less costly than its alternative, which is protracted stagnation of the European and hence the world economy, and the growing risk of a major financial collapse. Secular stagnation and zero interest rates are not a result of some remote astrological circumstance: they are mostly the effect on the global economy of using wrong European rules to manage huge imbalances accumulated due to flawed European institutions. Although Europe is declining, it is still too big to fail without causing great trouble in the global economy.

No matter how much political capital is invested in it, the euro will fall, as top US economists predicted. The most likely cause will be a collapse of the Italian banking system, which will take the German one with it. It is in the interest of any political power, certainly of the declining European leaders, and probably also of the US, to manage this event rather than passively await it. ■



Alberto Bagnai teaches economic policy at the Department of Economics of the Gabriele d'Annunzio University in Italy. He is the President of a/simmetrie – Italian association for the study of economic asymmetries and the author of "Il tramonto dell'euro". His blog Goofynomics was awarded the best economic information website prize by the Festa della Rete 2015.



Kamil Kamiński\*

# THE EURO AND THE UNMAKING OF THE EUROPEAN PROJECT



The victorious march of globalization, represented best by the Belle Époque, was brutally interrupted by the outbreak of the First World War in 1914. Only in the 1990s did free global markets enjoy a great comeback. The consecutive enlargements of the European Union and the four freedoms of the Single Market enabled Europe, at least in an economic sense, to return to ‘the world of yesterday’, borrowing from the title of Stefan Zweig’s famous memoir. A new Belle Époque was in the making. The euro was heralded as a symbol of this new era for Europe, but has instead turned out to be an economic trap. It has brought suffering rather than prosperity, fracture rather than unity—in short, it undermines the European project.

The eurozone has not experienced any serious recovery since the financial crisis of 2007/2008. Even worse, some European economies, including Italy, are still below pre-crisis levels of GDP. At the heart of the problem is the European Monetary Union (EMU). The launch of the euro distorted the European economy by unleashing a major, unexpected flow of capital to Southern Europe, eroding its competitiveness. Today, the euro-rescue policy is the primary reason Europe is undergoing a lost decade. The price of being in the EMU is to sacrifice the most important tools for responding to serious economic crisis: autonomous interest rate policy and currency adjustment. The economies of Southern Europe trapped in economic misery desperately need a deep devaluation. Finland would be next in line as a member of the EMU that would otherwise benefit from devaluation.

Moreover, the depression of Europe’s South and the German surplus are two sides of the same

story, or rather, two disparate consequences of the same single currency. The German surplus in 2016 is expected to spike to historic highs of about 8.5% of GDP. Far from being a sign of German economic health, this is a function of European and global malaise. Economic imbalances are a key reason why the global economy is underperforming. Undoing economic imbalances in a controlled manner is crucial to restarting global economic growth.

The European Union reached its period of greatest triumph in 2004 and 2007, as EU enlargement broke down the last remnants of the Iron Curtain and reunited the continent. By admitting Croatia in 2013, the EU began the integration of the Balkans into the European project, portending increased economic prosperity and political

**IT IS TIME FOR EUROPE TO LEARN THE LESSON THAT BAD MONETARY ARRANGEMENTS CAN BE VERY DESTRUCTIVE FOR DEMOCRACIES.**

stability for that region. In contrast, the euro has brought neither prosperity nor stability—it has done the opposite. The EU of 2016 is scarcely recognizable next to the confident, optimistic EU of 2004. The European project has lost its allure, and anti-EU sentiment is on the rise. Britain has decided to leave the club. Ideas of creating a European federation provoke only a stronger backlash against the Union, and a fiscal union cannot provide prosperity, as the case of Southern Italy teaches us.

A monetary system is about more than pure economics: it often metamorphoses into a system of values. The famous words of ECB President Mario Draghi that the euro would be saved ‘at all costs’ expressed the ‘euro mindset’, which seems to prevail among European decision-makers. This is why the

economic crisis in the eurozone was branded from its beginning as the eurozone sovereign debt crisis, even though the euro itself has been the source of the problem. In 2016, we are dealing with a very high level of public debt in the eurozone: in Greece over 175% GDP, in Italy 133% GDP, in Spain 100% GDP, higher levels than in 2010. It is no coincidence. The misguided ‘sovereign debt crisis’ narrative led to an economic policy of austerity advocated by the European Commission, the IMF, the ECB and the eurogroup which resulted in fall of GDP, massive unemployment, and more debt. Italy, Greece, Portugal and Spain are the best examples.

Given these challenges, the ECB was called to rescue the eurozone. Central banks have a key role in times of deep economic crisis, but

the ECB cannot solve economic imbalances within the EMU. From the start, the ECB was given a mission impossible – conducting one monetary policy for a very diverse club of economies. In consequence, the ECB’s monetary policy has had damaging consequences: it undermines the stability of the European financial sector, has helped in building up real estate bubbles and hurt Europe’s trade partners, to mention just a few. A further QE is likely to produce more political tensions. The crisis of the European banking sector is just another offshoot of the eurozone crisis. Despite the conviction that some form of public bailouts could save the day, without a return to a healthy economic environment in Europe, a well-performing banking industry is hard to imagine.

The single currency has led to the decline of centrist politics in Europe and the rise of anti-U.S. and anti-NATO radical right and left-wing parties. The promise of stability offered by a fixed exchange rates regime turned out to be a dangerous illusion. The migration



# New Direction

the foundation for european reform

crisis has only made matters worse. Worryingly, a strong anti-American feeling is penetrating the European public debate. It should be underlined that TTIP is not just a trade deal of a new generation, but also a reaffirmation of the transatlantic bond along economic dimensions. Without doubt, a strong transatlantic partnership is crucial for Europe. NATO is the best guarantee for European security. As the post-Cold War world order decomposes at the same time that new threats such as terrorism are on the rise, the transatlantic alliance ought to be renewed and strengthened.

The 'euro mentality' has produced the bizarre but now commonplace idea that a euro break up would be a doomsday scenario for the EU. This view is deeply wrong. In fact, it completely inverts reality. If the single currency persists, it has the potential to be the undertaker of the European project. The grave

mistakes of the 1930s of pursuing a deflationary policy in a fixed exchange regime are being repeated. The fall of the Weimar Republic and destabilization of the Japanese political system were the most tragic consequences of those mistakes. At some point the eurozone will collapse. This is inevitable. If this happens in a chaotic way, it might result in a banking panic, and therefore would be a cause for serious concern. It would be an affair with dire global repercussions. The EU needs a new Grand Strategy based on a controlled dismantling of the euro. Debt relief in the case of some countries must be a part of the deal. Were the US to support a new European Grand Strategy, this would be of benefit to both parties. Prudent pro-market economic policies on national and European levels should be implemented after the realignment of exchange rates in Europe to facilitate a return to robust and sustained economic growth. Only a coordinated strategy of

unmaking the eurozone conducted in the spirit of solidarity among European nations would limit risks and mitigate losses. In this way, centrist politics in Europe would be restored. This Grand Strategy would be an embodiment of the European raison d'Etat, as it would lead to a revival of the European project and transatlantic relations. It is time for Europe to learn the lesson that bad monetary arrangements can be very destructive for democracies. ■



Kamil Kamiński is an advisor to CEO of PKO BP. He worked previously in the public sector and strategic advisory.

\* The article represents solely the private opinions of the author and it does not reflect the view of PKO BP S.A.





*Brigitte Granville*

# LESSONS FROM DISMANTLING THE RUBLE ZONE FOR A EUROZONE BREAK UP

In 1994, Linda Goldberg, Barry Ickes and Randi Ryterman concluded their article on the breakdown of the ruble zone (RZ) by drawing what they depicted as an “ironic” contrast with the contemporary progress towards monetary union in Europe:

“In the European Community, participation in the Exchange Rate Mechanism, has in part, been linked to the desire of countries to import the monetary discipline imposed by a strong centre, Germany. This embracing of monetary discipline in Europe does not threaten the sovereignty and independence of the member countries. By contrast, the decision of countries to stay in the ruble zone clearly restricts the pace and direction of their economic reforms. Departure from the ruble zone is a rejection of both Russia’s control over monetary policy as the centre and or of Russia’s reform strategy.”<sup>2</sup>

These authors missed the true irony. The story of the RZ is that it started out by allowing the Former Soviet Republics (FSRs) to share Russia’s currency with virtually no constraints on their sovereignty – in the sense of being forced to abide by certain rules about how they conducted their monetary, fiscal and financial sector policies. In particular, for a time the FSRs central banks were able to issue non cash ruble as they pleased. So the RZ had two effects: it allowed the FSRs not to do the necessary reforms; and it undermined Russia’s own reforms aimed at macroeconomic stabilization (or, to put the matter more precisely, the RZ completed the bad job that the Russian central bank (CBR) was itself doing on fighting domestic inflation). It was only in 1993

when Russia started – in a form of economic self-defense – to impose strict policy and convergence conditions on the FSRs that they decided to opt out of this monetary union and introduce their own national currencies. By 1994, the RZ had gone into the dustbin of history.

This sobering precedent for the eurozone (EZ) prompted a Bloomberg reporter to comment in June 2012: “In hindsight, it’s amazing that the planners of the euro currency didn’t think more about the failure of the ruble zone when they were building their own grand architecture.”<sup>3</sup> In fact, the so-called planners did think a lot about the RZ. Within days of the signing of the Maastricht Treaty in December 1991, the Soviet Union collapsed and the RZ comprising the now sovereign FSRs was established. At precisely the moment when Europe had agreed to launch a monetary union between sovereign states, the last thing European officials wanted was the awkward spectacle of the failure of a similarly constituted monetary union on Europe’s doorstep.

Accordingly, the “planners of the euro” gave strong political support to the RZ. Just as the creation of the euro had been based on a contestable economic rationale to do with optimal currency areas, so the euro architects made out an economic case for the RZ as a way to preserve the deep trade links among the FSRs. Political considerations were at work here – ranging from fears about the destabilization of a nuclear power as a result of excessive economic dislocation to a more penny-pinching concern that radical economic adjustments in the ex-USSR – although necessary and ultimately beneficial – might lead to

1. Brigitte Granville, Centre for Globalisation Research, Queen Mary University of London, London, (e-mail: b.granville@qmul.ac.uk). As member of MFU I created the Monetary Report which was at the beginning of the 1990s the main source of monetary data and was widely used by international organizations, central banks, embassies and academics.

2. Goldberg, Ickes and Ryterman, 1994: 321

3. <http://www.bloomberg.com/news/articles/2012-06-08/the-ruble-zone-collapsed-in-the-1990s-and-it-was-bad>

**GERMANY COULD ITSELF DECIDE TO LEAVE, OR INSIST ON STRICTER RULES (OR, AT LEAST, THE STRICTER IMPLEMENTATION OF PRESENT RULES) WITH THE RESULT THAT OTHER WEAKER COUNTRIES OPT OUT.**

calls for larger amounts of balance of payments aid from western countries (which, both bilaterally and through the international financial institutions, had refused to grant Russia the same debt relief from which other post-communist transition economies like Poland had recently benefited).

However, that may be, the economic argument about commercial relations within the Former Soviet Union (FSU) was flawed. Those relations were the legacy of central planning; and once the Soviet Union collapsed, there was scant economic rationale for such ties to be maintained. Intraregional trade before price liberalization was mispriced and mostly done on a barter basis, leading to hoarding, black markets and shortages.<sup>4</sup> Most of the Soviet trade was based on products for which there was no demand. Operating under a ‘soft budget constraint’ free of competitive market disciplines, FSR state enterprises supplied goods to other republics, regardless of their needs and capacity to pay – and assuming instead that CBR credits would suffice to settle all transactions.<sup>5</sup> Gaddy and Ickes summed up the survival of post-Soviet industrial enterprises as being “*despite* their performance rather than because of it”.<sup>6</sup> While there was a gravity argument based on the short distances between the FSRs, once national currencies were

introduced and prices liberalized the inter-FSR share of total trade decreased from 57 percent in 1992 to 33 percent in 1997.<sup>7</sup>

In addition to dubious economic rationales, the origins of the RZ and EZ shared a further common feature: political voluntarism. Just as, in the case of the EZ, the governing class in France saw monetary union as a way to enhance French power by preventing the Bundesbank being the sole property of (reunifying) Germany, much of the Russian elite were similarly anxious to salvage as much as possible from the Soviet Union through which Russian power had been projected. Bordo and Jonung concluded that monetary unions are always politically motivated – driven (as argued by Mark Mazower, quoted in the same Bloomberg wire cited above) by “an ideological vision of the elite”.<sup>8,9</sup>



In the case of the FSRs, the political motivation was very different. Newly endowed with sovereignty, the FSRs had little will to work toward a cooperative RZ as the common currency became the symbol of “the last Soviet institution”.<sup>10</sup> At the same time, they did not immediately trash the RZ as they did with other Russian initiatives to establish some supra-national institutions such as the armed forces. On the contrary, and in a way that foreshadowed the present-day relationship between the ECB and EZ countries’ fiscal authorities, the incentive for the FSRs was to run deficits as large as possible by issuing ruble credits that “increased the real purchasing of the domestic government, but the cost falls on holders of nominal assets throughout the currency area.”<sup>11,12</sup>

This FSR agenda was supported inside Russia by the economic

interests of the powerful industry lobby that wanted central bank credits to underwrite the continuation of familiar transactions with suppliers and off-takers – very much including in the various FSRs. They had a powerful ally in the Soviet-minded CBR governor Viktor Gerashchenko (appointed on 17th July 1992) who provided abundant cash and interest-free loans amounting respectively to 3.1 percent of Russian GDP and about 10 percent of Russian GDP by the end of 1992.<sup>13</sup> Since Russia had lost access to international credit after

the Vneshekonombank default on short-term trade credit in December 1991, these quasi-fiscal expenditures through the CBR were financed almost exclusively by money creation, leading to very high and volatile inflation.<sup>14</sup>

This dynamic changed when Boris Fyodorov was appointed Minister of Finance in January 1993. The fight against inflation became a major priority and credits to FSRs a major target. The incentive to limit the cost of the RZ was given by the negotiations with the IMF on a new credit line facility especially designed for Russia (the Systemic Transformation Facility - STF). By this time, the IMF – having previously joined the EU in supporting the RZ – had recognized the necessity for each of the FSRs to introduce their own national currencies (Pomfret, 2002) (this IMF-EU dynamic seems like the story of Grexit foretold);

In April 1993 technical credits were abolished and all previous credits to FSRs accumulated over 1992-93 were transformed into state debts (denominated in US dollars and with an interest rate linked to Libor) channelled through the budget therefore under the control of the Ministry of Finance. This limited the generosity of the CBR chairman to the FSRs. With the tightening of credit policy to FSRs, their demand for cash increased dramatically and became the main threat. Russia acted on 24th July 1993 by introducing a monetary reform where Soviet-era banknotes (depicting Lenin) circulating in the FSRs ceased to be legal tender in Russia.<sup>15</sup> The FSRs were forced to choose between: introducing their own currencies; or negotiating with Russia on Maastricht-like criteria. They preferred to go their own monetary way.

So, to return to the quote from the Goldberg, Ickes and Ryterman paper that we started with, the

“ironic” lesson of the RZ story for Europe is that as the ERM morphed into the EZ, the peripheral EZ countries experienced precisely such an erosion of their sovereignty and independence that Russia ended up requiring from the FSRs as a condition for continuing to share the ruble. Applied to the EZ, the analogy of the collapse of the RZ suggests two scenarios: either the FSR-equivalents – i.e. the countries that are less competitive than Germany – finally balk at the constraints of the present rules-based transfer union and decide to leave; or else, Germany comes to regard the existing arrangements, whereby the ECB (and ESM) in effect finance budget deficits just as the CBR used to finance the FSRs, as posing an intolerable actual tax burden – and/or potential inflation tax burden – on its taxpayers. At that point, Germany could itself decide to leave, or insist on stricter rules (or, at least, the stricter implementation of present rules) with the result that other weaker countries opt out. ■



Brigitte Granville – Professor of International Economics and Economic Policy at Queen Mary University of London, London. The author was the main adviser in the Ruble zone negotiations as member of the Macro and Financial Unit (MFU) of Russia created by Professors Anders Aslund and Jeffrey Sachs, Economic Advisers to the Ministry of Finance of the Russian Government, November 1991 - January 1994.

**REFERENCES**

- Aslund, A. (2002). *Building capitalism, the transformation of the former Soviet bloc*. Cambridge, Cambridge University Press.
- Bofinger, P. (1993). *Options for a new monetary framework for the area of the Soviet Union, Reform issues in the former Soviet Union*. European Economy, Commission of the European Communities, Directorate General for Economic and Financial Affairs. 49: 181-193.
- Bordo, M. and L. Jonung (1999). “The future of EMU. What does the history of monetary unions tell us?” NBER Working Paper Series 7365 (September).
- Conway, P. (1995). “Currency proliferation: the monetary legacy of the Soviet Union.” *Essays in International Finance*, International Finance Section, Princeton University, Princeton, New Jersey, 197(June).
- Dornbusch, R. (1992a). *A Payments Mechanism for Eastern Europe and the Commonwealth*, Paper presented at the EC seminar on the Soviet Union, January.
- Ferguson, N. and B. Granville (2000). “Weimar on the Volga”: Causes and Consequences of Inflation in 1990s Russia Compared with 1920s Germany.” *The Journal of Economic History* 60(4): 1061-1087.
- Gaddy, C. G. and B. W. Ickes (2002). *Russia’s virtual economy*. Washington D.C., Brookings Institution Press.
- Goldberg, L. S., B. W. Ickes and R. Ryterman (1994). “Departures from the Ruble Zone: the implications of adopting independent currencies.” *The World Economy* 17(3): 293-322.
- Granville, B. (2002). *The IMF and The Rouble Zone, Response to Odling-Smee and Pastor*, *Comparative Economic Studies*, XLIV, no.4 (Winter 2002): 59-80.
- Granville, B. (1994). “Farewell, Ruble Zone” *Stockholm Institute of East European Economies Working paper* November.
- International Monetary Fund (1994). “Financial relations among countries of the Former Soviet Union.” *Economic Review* 1.
- Kornai, J. (1979). *Economics of shortage*, Amsterdam North-Holland.
- Pomfret, R. (2002). “The IMF and the Ruble Zone” *Comparative Economic Studies* 44(December): 37-47.

4. Dornbusch, 1992a: 8  
5. Kornai, 1979  
6. Gaddy and Ickes, 2002:3  
7. Aslund, 2002: 129.  
8. Bordo and Jonung (1999)

9. <http://www.bloomberg.com/news/articles/2012-06-08/the-ruble-zone-collapsed-in-the-1990s-and-it-was-bad>  
10. Aslund, 2002: 204.  
11. Bofinger, 1993: 183

12. Conway, 1995: 7  
13. IMF, 1994, table 2: 26  
14. Granville, 1994, Ferguson and Granville, 2000  
15. IMF, 1994: 44

Antoni Soy

# DEBT AND AUSTERITY IN THE EUROZONE THE CASE OF THE SPANISH ECONOMY



The fundamental cause of the crisis in the eurozone, especially in its periphery, has been mounting private sector debt (households and businesses), which in the case of Spain was largely due to the housing bubble. The crisis was not caused by public debt. Public debt has been a consequence of the crisis. Private debt has been converted into public debt in order to reorganize and save banks and financial institutions, especially in the northern countries. These banks granted too much credit—in risky, irresponsible ways—to the private sector of southern European countries, so that these countries could in turn buy products from northern countries, especially Germany.

Some heterodox economists defended this thesis even before the crisis began. It is noteworthy that in October of 2011, the monthly newsletter of European Central Bank (ECB) said: “During the years prior to the financial crisis, sectoral imbalances were building across the private sectors of some countries in the

**THE CURRENT CRISIS IS NOT A PUBLIC DEBT CRISIS, BUT A CRISIS OF PRIVATE EXTERNAL DEBT. CONSEQUENTLY, THE PRIORITY OF ECONOMIC POLICY SHOULD BE TO ADDRESS THE BALANCE OF PAYMENTS (“EXTERNAL COMPACT”), RATHER THAN EQUILIBRIUM ON PUBLIC SECTOR BALANCE SHEETS (“FISCAL COMPACT”).**

euro area, creating a dichotomy between those countries that were generating surpluses in their private sectors and those generating deficits”. Later, in 2013, the Vice President of the ECB, Vitor Constancio, acknowledged that public debt was a consequence and not a cause of the crisis, while excessive private debt and risky, inefficient management of credit by the financial sector was the primary cause of this crisis. Even more orthodox economists (Baldwin and Giavazzi among others), who had defended the contrary position, in 2015 recognized that “this was a classic

‘sudden stop’ crisis - not a public-debt crisis”.

In fact, Spanish private debt was 101.1% of GDP in 1999, reached 217.9% of GDP in mid-2010, and was still 175.8% in 2015. Breaking this figure down further, household debt was 38.8% of GDP in 1999, reached 84.8% in mid-2010, and is now 68.6%. Business debt was 62.3% of GDP in 1999, reached 133.1% in mid-2010, and is currently 107.2% of GDP. Companies borrowed more quickly than families before the crisis, and are now deleveraging faster but in any case more slowly than they borrowed. And globally, private debt levels remain important to monitor as they could lead to a new crisis of excessive and uncontrolled indebtedness in the hypothetical case of sustained economic recovery.

At the same time, external debt in Spain as a percentage of GDP was about 40% in 1995, rose to almost 100% in 2003 and increased to 167.9% of GDP in 2015. These high levels of external debt have rendered the Spanish economy very vulnerable.

Over the last three years of economic expansion (2005-2007), the Spanish economy had a surplus in the public sector. However, with the onset of the crisis, the deficit grew rapidly to a peak of 11% in 2009. Though the deficit has fallen since 2013, its level in 2015 was still higher than any G7 country (excepting Japan) and is far above the 4.5% of GDP threshold outlined by the stability pact and the “fiscal compact” for the Eurozone. The structural deficit, although declining, remains at 2.4% of GDP, well above the 0.4% envisaged by the law of budgetary stability.

Not surprisingly, these significant public deficits have dramatically increased public debt (more than in any country in the G7), which rose from 35.5% of GDP in 2007 to 98.9% of GDP in 2015. This corresponds to an increase of 179%, 2.5 times more than in Germany, which has grown less but 1.8 times more than France, the European country of the G7 where increases more after Spain.

Analyzing balance sheets by sector, it is clear that during

Spain’s period of growth from 1990 to 2007, private sector debts increased within the economy, and investment grew more than savings. This was financed largely (especially after the implementation of the euro) with external resources, while the public sector reduced public deficits reaching a surplus in the last three years of the period. When the crisis began, the private sector deleveraged, with savings exceeding investment each year beginning in 2009. Simultaneously, external investment plummeted, and the public sector saw its debts increase too quickly and intensely. In short, private debt became public debt.

The scenario in Germany, where private savings have exceeded private investment virtually every year, has been markedly different. Since the reunification, public sector borrowing has driven most investment. However, things changed after the introduction of the euro because trade surpluses grew, which has become the sector which now finances the economy with

some timely contribution of the public sector, and all that allows that the saving of the private sector is increasingly more and more important than the private investment.

Given these conditions, the policy of “internal devaluation” offers no solution, and produces a vicious circle of increasing austerity. At the same time, the belief that the solution is repealing austerity measures and promoting expansionary policies is just a dream. The existence of the euro—which means that countries do not have their own currency, or the instruments for the implementation of their own sovereign economic policy—makes this all impossible.

The current crisis is not a public debt crisis, but a crisis of private external debt. Consequently, the priority of economic policy should be to address the balance of payments (“External Compact”), rather than equilibrium on public sector balance sheets (“Fiscal Compact”). The proposal that international trade should be balanced, besides being logical, is not new: it was proposed by Keynes at Bretton Woods and it is also what Meade suggested later to ensure that economic integration could function. ■



Antoni Soy is Professor of the University of Barcelona. Former Deputy Minister of Industry and Business in the Government of Catalonia



*Mojmír Hampl*

## INSIDE AND OUTSIDE THE EUROZONE

# A BACK-OF- THE-ENVELOPE CALCULATION

Since its very inception, the EMU has been touted by its founding fathers and key representatives as a way to enhance the economic growth of the participating economies. For example, a leaflet that the European Commission (EC) produced in 2005 and that is still accessible on the EC's website, says that the euro "contributes greatly to the economic stability needed for more growth".<sup>1</sup> The euro was seen and presented by many almost as a miraculous wealth generator.

And now let's look at the facts. One way of assessing whether the euro really has brought more growth to eurozone members is to compare their growth rates prior to entry into the EMU with those prevailing since then. Using IMF data on real GDP growth in each of the nineteen economies that are now members of the eurozone (EZ), the average growth rate between 1990 and the last year before EZ entry is 3.3%, while for the time period inside the EZ the average growth rate is a mere 1.7% (see the last row of Table 1).

This means that after an average EZ member economy entered, its pace of economic growth halved.

Of course, this comparison is not entirely fair, as it mixes economies which have lived with the euro for a number of years with recent entrants – such as the Baltics – whose economic growth may not yet have been strongly affected by EZ membership (although thanks to their fixed exchange rate

1. [http://ec.europa.eu/economy\\_finance/publications/publication6706\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication6706_en.pdf)

**EU COUNTRIES LIVING WITHOUT THE EURO HAVE NOT PAID ANY PRICE FOR NOT OPTING IN AS MANY EUROPHILES FALSELY PREDICTED. QUITE THE OPPOSITE: NOT HAVING THE EURO HAS PROVED TO BE A NICE ECONOMIC BONUS FOR THEM.**

regimes, all the Baltic countries were de facto passively accepting the monetary conditions of the EZ anyway). Narrowing our sample to the eleven economies which entered the EZ at the very beginning in 1999, they grew at an average yearly tempo of 2.9% in the period 1990–1998 but only 1.8% in 1999–2015 (see the last-but-one row of Table 1). The growth rate during the euro years has only been around three fifths of what it used to be before the euro.

Maybe, however, the creation of the EZ roughly coincided with other shocks which hit many economies, including those eleven 1999 entrants, thus contaminating our comparison. If these other shocks were growth-reducing, then in their absence the observed change in GDP growth in the 1999 entrants would have been less negative or perhaps even positive. One way to estimate the direction and size of these other shocks is to look at what happened in the same time window in the rest of the EU.

The “rest of the EU” consists mostly of economies which, in the early 1990s, were undergoing periods of often rather wild transition. This is why this time we should take the “pre-euro” time period to start only in, say, 1995. The year-on-year real GDP growth in this period in the current nine non-EZ members was about 2.5%. Since 1999, these nine economies have continued to grow by some 2.5% each year on average. So, if the developments in the non-euro part of the EU really reflect the impact of all other

shocks except the switchover to the euro, then this impact was roughly neutral. The growth effect of the euro thus seems to have been as bad as is implied by the above-mentioned reduction of the growth rate in 1999 entrants from 2.9% before the euro to 1.8% with the euro.

One might object that EU economies outside the EZ, largely transition or post-transition ones, have been subject to specific pressures which make them an unsuitable “control group”. The primary specific pressure, however, seems to be real convergence, that is, the process whereby these economies gradually catch up with the advanced European economies in terms of GDP per capita. Assuming that demographic changes have not been dramatically different across Europe, the catch-up in terms of GDP per capita means that the differential in the rate of growth of GDP (non-EZ members versus EZ members) can be expected to be positive but fall over time. GDP growth rates in the non-EZ group since 1999 are thus likely to reflect a downward “convergence shock” which GDP growth rates in the EZ do not contain (assuming away potential convergence processes in the EZ periphery).

To sum up, our back-of-the-envelope calculations indicate that EZ membership alone caused the average real GDP growth rate in EZ member economies to fall by more than one percentage point.

This negative impact can be explained by various weaknesses in macroeconomic as well as structural and financial policies within the EZ. First, the EZ consists of rather heterogeneous economies, so the ECB’s single monetary policy is often sub-optimal for some EZ members; however, the relevant adjustment channels (fiscal transfers, labour market movements) have not worked

as needed. Second, growth in a number of EZ economies has been hindered by excessively tight regulation of various parts of the economy. Third, governments have often been too relaxed about the sustainability of public finances in good times, making public finance a source of problems rather than solutions in bad times. Last but not least, in some countries banking sectors have faced rather cavalier supervision, making room for ugly credit bubbles and sudden reversals in capital flows.

The crisis years opened the eyes of many policy makers, observers and voters. Recently, a lot of effort has been made to improve the EZ’s institutions and policies. Alas, some of the design flaws are most probably irreparable without making changes that are hard to achieve in standard democracies. One can thus summarize the eurozone as so far having been a wealth destructor rather than a wealth generator. And there is no reasonable cause to believe the future will be any different. EU countries living without the euro have not paid any price for not opting in as many Europhiles falsely predicted. Quite the opposite: not having the euro has proved to be a nice economic bonus for them. ■



Mojmír Hampl is the Vice Governor of the Czech National Bank since 2008 and a member of the CNB’s Board since 2006. He served as a board member of the Czech Consolidation Agency, a state-run bad asset institution, between 2004 and 2006.

TABLE 1.  
REAL GDP GROWTH RATES OF  
EZ MEMBERS (1990 -2015)

COUNTRY	AVERAGE REAL GDP GROWTH (YOY, %)		YEAR OF ENTRY INTO EZ		
	OUTSIDE EZ	INSIDE EZ			
Austria	2.63	1.61	1999		
Belgium	2.05	1.65	1999		
Finland	1.35	1.64	1999		
France	1.85	1.40	1999		
Germany	2.24	1.29	1999		
Ireland	6.68	4.06	1999		
Italy	1.41	0.30	1999		
Luxembourg	4.35	3.49	1999		
Netherlands	3.06	1.51	1999		
Portugal	3.35	0.62	1999		
Spain	2.57	1.86	1999		
Greece	2.45	-0.06	2001		
Slovenia	4.09	0.72	2007		
Cyprus	4.51	-0.74	2008		
Malta	2.31	2.91	2008		
Slovak Republic	5.36	1.64	2009		
Estonia	3.96	3.66	2011		
Latvia	3.29	2.55	2014		
Lithuania	4.58	1.59	2015		
AVERAGE OF 1999 ENTRANTS					
			2.87	1.76	
AVERAGE OF ALL					
			3.27	1.67	

TABLE 2.  
REAL GDP GROWTH RATES OF  
EZ NON-MEMBERS (1990 – 2015)

COUNTRY	AVERAGE REAL GDP GROWTH (YOY, %)			
	BEFORE 1999	SINCE 1999		
Bulgaria	-1.61	3.12		
Croatia	5.09	1.71		
Czech Republic	1.10	2.54		
Denmark	2.85	1.25		
Hungary	2.55	2.19		
Poland	6.26	3.62		
Romania	0.05	3.43		
Sweden	3.17	2.45		
United Kingdom	2.92	2.01		
AVERAGE OF ALL				
			2.49	2.48

Source: IMF

Zdzisław Krasnodębski

# THE EURO AS UTOPIA



“The euro succeeded beyond even the most enthusiastic projection of its supporters” - observed Jeremy Rifkin in his 2004 bestseller *The European Dream*.<sup>1</sup> Today, the more pertinent question is how anybody could have ever believed the euro would be a success.

Notwithstanding some critical voices, mostly from the US and the UK, the majority of economists and institutions of global financial governance (such as the IMF) supported the introduction of the euro. In July of this year, a team of independent experts writing on the record of the IMF commented that:

“Before the launch of the euro in January 1999, the IMF’s public statements tended to emphasize the advantages of the common currency more than the concerns about it that were being expressed in the broader literature. Individual staff members did express such concerns. Interviews with

former and current senior staff members suggest that, after a heated internal debate, the view supportive of what was perceived to be Europe’s political project ultimately prevailed in guiding the Fund’s public position.”<sup>2</sup>

Ambrose Evans-Pritchard summarized this report in the *The Telegraph*:

“The International Monetary Fund’s top staff misled their own board, made a series of calamitous misjudgements in Greece, became euphoric cheerleaders for the euro project, ignored warning signs of impending crisis, and collectively failed to grasp an elemental concept of currency theory.”<sup>3</sup>

The report gives the impression that the IMF succumbed to political pressure and ignored economic principles and facts. Today, the monetary union is seen as an arbitrary political act against economic rationality, a plot of politicians against economists, a disastrous victory of political will over economic reason. But the

truth is different—the failure of the euro is about failed economic reasoning, which like all human reasoning has its limits (a fact often ignored by economists).

For most economists, the monetary union represented another logical step in strengthening the single European market. As Harold James reminds us:

“There was a clear economic as well as political logic behind the creation of a single European currency.”<sup>4</sup>

And further:

“The quest for European monetary coordination and then for union was a response to genuine (and still-existing) problems of currency instability and misalignment at the international level.”<sup>5</sup>

Basic textbooks on the EU explain that the creation of the monetary union

“Was driven by the understanding that few barriers to the completion of the single market were as fundamental as the existence of multiple different currencies with fluctuating exchange rates.”<sup>6</sup>

In this way, it seemed a necessary, logical, and rational measure for completing the common European market. This was, in sum, a manifestation of the conviction that

“Gains already generated by single market and capital liberalization could not be fully realised unless accompanied by monetary union.”<sup>7</sup>

1. Jeremy Rifkin, *The European Dream*, Cambridge: Polity Press, 2004, p. 64  
2. The IMF and The Crises in Greece, Ireland, And Portugal: An Evaluation By The Independent Evaluation Office, 18 July 2016, p.23 - [http://www.ieo-imf.org/ieo/files/completedevaluations/EAC\\_REPORT%20v5.PDF](http://www.ieo-imf.org/ieo/files/completedevaluations/EAC_REPORT%20v5.PDF)  
3. Ambrose Evans Pritchard, IMF admits disastrous love affair with the euro and apologises for the immolation of Greece, *The Telegraph*, 29. 6. 2016  
4. Harold James, *Making the European Monetary Union*, Cambridge Mass.: Harvard University Press, 2012, p. 1  
5. Ibidem  
6. John McCormick, *Understanding the European Union*, Palgrave Macmillan: Basingstoke, New York 2008, p. 157  
7. Alan W. Cafruny, J. Magnus Ryner, *Critical Political Economy*, in: Antje Wiener, Thomas Diez (eds), *European Integration Theory*, Oxford: Oxford University Press, 2009, pp. 221-240 quotation p. 231

This “rationality” was of course premised on an assumption that “ever closer” Union is always a net positive, that the single market brings advantage to all European countries and regions. It was an element of a utopian world-view, which became dominant after 1989.

The 1980s was a decade of lost illusions. The decline of “real socialist” countries caused a shift in the intellectual atmosphere in the West. Marxists of many different varieties began to slowly vanish from Western intellectual life and Western universities. The rise of postmodernism, with its criticism of the Enlightenment, reason and the idea of progress was the result of lost progressive hopes of moving beyond capitalism and parliamentary democracy. As communism finally came to an end, a world without alternatives emerged. That should have also meant a world without utopian projects. Liberal democracy and free market economics remained the highest option for humanity. Many of those, who now ridicule Francis Fukuyama for his proclamation of the end of history actually, until now, shared his position that this form of polity and this form of economy are final human achievements. However, democracies were not yet really liberal and markets still were not sufficiently free.

In this way – and largely unnoticed – a new utopian ideal emerged: an economic utopia of a totally free global market and the political utopia of a world without sovereign states as political entities, without borders, without nations and their cultural identities, without dogmas and limitations.<sup>8</sup> The pioneer of

this political change was supposed to be the old yet reborn continent – Europe. European integration was meant to be more than just the ultimate solution to old problems of Europe’s past of war and destructive nationalism, but also a model for the world to follow. The formerly “dark continent”<sup>9</sup> was to become a shining example for all of humanity, a lodestar of progress. Monetary union was a central element of that world-view – a powerful symbol of Europe’s



unity and integration, and a vehicle for moving towards ever-closer union. National currencies seemed absurd anachronisms in the global economy – as did the many small German states before unification in 1871. Removing them seemed consistent with economic reasoning and, equally important, a requirement for cultural and moral progress towards the development of a collective European identity that would overcome “nationalism”.

Such a utopia of a totally liberal democracy, open society, and free markets was – as a utopia always is – in fact against liberty, because liberty can exist only where there is a possibility of action, of choice between different aims. The pretence of the possession of ultimate knowledge and striving for “totality”, one solution for all

problems, is precisely the enemy of liberty. The enemy of liberty is also historical determinism, the conviction that history has one, clear direction and where there are some people – Marxist philosophers or neoliberal economists – who know that aim of history. Such determinism, paradoxically, has the tendency of seducing society into radical social experiments and constructivism on a grand scale. The euro was such an experiment. It turned out to be painful as such experiments always are.

The Brexit referendum, the failure of the euro and the whole financial crisis show us once again that history is open, our knowledge limited and our pretence of moral superiority a vanity. Economists do not have access to divine insights and, like all human beings, are influenced by current intellectual fashions, political ideas, and moved by their own personal

moral and political convictions. Economics is not a strict science, but shares weaknesses (as well as advantages) with social sciences. Its power of prediction and control are limited. Markets are not rational, and never fully free; a totally open society is a chimera as is a totally liberal democracy. We are imperfect and therefore free. ■



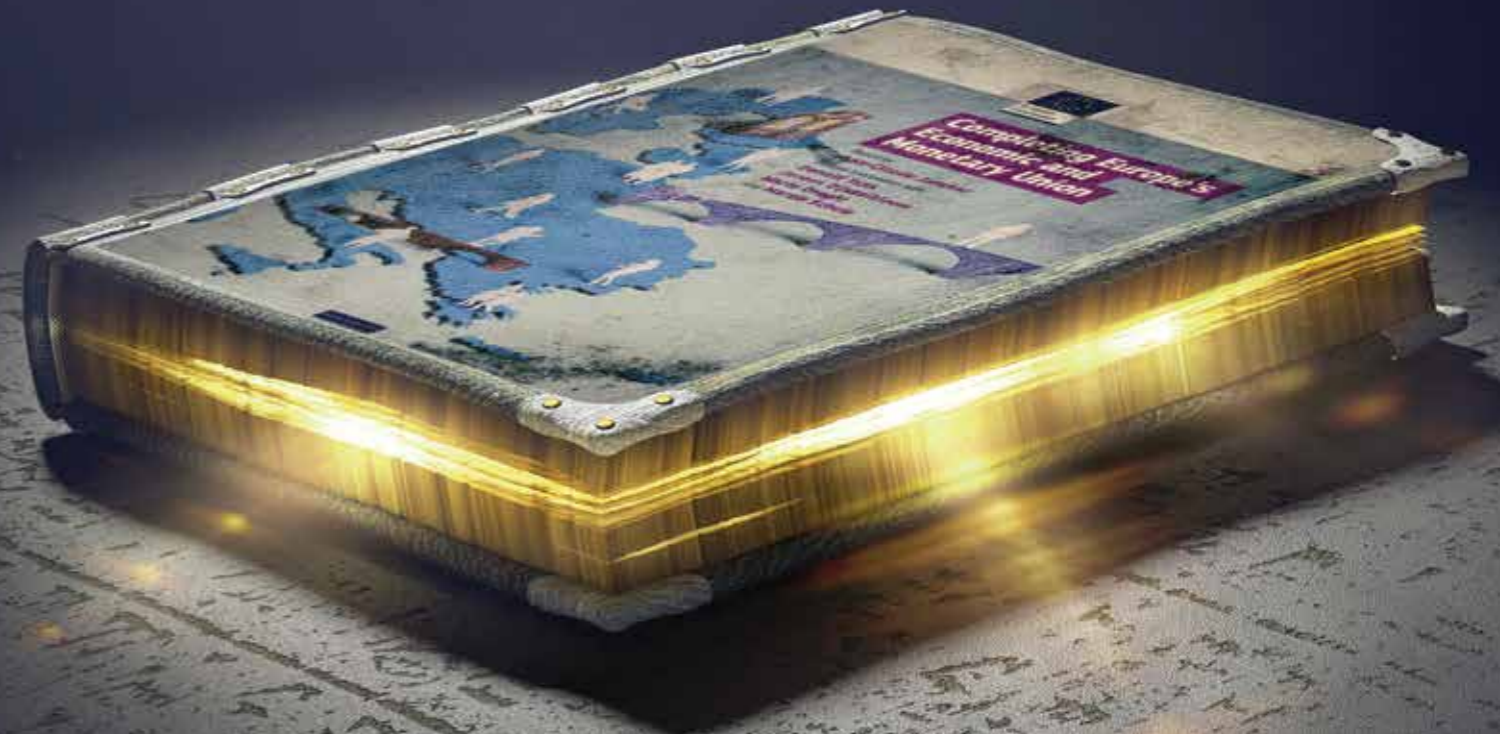
Zdzisław Krasnodębski is a sociologist, social philosopher and publicist. He is a professor at the University of Bremen and currently serves as a Member of the European Parliament.

8. Against my expectation, see: Zdzisław Krasnodębski, *Upadek idei postępu (Decline of the Ideas of Progress)*, Warszawa: PIW 1991

9. Mark Mazover, *Dark Continent: Europe's Twentieth Century*, London: Penguin Book, 1999.

Jacques Sapir

# THE ILLUSIONS OF THE 'FIVE PRESIDENT'S REPORT'



The “Five Presidents’ Report” belongs to a genre of political publication that tends to be quickly forgotten. It would however be a mistake to do so. The report, which appeared during a period of profound doubt with regards to the European Monetary Union, makes the case for necessary changes moving forward. However, in doing so it exposes some of the flawed thinking of the euro’s most powerful supporters. In fact, the “Five Presidents’ Report” restates the core aims, as well as the major mistakes of EU supporters. The report was conceived as a way to deliver a calming message to those concerned about the state of the EMU. Indeed it does quite the opposite. A careful reading of this consensus document, produced by Martin Schulz, Jean-Claude Juncker, Donald Tusk, Jeroen Dijsselbloem, and Mario Draghi, makes it clear that nothing has been learned from the crisis in the eurozone.

Let us start with the beginning. This report opens with a statement that is difficult to dispute: “A complete EMU is not an end in itself. It is a means to create a better and fairer life for all citizens, to prepare the Union for future global challenges and to enable each of its members to prosper”.<sup>1</sup> Duly noted: the eurozone is not an end in itself. Given this sentiment, one might reasonably expect this report to deliver a rigorous and honest review of the situation of the Economic and Monetary Union.

However, this hope quickly evaporates. On page 4, we find this startling statement: “The euro is a successful currency and steady. It is shared by 19 EU Member States and more than 330 million citizens. It has provided its members with price stability and shielded them from external instability. Despite the recent crisis, it remains the second most important currency in the world,

with a share of almost a quarter of global foreign exchange reserves”. The fact is, in this document, one would look in vain for any kind of critical reflection about the role of the euro in the Greek, Portuguese, Spanish or Italian economic crises.

But it is rife with delusion. Price stability, for example, is not a product of the eurozone but the combination of international factors that have put strong deflationary pressure on the countries of the eurozone. In fact, we can blame the latter for removing the means in these countries to fight against these deflationary pressures. Similarly, when it is claimed that the eurozone has protected members from instability in the global context, we forget too quickly the Greek and Spanish crisis and the slow deterioration of the Italian economy, which is fully on the account on the eurozone. Finally, when the “Five Presidents Report” raves that the euro has become the second largest reserve currency in the world, it fails (a) to mention the importance of the US dollar, and (b) to compare the weight of euro in currency reserves with the weight of the old currencies of member countries of the eurozone before 1999. The combination of the Deutschmark and the French Franc accounted for 20% of global reserves in the early 1990s. In fact, the weight of the euro as a reserve currency matches, almost exactly, the weight of the currencies of member countries of the eurozone before the creation of the euro.

The “Five Presidents Report” repeats the most commonly used disinformation about the euro. Given the list of authors, it was difficult to expect anything else. But this simple fact speaks volumes about the decrepit state of the eurozone.

Even so, with careful reading, there are some hints of critical

**THE SOLUTIONS PROPOSED BY THE “FIVE PRESIDENTS REPORT” APPEAR LARGELY DISCONNECTED WITH THE REALITY OF THE EUROZONE CRISIS. IT IS NOT CLEAR THAT THE THREE-POINT PLAN, PROPOSED BY ITS AUTHORS, HAS ANY MORE TO DO WITH THE ECONOMIC CRISIS THAN WOULD ANY PAPAL ENCYCLICAL PICKED AT RANDOM.**

analysis. The report acknowledges: “relative price adjustment will never occur as quickly as exchange rate adjustment. And we have seen that market pressures can deprive countries of their fiscal stabilizers in a slump (...) (all economies) need to be able to share the impact of shocks through risk-sharing within the EMU... Preventing unsustainable policies and absorbing shocks individually and collectively did not work well before or during the crisis”.

What are the mechanisms proposed by the “Five Presidents Report” to replace exchange rate adjustments (which it acknowledges as infinitely faster than adjustments by domestic prices)? This is the key question for the eurozone, as evidenced by a recent study published by the International Monetary Fund.<sup>2</sup> This study shows that the activity depends to a large extent on exchange rate, and it also shows that the exchange rate of the euro is overvalued for France 6% and undervalued by 15% for Germany, resulting in a 21% gap between the two countries. In this way, the euro is a danger to the consensus that has developed since the Franco-German Treaty of 1963 through to the fall of the Berlin Wall. Many economists now share this dark view. Lord Mervyn King, the former governor of the Bank of England, has just published a book lambasting the euro.<sup>3</sup> Joseph



Stiglitz has similarly just published a book entirely devoted to the risk that the euro poses to the European Union.<sup>4</sup>

With the Treaty on Cooperation and Governance (TSCG) ratified by François Hollande in September 2012, control of the fiscal and budget process, essential elements of sovereignty, are about to be snatched from French hands. If the budget process is outside the control of government, so is the tax process. This new treaty strikes at a foundational

principle of democracy: that the representation of the people, the parliament—and the parliament alone—should have the last word on the budget and taxes. The euro is slowly destroying the old nations that built European democracy and threatens to turn the clock back to before 1789.

The solutions proposed by the “Five Presidents Report” appear largely disconnected with the reality of the eurozone crisis. It is not clear that the three-point plan, proposed by its authors, has any more to do with the economic crisis than would any papal encyclical picked at random. And therein lies the problem. The euro has become a religion, and requires its supporters to hold a religious discourse and display the same utmost observance. ■



Jacques Sapir is professor of economics at EHES-Paris and a well-known specialist on the Russian economy. He has been a constant contributor to the debate about the euro for the last five years. His book “faut-il Sortir de l’Euro” was published in 2012.

*Hans-Olaf Henkel*

# THE EURO AND THE GERMAN MINDSET

In the last few years the EU has been forced to deal with a number of existential crises. Angela Merkel plays a central role in all of them. To understand why the eurozone crisis has dragged on in the way it has, we must understand the mentality of the German leadership. When hundreds of thousands of refugees flooded Germany, many in Europe wondered why

Chancellor Merkel opened the borders despite warnings about the inevitable consequences. Once the social-democratic government of Sweden decided to close its borders to refugees and the Austrian government officially announced a numerical cap of 37.000 refugees per year, Germany found itself in a new role: it succeeded Sweden as the undisputed moral champion of Europe, if not the world.

The trouble is, this policy not only isolates Germany politically; it is counterproductive, too. Through a policy of welcoming refugees to Germany, Angela Merkel incited a large number of refugees to leave not only dangerous, embattled parts of Syria but an unknown and certainly significant number of refugees from relatively safer areas in Turkey, Jordan and Iraq. All of them risking their lives to get to Germany!

It is not the first time that Germany, and in particular Angela Merkel, has tried to impose questionable policies at the expense of German citizens (and indeed, the citizens of other countries), justifying them with superior moral standards. Germany tries to save the world's climate by constantly ramming German green policies down the throat of other European nations. Merkel shut down Germany's

nuclear plants, which were without question the safest in the world. In no other country is the opposition against CETA and TTIP as widespread and as aggressive as in Germany. Lately in Brussels, German politicians tell their Polish colleagues how they have to behave as democrats.

Already in May 2010, with her first rescue package for Greece, Angela Merkel was explicit in her

desire not only to save Greece and the euro, but, according to her own words, all of Europe! She was rolling out the same moral arguments that we have heard most recently justifying her actions in the refugee crisis: Germany has a special responsibility for the euro and Europe for historical reasons.

“ If the euro fails, Europe will fail, too



- has become her mantra ever since, ignoring the fact that those EU countries that wisely decided to stay outside the common currency have done much better than those within the eurozone. When it became all too apparent that the “one time rescue effort” (Merkel) for Greece wouldn’t work and that further rescue packages would need to be sent to Ireland, Cyprus, Spain, Portugal and two additional ones to Greece, Merkel changed her rhetoric first from economic to political reasoning, and finally to a moral justification. Now, the euro had to be saved for maintaining peace and for avoiding World War Three.

Very much like Merkel’s refugee policy, her euro policy resulted, more or less, in the opposite of what she originally intended to achieve. The economic and social consequences of a common currency which turned out to be much too strong for the South of Europe including France and much too weak for some countries in the North of Europe including Germany, are well documented. That’s why I would like to highlight some less known side effects of this policy. Some of these turned out to be so significant that they in themselves justify calling off the euro experiment once and for all.

### 1 THE EURO FORCED GERMANY INTO THE POSITION OF A RELUCTANT HEGEMON.

The euro-policy put Germany into the position of Europe’s largest potential creditor. Consequently, Chancellor Merkel and her Finance Minister Schäuble feel obliged to constantly stick their noses into the economic affairs of the potential debtor countries. They asked for labour reforms in Spain, accelerated privatization in Greece, pushed for less vacation time in Spain and austerity everywhere. While these demands make a lot

### THE TROUBLE IS, THESE POLICIES NOT ONLY DAMAGE GERMANY, THEY HURT GERMANY’S NEIGHBOURS. TIME FOR GERMANY TO TAKE A BREAK, AND HIT THE COUCH!

of economic sense, they make no friends. The German government was elected by Germans, not by the Italians, French or Portuguese. In 2010, before the first bailout package for Greece, which included many German strings attached, Greeks regarded Germany their favourite country in the EU. Soon after, Merkel was twice in Athens, and each time she had to be protected by thousands of policemen. Meanwhile, Franco-German relations have reached all-time post-war lows, entirely thanks to differences in economic and

fiscal policies. Whenever Germans shout “Solidity” across the Rhine, the French reply with “Solidarity”. In other words: rather than create peace, the euro has created distrust and aggression in Europe.

### 2 THE EURO DAMAGES EUROPE’S COMPETITIVENESS.

In order to keep the euro afloat, the euromantics had to prescribe medicine with rather serious side effects. Subsidiarity was replaced by centralization. Self-responsibility for a country’s state and banking debts was replaced by socialization of these debts. Competition between countries was replaced by harmonization. Centralization makes any economic entity, be it a company in the private sector or a political entity, slow to react. Harmonization kills competition.

Socialization of debts creates a dangerous moral hazard. Small wonder that the eurozone countries’ economic growth figures rank as some of the worst in the world.

### 3 THE EURO CONTRIBUTED TO BRITAIN’S EXIT FROM THE EU.

It is not surprising that British citizens often don’t realize how much the euro contributed to “Brexit”. After all, they kept their pound sterling. However, many of the above-mentioned political and economic decisions related to the euro were totally against what the British wanted. Some of them were not only a violation of the Treaty of Maastricht but also of the Lisbon Treaty. Each time a new rescue package for the euro was assembled, the euromantics blamed

a lack of common policies for it. As a consequence, “more Europe” became unavoidable. But Britain never signed up for an “ever closer Union” in the first place! In 2010 only around 3% of Britons voted for UKIP. Four years later - after more and more centralization and harmonization—Nigel Farage’s party became the biggest British party in the European Parliament! No wonder David Cameron felt pressed to promise a referendum on British membership of the EU. There are voices from within the Tory party which claim that the Brexiteers prevailed due to Angela Merkel’s refugee policy. Indeed, Farage and Johnson were able to direct the discussion on whether to stay in or leave the EU entirely on immigration issues.

Both the refugee policy and euro policy are guided by Merkel’s urge

to turn Germany into a moral superpower. The trouble is, these policies not only damage Germany, they hurt Germany’s neighbours. Time for Germany to take a break, and hit the couch! ■

IT IS NOT SURPRISING THAT BRITISH CITIZENS OFTEN DON’T REALIZE HOW MUCH THE EURO CONTRIBUTED TO “BREXIT”. AFTER ALL, THEY KEPT THEIR POUND STERLING.



Hans-Olaf Henkel is a former CEO of IBM Europe and a former head of the German Federation of Industries (BDI). He is a member of the European Parliament and a Vice-President of New Direction.

Jean-Pierre Vesperini

## THE TRAGEDY OF THE

# EMU

## AND A CALL FOR A NEW FRENCH PARADIGM

**T**he trouble is, France's president Francois Hollande's mandate is ending in complete failure and embarrassment. This is true for a variety of reasons, but most relevantly, because of his astonishingly poor record with the economy. Hollande managed to increase unemployment in France at a time when it decreased both in the EU and the euro-area. Between the beginning of his term in 2012 and

halfway into 2016 unemployment increased from 9,7% to 9,9%. In that same period, unemployment in the EU dropped from 10,4% to 8,6%. Even in the euro-area it fell from 11,3% to 10,1%.

There are two underlying reasons for Hollande's failure.

The first is his unquestioning acceptance of European federalist dogmas. Hollande is committed to

the dream of a completely federal Europe in which the euro would reign as the single currency. For this reason, he is convinced of the necessity to respect the rules of the Stability Pact that requires each member to keep public deficits under 3% of the GDP.

Thus, to satisfy the EC, he embarked on a plan to reduce the public deficit in the fall of 2012 to 3% in 2013.

He was presented with two options to achieve this:

- **a reduction in public spending, and**
- **an increase in taxes.**

Unsurprisingly, Hollande chose the track that required less political courage: he increased taxes. This decision is the second reason for the anaemic performance of the French economy under Hollande. The sizable tax hikes on companies and households had the effect of restricting growth. Notably, although Hollande brought down private sector taxes in 2014 and 2015, he continued raising taxes on households through 2015.

The truth is that the single currency is not the only cause of the low growth and high unemployment economic exigencies in France.

President Hollande has also had to respect other constraints, including deeply engrained beliefs about the importance of capital taxes as bulwarks of French socialism, which have been passed down from François Mitterrand. These capital taxes not only frighten off investment but also innovators and entrepreneurs.

**THE EURO PARADIGM MUST ADAPT TO THE NEW REALITIES OF THE GLOBAL ECONOMY, NAMELY, LOW INFLATION AND LOW INTEREST RATES. FRANCE, WHICH CURRENTLY SUFFERS FROM WEAK GROWTH AND MASSIVE UNEMPLOYMENT, MUST THEREFORE SEIZE THE OPPORTUNITY TO UNDERTAKE A POLICY OF ECONOMIC RECOVERY, PREDICATED ON INCREASING THE PUBLIC DEFICIT TO FUND INVESTMENT, AND DECREASING TAXES.**

Hollande will almost certainly lose next year's presidential elections, which may mark the end of the worst measures of French Socialism and its destructive capital tax regime. This is a relatively new development. Until now, no political leader from the conservative party has dared to roll back capital taxes: neither Jacques Chirac in 1995 or 2002, nor Nicolas Sarkozy in 2007 or 2012. There is every indication that in 2017 that could change.

But even if the 2017 elections see the end of the constraints of French socialism on economic growth, it is less clear how the equally restrictive policies emanating from Brussels can be lifted.

Of course, no French government, left or right, has fully respected Brussels' budget policies. But, at the same time, no government has challenged the legitimacy of those rules.

The time has come, on the eve of this crucial presidential election, to ask ourselves whether or not we should change this paradigm. There are at least two reasons why the French people ought to seriously reconsider how they respond to EU economic dictates.

First, the French economy is characterised by excessive tax pressure both on the private sector and on households. Any plan for renewed economic growth in France would require a whole new tax policy. In constructing a new tax regime and fiscal policy, it would be impossible to respect Brussels demands every step of the way—those rules will have to be broken at least in the short term. Hence, if a newly elected French government is to take on serious pro-growth policies, it will have to change its approach to Brussels.

Second, and more generally, the radical shift in the global economy (and specifically in the Eurozone) calls for a new paradigm. At present, all euro-area governments operate on

the basis of three assumptions which have wafted from the Bundesbank:

- **inflation is the worst imaginable evil,**
- **inflation is always the result of excessive monetary supply, and**
- **excessive money supply is caused by central banks covering public deficits.**

The fight against inflation limits the public deficit and forbids central banks from intervening to fund it.

Today, those beliefs do not square with the facts. Indeed, the ECB is funding public deficits in the euro-area with an extensive quantitative easing policy without any inflation because of an excess of savings, globally. The euro paradigm must adapt to the new realities of the global economy, namely, low inflation and low interest rates. France, which currently suffers from weak growth and massive unemployment, must therefore seize the opportunity to undertake a policy of economic recovery, predicated on increasing the public deficit to fund investment, and decreasing taxes.

Increases in the public deficit must be coupled to structural reforms aimed at lowering social spending, especially on retirements. ■



Jean-Pierre Vesperini is a professor of economics. He taught at l'Institut Catholique de Paris, Sciences Po Paris, HEC. He was a member of the French Prime Minister's Council of Economic Analysis.

Joachim Starbatty

# A TRUE KEYNESIAN PERSPECTIVE ON THE EUROZONE CRISIS



The remedy of John Maynard Keynes—that governments should increase spending to stimulate economic recovery in a recession—is often proposed as a solution for the overindebted countries of the eurozone’s

south. But for the countries at the euro-area’s periphery, this approach would not provide a reliable path back to growth. In his epoch-making book “The General Theory of Employment, Interest and Money” (1936) Keynes demonstrated that idle production

capacity and workers could be put to use with government spending. What he does not discuss at all is competitiveness, which is the heart of the problem facing the eurozone’s crisis economies. Deficit spending must be understood as a bridge. Keynes offers a way to

make use of idle resources until market demand picks up again. However, government spending will not achieve an efficient allocation of production factors, when there were none to begin with. In short, it cannot resolve the problem of underlying economic uncompetitiveness. Also, large-scale public spending would require more public debt, which in many countries is already unsustainable.

In Keynes’ “General Theory,” we do, however, find a suggestion that an economy can fight against unemployment by manipulation of its exchange rate. A government faced with high unemployment can stimulate employment by devaluing its currency, which translates to exporting more goods and importing employment. Consequently, trade

counterparts import more goods and export employment. The catchphrase for this strategy is “Beggar-my-neighbour-policy”. And this is what is happening in the eurozone. The

currency union’s main problem is a false relative price: The value of the euro is too low for Germany and too high for the countries of the Southern periphery. In Germany, the surplus in the balance of payments has increased from 1 percent in 2000 to more than 8 percent now and the unemployment rate has fallen from 11 in 2005 to 5 percent at present, whereas the unemployment rate in the Southern periphery has nearly doubled. That is clear empirical proof of a “Beggar-my-neighbour-policy”. It makes sense that German exporters are content with the euro regime; but it is incomprehensible that the governments of countries in the Southern periphery stick to a monetary system that is ruining their respective countries.

There is only one road for them to come back to economic prosperity:

significant devaluation of re-established national currencies. In some cases, a debt write-off will be needed. The German government knows of course about the false relative price and forces the governments of the Southern periphery to devalue internally by lowering wages because of increasing unemployment, austerity policy and diminishing imports. We can learn in detail from Keynes what happens to governments that follow the recipe of German Chancellor Angela Merkel. In his “Tract on Monetary reform” (1923) he harshly criticised the deflationary policy in France to protect an overvalued franc. After the Great Depression, Britain and the U.S. heeded this advice and abandoned the gold standard. The British pound and the US dollar depreciated, and they became

**THE EURO IS A SYMBOL FOR EVER-CLOSER UNION. THEREFORE, IT IS DEEMED POLITICALLY “INCORRECT” IN THE EU-ESTABLISHMENT TO QUESTION THE EURO’S CURRENT FORM, DESPITE THE IMMENSE SOCIAL COSTS IN SOUTHERN EUROPE.**

more competitive than France. The French government faced the choice of either depreciating as well, or to pursue a deflationary policy of spending cuts in order to regain competitiveness. Keynes observed that “not even a reckless politician should pursue a policy that is to halve wages, double the burden of the national debt and to drastically reduce the prices obtained for exports.” Sound familiar? The troika and politicians from Europe’s creditor countries have implemented precisely this policy for six years. So, even if increasing government spending cannot solve the crisis, cutting expenditure, pensions and wages only make matters worse.

Keynes dedicated a whole chapter of his “Tract” to the question of whether a nation should pursue deflationary policies or devalue

its currency. He came to a clear conclusion: the right policy for countries is to devalue, and to find an appropriate value of the currency to which commerce and wages are adjusted. Hence, countries should pursue an external devaluation, i.e. an adjustment of their exchange rate, instead of an internal devaluation in form of wage cuts. If Keynes lived today, he would recommend a Grexit and the exit of other countries in economic depression. A return to national currencies would also restore individual countries’ power over their monetary policy, which could finally align with the needs of each respective national economy. Locking Germany and Greece together in one monetary policy was doomed to have disastrous consequences. The current situation is not a surprise, but a logical extension of the European Monetary Union.

Why does the political elite in the European Union refuse to even talk about the notion of a country exiting the eurozone, let alone develop a long-overdue legal framework for such an event? The only answer is: The euro is now about ideology. The euro is a symbol for ever-closer union. Therefore, it is deemed politically “incorrect” in the EU-establishment to question the euro’s current form, despite the immense social costs in Southern Europe. ■



Joachim Starbatty is professor emeritus at the University of Tübingen. He is a Member of the European Parliament.



*David Liebers*

# UKRAINE

## THE UNNAMED VICTIM OF THE EUROZONE CRISIS

“ As for you, my dear  
Ukraine, Widow  
without fortune...  
I shall fall to you  
at midnight... Then  
together we'll take  
counsel, grieving for  
our woe.

– Ukrainian poet Taras  
Shevchenko, *The Dream*

**A**pologists for the European single currency often fall back on this defense: “the euro was from the beginning a *political* not *economic* project, so we should not allow economic setbacks to change our views.”

This justification—as fatuous as it is popular—betrays a dangerous assumption about politics and economics existing as independent spheres, one walled off from the other. The truth is that just as political decisions affect economics, economic conditions can, in turn, have political consequences. Those that fail to heed this fundamental point will also fail to understand that Europe’s present economic malaise, rooted in the euro, has fueled the shift towards populism across the continent.

As a result of this new political balance, Europe is suffering a defeat in its most significant geopolitical test since the 1990s: Ukraine.

Fragile economic conditions and high unemployment in the eurozone have sharpened populists’ message and increased voters’ skepticism about Europe’s ties with its neighbors. Across the continent these are good times for populist politicians of all stripes.

This shifting political mood helps explain why, in April, the Netherlands voted against the European Union’s proposed association agreement with Ukraine, which would have seen deeper political integration and a free trade area without Ukraine actually joining the Union. The

striking 14-point margin in the Dutch national plebiscite signaled a decisive European turn away from its eastern neighbor.

The symbolism could hardly have been plainer: the Dutch rejected the very same agreement for which a generation of Ukrainians have fought, and in some instances, died.

Geert Wilders, the hard-right, populist leader of the Dutch Party for Freedom, led the campaign against the agreement. He explained his position to the Kremlin-funded Russia Today television network in this way: “the Dutch voters don’t want to spend any more money on... or have any more immigrants from those countries.” Dutch voters do not have any special enmity for Ukraine or its people. Rather

**UKRAINE WAS AT THE CENTER OF WHAT HISTORIAN TIMOTHY SNYDER FAMOUSLY CALLED THE “BLOODLANDS” OF THE 20TH CENTURY—THAT GEOGRAPHIC BAND OF EASTERN EUROPE THAT SUFFERED MOST GREATLY AT THE HANDS OF TOTALITARIANISM. LIBERATION OF UKRAINE FROM ITS TRAGIC FATE IS STILL POSSIBLE.**

this vote was an opportunity for a surging isolationist, populist force in Dutch politics to express its hostility towards the EU and wariness about its expansion.

If the same referendum were put to the people of other Western European countries it is increasingly likely that the outcome would be the same. After successive bailouts across the continent’s economically despondent south, many Europeans are unwilling to support the kind of economic assistance necessary for stabilizing Ukraine. George Soros observes that Ukraine has been treated like a “second-class Greece,” which will ultimately lead Europe to turn the “new Ukraine back into the old Ukraine.” Ukraine needs its own Marshall Plan, and far more debt reduction than was offered in 2015. But if the EU is to be a serious partner for Ukraine, it needs to return to a path of economic growth and security itself.

Doubtless, there is much to blame on Ukrainian politicians who have not delivered on pledges to root out endemic corruption. This has provided an easy excuse for Europeans to turn their backs on Ukraine. The prevailing view is that that “a corrupt Ukraine is not worth the investment and political risk, especially given the disastrous eurozone saga.” This betrays a complete misunderstanding of what EU leadership can mean.

The case of Romania demonstrates that EU-backed anti-corruption efforts can be crucial in facilitating a transition towards a political culture based on the rule of law. European pressure helped Romania build transparent institutions, and it can help Ukraine.

Moreover, the crisis in Ukraine is not like the crisis in Greece—although each affects the other. Greece is suffering because of the single European currency, and will continue to do so until European leaders muster the courage to oversee a controlled breakup of the eurozone. Ukraine, on the other hand, is struggling to sketch out a path towards a future more in line with the political and cultural values of the Europe, rather than one tied to Vladimir Putin’s Eurasian Union. To abandon those with democratic-values in Ukraine is to vindicate Putin’s gamble that annexing part of another European country would not be met with a serious response.

Ukrainians who took serious risks for change have been let down by the politicians who promised them a new Ukraine, and now they are in danger of being left behind by a new Europe: one of populism, isolationism, and vulnerability. Today, Ukraine is just one symptom of this new Europe’s geopolitical impotence.

If Europe chooses to abandon Ukraine, the stakes are high. This is true because historically, there have been so few opportunities for Ukraine to make a serious political bid to join the European family of nations.

The last chance was in 1920. Against the background of the collapse of the Russian empire, Polish and Ukrainian leaders Józef Pilsudski and Symon Petliura laid the basis for a political and military partnership that allowed them to momentarily repulse incursion by Russia’s new Bolshevik Soviet

state. Both took criticism from nationalists in their respective countries for doing so, but the agreement represented real opportunity for a free Ukraine to emerge and was an early manifestation of what would now be called “European solidarity.” That possibility collapsed as the Soviets prevented the formation of an independent Ukraine at the conclusion of the Polish-Bolshevik war in 1921. The Western powers did not intervene to help Ukraine in 1920. Now, again, the fate of the country will be depended up to a large point on how the West reacts.

Ukraine was at the center of what historian Timothy Snyder famously called the “Bloodlands” of the 20th century—that geographic band of Eastern Europe that suffered most greatly at the hands of totalitarianism. Liberation of Ukraine from its tragic fate is still possible. Events in 2014 offered a new chance for Ukraine. Yet, Europe seems prepared to discard this latest opportunity to guide Ukraine’s fate. Ukraine does not deserve to be sacrificed on the altar of the euro, but it has become difficult to imagine any other possible conclusion. ■



David Liebers serves on the board of the Warsaw-based Democratic Initiative Foundation. He is a Humanity in Action Senior Fellow and was previously a Gates-Cambridge Scholar in the History of Science at Trinity College, Cambridge, and Fullbright Scholar in Warsaw, Poland

Pieter Cleppe

# BR€XIT

## THE EURO'S FIRST MAJOR BLOW TO THE EUROPEAN UNION?



In his book “The Euro: The Politics of the New Global Currency”, David Marsh shows that the drive to forge a common currency in Europe was animated by the traumatic experience of the break-up of the Bretton Woods agreement in 1971, when the US declared it would default on its obligation to exchange the dollar reserves of European nations for gold.

At the beginning of the 1990s, a system of fixed exchange rates was in place in Europe, in preparation for this planned common currency. In 1992, investor George Soros made a lot of money as his speculation forced the British government to pull the pound from the European Exchange Rate Mechanism (ERM). Soros understood Germany would not be willing to take extreme measures to keep Britain in the ERM, an insight lost on many in the City of London.

Similarly to the euro crisis that would come later, this humiliating chain of events did not stop the big project from proceeding. The 10 year borrowing costs of struggling European countries such as Italy, Spain or Belgium continued to stay high over the next few years. No half-hearted budget cuts, gold sales or tax hikes succeeded in bringing them down. The only measure that lowered borrowing costs was the decision to create a common currency. In 1995, investors became convinced that the common currency would be a reality and that Italy and other weaker European economies would become members. This is evidenced by the fact that this was the last peak before which borrowing rates dropped off precipitously. For each of the eurozone’s member states, the prospect of entering the common currency zone resulted in a drastic reduction in borrowing rates.

Why does this matter? It matters because it explains how the euro

was not born as a result of positive experiences with fixed exchange rates or of some ideological consensus. There were many opponents, not least in Germany, but also in France, where almost half of the population voted against the Maastricht Treaty, which provided the euro’s framework. Rather, the euro emerged because it allowed politicians to postpone painful decisions and in some cases even outright state defaults. When politicians were desperately scrambling for ways not to have to cut spending in the 1990s, they eventually discovered that deciding to create a common currency allowed them to kick the can down the road. As the US dollar has proven for decades, a

**SIMILARLY TO THE EURO CRISIS THAT WOULD COME LATER, THIS HUMILIATING CHAIN OF EVENTS DID NOT STOP THE BIG PROJECT FROM PROCEEDING. THE 10 YEAR BORROWING COSTS OF STRUGGLING EUROPEAN COUNTRIES SUCH AS ITALY, SPAIN OR BELGIUM CONTINUED TO STAY HIGH OVER THE NEXT FEW YEARS.**

large currency zone affords more mismanagement, in terms of loose budgetary or monetary policy, than a small currency zone.

Just as the euro was pushed through despite the opposition of a large part of the political class, it has now given rise to a transfer union, despite the reluctance of both Northern European politicians, who had to defend to the system of transfers to their taxpayers, and Southern European politicians, who had to accept the conditions and foreign interference linked to the transfers.

Just as the common currency emerged unintentionally, also eurozone protectionism, which

endangers the whole EU project, may emerge as a result of events. When Spanish banks got in trouble in 2012, frightened Northern European politicians provided Spain with a 100 billion euro bailout, they could only get away with this move, politically, by ensuring that the bailout had strings attached. In this case, the strings amounted to a concession that a eurozone framework for financial supervision would be created, parallel to the EU framework, to supervise Spanish and other eurozone banks. The ECB was entrusted with this task, and thereby directly ended up in direct competition with an existing EU banking watchdog, the “European Banking Authority” (EBA) in London.

One can imagine that after yet another round of bailouts and further, stricter prescriptions for banks, eurozone banks may start to lobby to exclude competitors who enjoy market access in the eurozone without having to comply with ECB rules. In short: common eurozone rules might easily serve as an excuse for keeping out external non-eurozone competition in the future. The aftermath of the Brexit vote and the many warnings from the continent about Britain losing its single market access hint at the underlying desire to kill off competition from outside the eurozone.

The ECB has proved not to be immune for the protectionist virus. Already a few years ago, it tried to force clearing houses to relocate to the eurozone if they wanted to continue clearing in euros. This attempt at grabbing business from London failed and the ECB had to back down, thanks to Britain’s EU membership, which allowed the UK government to exert some pressure.

As Britain leaves the European Union, further, more aggressive, attempts will likely be made to

export eurozone rules outside of the common currency zone. This in turn will likely boost anti-EU sentiment in Denmark, Sweden and Poland, which may have their financial institutions barred from the eurozone market. Once the EU's free movement of capital is damaged, it is only matter of time before the freedom of movement of services, persons and goods comes under fire.

Still the differences within "old Europe" are quite material and this itself may be the reason for a hypothetical future EU break up. It is unlikely that the far right in France or the populist left in Italy will manage to convince the citizens of those countries to leave the euro by referenda, because of fears that savings would be ruined in ensuing banking crises. If the euro does blow up, it will likely be the result of some financial event, not a political one. Such a scenario would force the German government to

make a choice: will it only bail out its own banking system or will it bail out the banking systems of the Benelux, Austria, France and Italy as well? The German government would not have more than a few hours to make this choice. Perhaps on the next two occasions when it has to make this choice, it will

**GIVEN THE SERIES OF EURO CRISES THAT WILL CONTINUE INTO THE FUTURE, AND WHICH EVENTUALLY MAY LEAD TO ITS DEMISE, IT IS NOW CRUCIAL TO MAKE THE CASE FOR AN ARRANGEMENT IN EUROPE THAT SECURES THE RIGHT TO DO BUSINESS AND MOVE CROSS-BORDER, AND MAKE SURE THIS GREAT PART OF EU COOPERATION ISN'T TAINTED BY THE FAILURE OF THE EURO.**

again decide to bail out the whole of Europe. Perhaps the German government will go much further than anyone can now imagine—but at some point, enough will be enough.

Why would there be financial crises forcing the German government to make such a choice? The answer to this question is not just about

the euro. It is related to the nature of our fractional reserve banking system, whereby banks are allowed to only keep a fraction of the funds they owe to their clients in reserve. This is a means by which the total amount of money in circulation can be expanded, which drives down the price of money, also known as the interest rate. This in turn allows governments to refinance their old loans more cheaply, so they can avoid raising taxes. The unsustainable investment following excessive creation of money produces investment bubbles and financial crises.

When these appear in Japan or the United States, the odds are high that the respective governments will bail out the whole currency zone, even when this means they have to impose significant financial repression. In Europe, this is more difficult, given that the burden wouldn't be suffered evenly across the monetary union. Nationalism would pop up as violently as it

did in Greece, where anti-German sentiment was rife during the eurocrisis, which even led to a Greek Parliamentary investigation aimed at pushing for German World War II reparation payments.

Why should the EU break up when the euro collapses? There is no reason that it should, but politicians like Angela Merkel have linked the two together, in order to get away with eurozone bailouts. In 2011, she said: 'If the euro falls, Europe falls'. One can only hope people understand that to have a common currency is different than to have a treaty whereby countries promise not to impose trade barriers upon each other. When banks close and people lose considerable parts of their savings that message may be a hard sell and human folly may rule the day.

Still, one shouldn't be overly pessimistic. Already now, many have understood that to have savings in the bank is a risky undertaking, and that it's probably a good idea to shift a part of one's wealth into hard assets like real estate, stocks and physical gold and silver, despite the fact that also these investments come with great volatility and risks. Today in 2016, only a tiny part of services are compensated in private "cryptocurrencies", of which Bitcoin is the most popular, but this will only grow. This kind of currency has proven to be very volatile and risky, but at the same time they have proven to be a very effective way to avoid capital controls, while the technology behind bitcoin, blockchain, has now been adopted by major banks. If in 20 years time, one third of transactions would be in private currency, a breakdown of the public money system in Europe may be much less traumatic than it would be today.

Another alternative is of course that we could just see the German government effectively allowing

the full erosion of savings in the eurozone in order to save the euro-project, but this isn't likely, given the current German hostility against such payments. Some may think that common eurozone joint debt issuance may save the eurozone, but this overlooks the fact that the ECB has been the crucial actor in propping up the currency zone, precisely because there was no political support for doing bailouts in a more transparent manner, through the eurozone's lending schemes, such as ESM and EFSF. According to prominent German economist Hans-Werner Sinn, the ECB has provided for about 75% of the bailouts in the eurozone.

Alternatively, we could see moves towards a world currency, in the framework of the IMF's "Special Drawing Rights" (SDR). In the same way that the decision to create the euro effectively bailed out struggling European welfare states, the debt-crippled industrial nations of today may get a few decades respite as a result of beefing up the SDR system. US economist Jim Rickards suggests that the world's bad debt could be rolled up into the Special Drawing Rights (SDR), which he thinks is also why China has been buying SDRs on the market.

Of course, there are two sides to this coin, and savers would pay the price for such a move. Perhaps there may simultaneously be moves to reboot the system. There may be "bail-ins" or operations to recapitalize banks through the shrinking of the money supply, similar to what happened right after World War II.

Britons had a lot of reasons to vote to leave the EU. What they most certainly did not like, was that the club which was supposed to be about scrapping trade barriers turned out to be a club mostly centred around a common currency helping to boost an

ever-centralising bureaucracy and helping to prop up virtually bankrupt European welfare states. Without the eurocrisis, which gave the EU such a bad reputation, the British may well have voted to stay, despite concerns about freedom of movement. Brexit is just the first big blow the euro has inflicted on the European Union.

At the moment, elites in Berlin, Paris and Rome still believe they will manage to save the euro project through a "transfer union", despite the fact that the large eurozone transfers since 2010 (and before, through the ECB) have done little to mitigate the crisis. Given the series of euro crises that will continue into the future, and which eventually may lead to its demise, it is now crucial to make the case for an arrangement in Europe that secures the right to do business and move cross-border, and make sure this great part of EU cooperation isn't tainted by the failure of the euro. Otherwise, the enemies of free and open trade will happily seize the occasion to kill the EU, alongside with the euro. ■



Pieter Cleppe is the Head of the Brussels office of Open Europe. Pieter previously practiced law in Belgium, and has worked as a cabinet advisor and speechwriter to the Belgian State Secretary for Administrative Reform. He received his legal training at the Catholic University of Leuven, and also studied economic analysis of law at the universities of Hamburg, Bologna and Vienna

Stefan Kawalec

# THE EUROZONE IMBALANCES AND GLOBAL TRADE CONFLICTS

The euro is a problem not only for Europe but also for its trading partners, and the whole global economy. The eurozone's inability to liquidate internal imbalances, together with a very tense social and political situation in crisis-hit countries, is forcing it to desperately try to generate trade and current account surpluses. This is likely to be a permanent situation which, given the eurozone's leading position in the world economy, will have a detrimental impact on other countries and thus may spark global currency wars and inhibit international trade.

A controlled dismantlement of the eurozone would be beneficial for its crisis-hit members and for Europe's trading partners, and - contrary to appearances - also for Germany.<sup>1</sup>

## 1 PROLONGED STAGNATION IN SOUTHERN EUROZONE COUNTRIES AND THE DANGER OF GLOBAL CURRENCY WARS

### THE DISASTROUS CONSEQUENCES OF AN INTERNAL DEVALUATION POLICY

In 2010, when the eurozone crisis erupted, it was estimated that in order for the southern EU countries (such as Greece, Italy, Portugal, and Spain) to regain competitiveness and repair their trade and current account balances, they needed to bring their wages down by 20-30% in relation to wages in their trading partners. However, the eurozone countries in crisis cannot improve their competitiveness through currency depreciation. Instead they have been trying to implement a so called "internal devaluation" which is the contemporary equivalent of the deflation policy applied during the Great Depression in the 1930s in order to defend the gold standard system. The scale and duration of economic collapse in the crisis-hit eurozone countries is comparable to and in some cases even greater than it was during the Great Depression.

### IN A WEAKENING THE EURO WE TRUST

Many observers noted that a weakening of the euro could be the most effective macroeconomic tool via which the European Central Bank (ECB) could help the eurozone's struggling member countries. On many occasions

economists and politicians have called on the ECB to weaken the euro in order to improve the situation in struggling eurozone member countries. Ultimately, in the middle of 2014, a combination of factors such as European quantitative easing (QE), the introduction of negative deposit interest rates by the ECB, US QE tapering, the prolongation of the eurozone crisis and a revival of the US economy resulted in the beginning of a slide of the euro. The euro exchange rate decreased from the monthly average of \$1.37 in May 2014 to \$1.08 in March 2015 and over the next few months, it fluctuated near this reduced level.

### CURRENT ACCOUNT SURPLUS IS HIGHER THAN IN CHINA

In 2010, when the eurozone crisis erupted, France and the eurozone's southern countries such as Greece, Italy, Portugal and Spain, had an aggregate current account deficit of 159 billion euros. This deficit was counterbalanced by a surplus of 145 billion euros in Germany, as well as surpluses in the Netherlands and Ireland. Altogether, the eurozone had a small current account surplus of 36 billion euros (USD 48 billion) or 0.4 percent of its GDP.

In the following years, current account deficits in the eurozone's

southern countries diminished or disappeared as a result of the economic recession and a weaker euro. At the same time, current account surpluses in countries like Germany increased, causing the Eurozone's overall surplus to swell. In 2015, the eurozone's current account surplus of 330 billion euros (USD 366 billion) or 3.6 percent of its GDP was, for the third consecutive year, the largest among the world economies, including China. The eurozone became a main source of global imbalances.

### THE DANGER OF GLOBAL TRADE CONFLICTS

In the entire global economy, both the current account and trade are by definition balanced. Therefore, maintaining huge surpluses in the eurozone means that other economies in the world must have significant current account and trade deficits, which results in slower economic growth and higher unemployment. Taking into account the great size of the eurozone economy, and the scale of its international surpluses, Europe's trading partners are unlikely to tolerate such a situation for long. If eurozone surpluses continue, sooner or later they will spark an international trade war with dire consequences for Europe, its trade partners and the whole global economy.

1. This article draws from the following texts:

- S. Kawalec and E. Pytlarczyk, Controlled Dismantlement of the Eurozone: A Strategy to Save the European Union and the Single European Market, "German Economic Review", 14 (1), February 2013, p. 31-49.
- S. Kawalec and E. Pytlarczyk, Controlled Dismantlement of the Eurozone: A Proposal for a New European Monetary System and a New Role for the European Central Bank, National Bank of Poland Working Paper No 155, Warsaw 2013. [http://www.nbp.pl/publikacje/materialy\\_i\\_studia/155\\_en.pdf](http://www.nbp.pl/publikacje/materialy_i_studia/155_en.pdf).
- S. Kawalec, Europe's Currency Manipulation, "Project Syndicate", <http://www.project-syndicate.org/commentary/euro-currency-manipulation-by-stefan-kawalec-2015-04>, 2 April 2015.
- S. Kawalec, The permanent necessity to undervalue the euro endangers Europe's trade relations, Paper for 12th EUROFRAME Conference on Economic Policy Issues in the European Union "Challenges for Europe 2050", organized by the EUROFRAME group of research institutes, Vienna, Austria, 12 June 2015.
- S. Kawalec, The Euro as a Threat to European Integration, "That Sinking Feeling", New Direction - the foundation for European reform, Autumn 2015, p. 6-9.
- S. Kawalec and E. Pytlarczyk, Paradox euro. Jak wyjść z pułapki wspólnej waluty (The Euro Paradox: How to Break Out of the Trap of a Common Currency?), Pol-text, Warszawa 2016.

# 2 FALSE HOPES FOR FIXING THE EUROZONE'S INTERNAL IMBALANCES

## GERMANY IS UNLIKELY TO VOLUNTARILY DESTROY ITS HARD-WON COMPETITIVENESS

An unsolvable problem for the ECB is that the euro remains too strong for the depressed southern countries and too weak for Germany. While allowing it to appreciate would help to reduce the current-account surplus, it would also exacerbate the economic distress in the depressed southern countries. This, in turn, would further strengthen the populist and anti-European political movements that have capitalized on social hardship to win support.

Some observers believe that the eurozone's internal imbalances can be reduced if Germany increases infrastructure spending and allows wages to rise faster. But for many Germans, who withstood difficult social-security and labor-market reforms in 2003-2005, a deliberate effort to diminish

hard-won competitiveness gains is not an option. The fact that 63% of German exports go to countries outside the eurozone – meaning that German companies must be able to compete with their counterparts all over the world, not just in the monetary union – makes the issue even more sensitive.

## PROGRESS TOWARDS A FISCAL UNION WOULD NOT HELP

Other observers claim that further integration, especially progress towards a fiscal and political union, would provide the zone with alternative instruments – namely, wealth transfers – to improve depressed countries' competitiveness. But, as Italy and Germany have learned in their largely failed (and extremely expensive) efforts to stimulate uncompetitive regions, such expectations are unjustified. Indeed, despite spending huge amounts of taxpayer money – amounting annually to 16% of regional GDP in southern Italy and

25% of regional GDP in eastern Germany – the Italian and German economies have gained little.

In fact, an attempt to improve the competitiveness of depressed areas within a currency union through fiscal transfers is a contradiction in itself. The inflow of funds to countries that are trying to regain competitiveness through an internal devaluation policy only undermines this very policy. While an internal devaluation policy intends to diminish domestic demand in order to decrease prices and wages, incoming fiscal transfers boost domestic demand and contribute to wage and price increases, and thus make it more difficult to regain competitiveness.

## THE AMERICAN EXPERIENCE DOES NOT PROVIDE ANY HOPE EITHER

Supporters of the euro often point to the United States, which is similar to the European Union (EU) in terms of total area,

population and level of economic development. They conclude that since the US economy can operate successfully with one currency, the same could happen in Europe, provided the eurozone's architecture is adequately enhanced.

However, the American way of dealing with regional imbalances would be hardly acceptable for European countries. Some US states and territories have been permanent recipients of net federal transfers exceeding annually 10 percent of local GDP. Those transfers do not help to resolve problems of non-competitiveness of recipient states and territories, but simply provide resources to finance the deficits resulting from those problems. As demonstrated in the classic study by Olivier

Jean Blanchard and Lawrence F. Katz,<sup>2</sup> the factor that solves the problem of higher unemployment in distressed US regions is not “internal devaluation,” i.e. local wage adjustment, but the emigration of people of working age to other parts of the country. The strengths of the American adjustment mechanism (as well as some of its extreme effects) can be seen in the cases of Detroit and Puerto Rico, as described by “The Economist”.<sup>3</sup>

Detroit, the former capital of the American motor industry, has lost thousands of jobs. However the unemployment level in the city (5.7 percent in 2015) is only slightly higher than the American average, and substantially lower than in the eurozone (10.9 percent in 2015). This is because inhabitants have left the

city. Detroit's population decreased by 62 percent - from 1,850,000 in 1950 to 700,000 in 2013. The city's problem is not unemployment, but a low number of inhabitants, who are unable to finance local infrastructure. As a result, Detroit filed for bankruptcy in 2013.

In Puerto Rico, which is a US dependent territory, unemployment has long been constrained by emigration. The territory is now inhabited by 3.5 million people, while 5 million, i.e. 59 percent of Puerto Ricans, live in other parts of the US. The shrinking economy and population, however, are no longer able to finance the obligations of Puerto Rico. “The Economist” claims that sooner or later, the federal government will have to take over some of the island's debts.

# 3 WITHIN THE EUROPEAN UNION, THE OPTIMUM COMMUNITY LEVEL FOR A CURRENCY AREA IS THE MEMBER STATE

## NEITHER LONG-TERM STAGNATION NOR MASS EMIGRATION ARE ACCEPTABLE SOLUTIONS FOR THE EUROPEAN NATION-STATES

Europe consists of countries with different languages characterized by different historical and cultural traditions. Nation states constitute the major source of citizen identity; they also serve as the source of governments' democratic legitimacy. For the cohesion of the European Union and its member states, it is important that European citizens

have the best possible chances for personal development and well-being in their own countries. Neither long-term stagnation nor mass emigration are acceptable solutions for Europe's nation-states. In addition, permanent fiscal transfers financing the deficits of some nation-states are hardly an acceptable solution in the eurozone, as evidenced by a report by presidents of five leading European institutions.<sup>4</sup>

In emergencies, exchange rate change is an effective and basically irreplaceable adjustment mechanism that improves the competitiveness of a given currency area. Therefore,

it is rational that the power to use this instrument should be located at the level of the community at which citizens identify most, and to which they are prepared to delegate responsibility for their fate. In the case of the European Union, the optimal community level for a currency area is the member state. Within a nation-state, both migration and permanent fiscal transfers are not politically disruptive and could be acceptable.

Depriving member countries of their currencies may, contrary to intentions, menace the future of the EU instead of fostering further European integration.

2. O. J. Blanchard, L. F. Katz, Regional Evolutions, „Brookings Papers on Economic Activity”, 1:1992.

3. „The Economist”, For richer, for poorer: One way or another, America's government will end up bailing out Puerto Rico, November 28, 2015.

4. The presidents of the European Commission, the Euro Summit, the Eurogroup, the European Central Bank, and the European Parliament, presented cautious preliminary ideas for the Eurozone budget under the euphemistic term of “a euro area fiscal stabilisation function”. They however stated that: “It should not lead to permanent transfers between countries or to transfers in one direction only ... It should also not be conceived of as a way to equalise incomes between Member States.” See: The Five Presidents' Report: Completing Europe's Economic and Monetary Union, report by: Jean-Claude Juncker in close cooperation with Donald Tusk, Jeroen Dijsselbloem, Mario Draghi, and Martin Schulz, The European Commission, 22 June 2015, p. 15.

# 4 EUROZONE DISMANTLEMENT COULD BE BENEFICIAL NOT ONLY FOR CRISIS-HIT EUROZONE MEMBERS BUT ALSO FOR EUROPE'S TRADING PARTNERS, AND FOR GERMANY

## A CONTROLLED DISMANTLEMENT OF THE EUROZONE COULD IMPROVE THE SITUATION OF SOUTHERN COUNTRIES

In order to save the European Union and the common market, the eurozone should be dismantled in a controlled manner. Eurozone segmentation conducted in the most obvious way i.e. via the exit of less competitive countries could result in bank runs and the collapse of the banking sectors in these countries. Therefore some economists propose a different scenario, in which the eurozone is dismantled from the other end via the gradual exit of the most competitive countries.<sup>5</sup> Along with the segmentation of the eurozone, a new mechanism for currency coordination should be established in Europe aimed at preventing currency wars as well as the excessive appreciation of the new German currency. The proposed segmentation of the eurozone would enhance the competitiveness of the southern countries via currency depreciation. Some countries may still need debt restructuring. The scale and cost of this debt reduction would however be smaller, than if these countries stayed in the current eurozone and if their economies suffered a below-potential level of economic activity and high unemployment.

## A EUROPE WITH NATIONAL CURRENCIES COULD HAVE BETTER TRADE RELATIONS WITH THE REST OF THE WORLD

According to a popular view, the EU needs a single currency to operate successfully in the world economy among big players like the US, China and India. However, the single currency forces the eurozone to try to desperately generate trade and current account surpluses, which could spark currency wars with its main economic partners.

If the eurozone countries returned to their national currencies, linked through adjustable currency bands, trade and current account deficits in countries in crisis could be eliminated. This could be achieved by balancing imbalances among present eurozone members, without generating a huge surplus by the eurozone as a whole, and thus without causing an overall negative trade effect in Europe's trading partners. This would be more advantageous to Europe's trading partners than the 'defending the euro at all costs' situation, in which the eurozone is likely to build a substantial trade surplus by suppressing the value of the euro.

## GERMANY WILL AVOID A HARD LANDING

According to a widespread view, the euro dismantlement and the

return to national currencies in Europe would have negative consequences for Germany, as the new German currency would appreciate, causing the country's trade surplus to shrink or even turn into a deficit. Michel Pettis argues however that Germany's huge trade and current account surplus is unsustainable. Sooner or later Germany will have to undergo an adjustment process which would reduce its surplus at the cost of slower economic growth. The severity of this adjustment will depend on the circumstances. If an adjustment is forced during the global downturn, it can be very severe. Pettis gives the example of France, which in 1930 had a high trade surplus and low debt. It was thought therefore that it would be resistant to a forthcoming worldwide depression. But it turned out differently and France suffered during the Great Depression of the 1930s disproportionately more than other countries.

A permanent trade surplus is not a buffer that protects an economy from the effects of adverse changes in economic conditions. A permanent surplus is a sign of inflexibility, reflecting the inability of the economy to utilize its labor resources in the situation of balanced foreign trade. This state of affairs exposes the country to great risk. A sizable economy cannot rely on a

## A CONTROLLED DISMANTLEMENT OF THE EUROZONE WOULD ALLOW GERMANY TO SOLVE THE PROBLEM OF A PERSISTENT TRADE SURPLUS IN A GENTLER AND SAFER WAY THAN OTHER POTENTIAL METHODS.

trade surplus indefinitely. If the economy itself is unable to reduce this surplus, sooner or later this will happen as a result of changes in the policies of its trade partners or changes in the world economic situation. An inflexible economy, dependent on trade surplus, in this case is the most likely to undergo a hard landing that would mean recession and rising unemployment. Currently, the risk of a hard landing threatens the Chinese economy, which raises concerns and anxiety around the world. One day, a hard landing will also threaten Germany if it fails to reduce its trade surplus by itself.

It is worth analyzing, from the perspective of Germany, the difference between two options for reducing its trade and current account surpluses:

**(a)** Balancing imbalances among present eurozone members by a return to national currencies and enabling exchange rate adjustments within currency bands (which is advocated here), versus,

**(b)** Doing it by fiscal expansion and the relaxation of wages in Germany (which was disqualified in part II of this article).

Both methods are expected to result in an increase in German wages, as denominated in the currencies of the foreign trading partners. However, in **(a)**, this would happen via the appreciation of a new German currency, while in **(b)**, via a nominal increase in wages across the German economy.

A big difference between these two methods would appear if, at some point in the future, wages in Germany become uncompetitive (which may be caused by various factors and processes happening in Germany or in the economies of Germany's trading partners). Then:

In **(a)**, the excessive wage increase vis-a-vis Germany's trading partner would be automatically reversed by the adjustment of the exchange rate.

In **(b)**, by remaining in the eurozone and having uncompetitive wages, Germany would be sentenced to a painful 'internal devaluation' therapy, which could mean years of economic stagnation and high unemployment.

Historical experience shows that the German economy managed to develop very successfully, increasing labor productivity and wages while maintaining its competitiveness, during the continuous process of currency appreciation. The German economy has proved that it is able to deal well with currency appreciation, provided of course that it happens within the limits set by differences in productivity increases versus trading partners. Over the last 60 years however, in spite of a very strong trend of German currency appreciation vis-a-vis the USD, there were episodes of depreciation as well. So, currency adjustments in both directions have played an important role in protecting the competitiveness of the German economy.

5. European Solidarity Manifesto, Brussels, January 24, 2013, <http://www.european-solidarity.eu/>.

6. Michael Pettis, The great rebalancing: trade, conflict, and the perilous road ahead for the world economy, Princeton University Press, Princeton and Oxford 2013.



A controlled dismantlement of the eurozone would allow Germany to solve the problem of a persistent trade surplus in a gentler and safer way than other potential methods. The relative mildness of this process would result from the combination of two factors.

Firstly, the process would run in the situation of economic growth in Germany, due to economic growth in Europe caused by the segmentation of the eurozone. In conditions of economic growth, a decrease in export surplus will be much less painful than if it took place in a situation of global recession and the collapse of

international trade (as was the case in France in the 1930s).

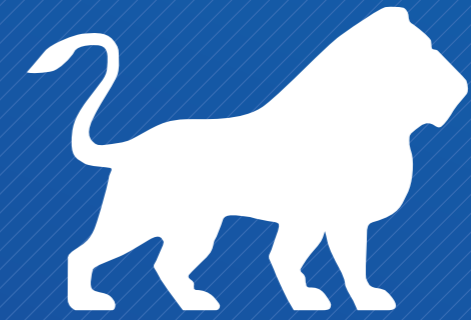
Secondly, the appreciation of the new German currency would be controlled by exchange rate bands within a new European currency coordination system.

The safety of this process stems from the fact that Germany would regain a flexible currency, which would help the country to remain competitive regardless of future changes in relative costs and fluctuations in the international situation. For this reason - as explained above - the reduction of the trade surplus through the adjustment of the exchange rate of the new German

currency is safer than bringing this about through nominal wage growth in Germany in the current shape of the eurozone. ■



Stefan Kawalec is the CEO of Capital Strategy, a strategy consulting company. He served as a former vice-minister of finance of Poland.



# ACRE

ALLIANCE OF CONSERVATIVES  
AND REFORMISTS IN EUROPE



## FREE PEOPLES FREE NATIONS FREE MARKETS

[acreurope.eu](http://acreurope.eu)



[www.europeanreform.org](http://www.europeanreform.org)  
Follow us @europeanreform