The Crises of the Euro

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The 85 billion euros that were recently mobilised by the IMF, the European Union and various bilateral lenders to save Ireland – or, rather, to save banks and other private investors who have invested in Irish assets – confirms my view of the European Monetary Union (EMU) as a club with the wrong membership and a weak management.

Early in 2010, Greece was the ideal scapegoat. A huge fiscal deficit which previous governments had tried to cover up with the help of creative bookkeeping and outright cheating provided a reason for the vilification of Greece. But it was membership in the currency union that had made it possible for Greece – and, indeed, for all members of the union - to benefit temporarily from a rising euro and easy access to cheap credit. Neither the financial markets, nor the European Central Bank (ECB) or other EU authorities, were vigilant enough to warn of the danger of the growing bubbles and deficits that came to characterise a large number of the euro zone countries.

Yesterday Greece, today Ireland, tomorrow Portugal and Spain, the day after tomorrow perhaps Italy and France. A large part of the EU is in severe financial trouble and the recipient of punitive loans with adverse policy conditions attached. These are the prospects for an association that was formed with supposedly binding rules for responsible behaviour.

The cornerstone of the EMU was the so-called Growth and Stability pact, which stated that no member of the club was allowed to run a fiscal deficit exceeding three per cent of GDP. When Germany and France soon after the formation of the EMU broke this golden rule the stability pact was *de facto* buried. At present, the average size of the euro zone's fiscal deficit is 6,5 per cent of GDP.

The next rule that was violated, and proved to be fiction last spring, was the "no bailout" clause in the Lisbon Treaty, which explicitly forbids the EU to rescue countries in crisis. Furthermore, the 110 billion package to Greece was, as was the case in the recent deal with Ireland, tied to the implementation of austerity policies that were so severe that even the IMF expressed its concern.

The loan conditions to Greece and Ireland are very tough. But the EU and IMF message could also be interpreted in the following way by countries in crisis: if you promise to reduce your deficits you may borrow enough euros to be spared. For the time being.

The third pillar of responsible behaviour was the European Central Bank, which was forbidden to bail out member countries in crisis by buying their government bonds. Today ECB is the largest – and soon, perhaps the only - together with China – single buyer of Greek and Irish bonds. The sellers are those private investors who with a sigh of relief are happy to find someone willing to buy their high-risk assets.

These rescue operations suffer from one major weakness: they fail to solve the main problems of the euro zone, which are rather likely to be aggravated.

Insolvency, not illiquidity

If illiquidity, i.e. a temporary lack of liquid funds, is the problem, borrowing in order to bridge a brief financial gap is an excellent solution. But when a country – or an individual – is unlikely to be able to service its debt in a longer-term perspective, we are talking about insolvency. However, the crisis affecting a number of euro-zone countries is not a short-term liquidity crisis. If that had been the case, the rescue packages would have made sense. But we are dealing with a crisis of insolvency, not illiquidity.

The EU leaders are amazingly silent on the grave predicament the EMU is now in. Simply put, those EU countries unable to service their debts will not be helped by taking up new loans, especially not if these loans are given at exorbitantly high interest rates.

The only viable solution to the problem of insolvency is some kind of debt relief. Either through outright default, or by an orderly restructuring. But at present, the management of the EMU club only envisages this as a medium or long-term solution. When Angela Merkel a few weeks ago stated the obvious – that not only taxpayers but also private investors who have made risky deals should pay part of the bill – she was silenced by her colleagues, who thought it was improper to scare the financial markets. But the high and rising interest rate spreads between German bonds and those of the peripheral countries indicate that financial markets have already woken up to the harsh realities, after having been asleep for too long.

For people in the crisis countries, reality is already harsh, with unemployment high and rising. Before the crisis, the Irish government deficit was non-existent. The debt now owed by the Irish taxpayers due to the bailout of the private banking sector approaches 130 per cent of GDP.

The latest international rescue package by the EU, which carries an interest rate of 5,8 per cent, will add further to the debt and in a year or two, Ireland is expected to spend almost ten per cent of GDP servicing the public debt. Furthermore, this in a situation when the lenders demand austerity, which paves the way for a downward spiral of falling income, employment and tax revenue. If the policies lead to deflation – which is a highly likely outcome, or even purpose, of the programme – this will add further to the real burden of the debt.

We can only guess what the social and political consequences of rescue packages of the Greek or Irish kind will be when tomorrow's victims are to be saved.

But the euro zone's crisis is not confined to the insolvency among some of its members. Even more serious, in a longer term perspective, is the structural problem which expresses itself in a dramatic lack of international competitiveness of a large number of EMU members.

The Achilles Heel of the Currency Union

If we look at the external balance of the 16 members of the EMU, the aggregate deficit on the current account is negligible, or some 50 billion euros, representing less than 0,5 per cent of the union's GDP. Nothing to worry about. But the reason why the deficit is so small is that Germany´s surplus is huge, or some 140 billion euros. A few other countries, most notably Holland and Austria, also register sizeable surpluses. These three countries together have a surplus on their current account of around 200 billion euros. Which means that the remaining 13 countries have an aggregate deficit of 250 billion euros. Which is a lot of money.

What the statistics show is that behind the appearance of a rather comfortable external balance we find Germany and a few other countries with large surpluses and a majority of countries with deficits. Or, formulated in another way: the major long-term structural problem in the euro area is that around ten countries lack international competitiveness, which is a reflection of the fact that costs and wages in these countries increased much faster than in the rest of the EMU, and among their major trading partners in general.

While unit labour costs in countries such as Ireland, Spain and Portugal have increased well over 20 per cent since 2001, they have actually decreased in Germany.

Since the formation of the EMU, Germany has improved its international competitiveness dramatically. A combination of high productivity growth and a low or negative increase in normal wages has produced an export miracle, and a current account surplus of over five per cent of GDP. The strength of Germany's export-oriented economy has put an upward pressure on the euro, and the result has been that while the euro is undervalued for Germany, it has become strongly overvalued for the peripheral economies.

A gradual depreciation of the euro would provide some relief. But the dilemma is that since the deficit countries have most of their exports going to other euro countries, even a weakening of the euro would fail to restore their international competitiveness. Indeed, the main beneficiary would be Germany, whose high-productive and well diversified exporters would be in a much better position to take advantage of a weak euro than the peripheral countries, who to a large extent compete among themselves – and in some areas with low-cost producers in Asia - in sectors such as light industry, agriculture, tourism and services.

What the euro zone would need is a strong increase in effective demand in Germany, with rising wages and purchasing power and a substantially higher inflation than in the other euro zone countries. But German politicians do not like such policies, especially not today when German money is likely to be needed for various rescue operations elsewhere.

I am not criticising Germany. Germany has very good historical reasons to pursue responsible economic policies. But the truth of the matter is that the German fear of fiscal deficits and inflation is lubricating the slippery slope for the EMU as a whole.

In order to improve their international competitiveness and restore economic growth and create new jobs, the euro zone countries whose international competitiveness has become eroded must, as long as they are members of the EMU, undertake what is called an internal devaluation, i.e. reduce costs sufficiently enough to be able to compete again. Given today's low rates of inflation in all major trading partners, this basically means that nominal wages need to decline, in some cases rather drastically. The gap in unit labour costs between Germany and the crisis countries amounts to some 20-30 per cent, but it is difficult to envisage how governments will be able to enforce the wage reductions that are required without social unrest and political turmoil.

There is another dilemma: if an internal devaluation in a country suffering from a lack of international competitiveness were to succeed, the real burden of the country's debt would increase. This would be true not only for its public debt, but also for all indebted households and businesses.

The sad conclusion is that the rescue packages we have seen so far address the wrong problems. By extending new loans to countries that are insolvent, the EU and EMU authorities, in close cooperation with the IMF, are aggravating their insolvency. Also, by forcing the borrowing countries to undertake drastically deflationary policies, the insolvency problem is accentuated further. For today's and tomorrow's crisis countries in the EMU, prospects are bleak: as long as they share a common currency with Germany, they cannot restore their competitiveness without adding to the real burden of the taxpayer's debt.

The costs of breaking up the EMU are likely to be huge. If the financial markets one day decide that they don´t trust the currency union, we would have to go through a period of financial unrest and large-scale capital flight from the weaker member states. A threatening scenario, indeed. But perhaps the costs of preserving a project based more on political prestige than on sound economic analysis will be even higher?