The permanent necessity to undervalue the euro endangers Europe's trade relations

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ABSTRACT

In 2014, the eurozone, with its huge current account surplus, was a major source of global economic imbalances. This phenomenon could last for a long time. Monetary expansion, which leads to currency depreciation, is the only macroeconomic tool available to the European Central Bank (ECB) to boost the competitiveness of struggling southern economies. With the current economic imbalances within the eurozone, the elimination the eurozone's current account surplus through appreciation of the euro would aggravate economic conditions in struggling member countries and could be politically explosive. Some observers hope that the eurozone's internal imbalances can be reduced by more expansionary policies in Germany or, in the future, by wealth transfers to be enabled when the fiscal and political union materializes. Both hopes are unjustified. A huge eurozone current account surplus is likely to persist, and this will lead to tensions with the US and other trade partners. It could especially undermine the proposed Transatlantic Trade and Investment Partnership (TTIP). This contradicts a popular view that the European Union needs a single currency to operate successfully in the world economy among big players like the US, China and India. In fact, if the eurozone countries had (or returned to) their national currencies, linked through adjustable currency bands as proposed in Kawalec and Pytlarczyk (2013 a, 2013 b), trade and current account deficits in countries in crisis could be eliminated through balancing imbalances among present eurozone members, without the necessity to generate a huge surplus by the eurozone as a whole. However, a single currency forces the eurozone to try to desperately generate trade and current account surpluses, which is likely to spark currency wars with its main economic partners. This would impede international trade and diminish the benefits that Europe could achieve from international cooperation.

Introduction and overview

The paper expands upon considerations about the economic consequences of the euro that were presented in two earlier papers written by the author together with Ernest Pytlarczyk.

In Kawalec and Pytlarczyk (2013 a), we justified the view that the problems with a single European currency are neither temporary nor curable, and that the euro constitutes a serious threat to the European Union (EU) and the Single European Market. We argued for a controlled dismantlement of the eurozone, to be initiated by the exit of the most competitive countries, and we propose an agreement on a new European currency coordination system.

In Kawalec and Pytlarczyk (2013 b), we undertook a deeper analysis of the measures which would minimize the risks throughout the process of eurozone dismantlement and contribute to rebuilding confidence in the future of Europe.

This paper responds specifically to a popular view that is being used as one of the arguments justifying the need for a single currency. According to this view, the EU needs the single currency to operate successfully in the world economy among big players like the US, China and India. The paper questions this view, arguing that the euro will actually inhibit relations with Europe's main trading partners.

In chapter 1, we explain that weakening the euro is currently the only macroeconomic tool available to the European Central Bank (ECB) to boost the competitiveness of struggling southern economies. We recall that on many occasions, European politicians, especially the French, called on the ECB to weaken the euro in order to improve the situation in struggling eurozone member countries.

In chapter 2, we explain that the weakening of the euro does not fix internal imbalances within the eurozone, but simply pushes those imbalances out of the euro area. An unsolvable problem for the ECB is that the euro remains too strong for the depressed southern countries and France, and too weak for Germany. In 2010, when the euro crisis erupted, the eurozone as a whole had a current account balance close to zero. In 2014, the eurozone produced a current account surplus of about $300 billion, which was the highest surplus in the world and about 36% larger than China's. The eurozone has become a main source of global economic imbalances.

In chapter 3, we discuss the current economic, social and political situation in the eurozone's struggling countries. Several years of applying the 'internal devaluation policy' were not effective enough to bring wages to a competitive level. With the current level of competitiveness in southern countries, current account and trade deficits would recur if these countries used the potential of their economies to their full extent, thus reducing unemployment, or if the euro strengthened to a level balancing the current account balance of the eurozone as a whole. With the existing economic imbalances within the eurozone, the elimination the eurozone's current account surplus through the appreciation of the euro would aggravate economic conditions in the countries in crisis. This could pave the way for populist and anti-European political movements coming to power in more and more European countries.

In Chapter 4, we discuss two potential mechanisms that are often regarded as instruments with the ability to fix the internal imbalances in the eurozone. It is irrational and unrealistic to expect that the internal imbalance within the eurozone can be fixed by more fiscal expansion and wage relaxation in Germany. The majority of German exports go to countries outside the eurozone, so German companies have to compete against the whole world, not just against the firms from the southern European countries. Therefore, Germany should not be expected to undertake actions that could permanently undermine its competitiveness. Expectations that further integration, especially progress towards a political and fiscal union, will equip the eurozone with alternative instruments to improve the competitiveness of depressed countries, are also unjustified. We demonstrate that structural policies aimed at improving the competitiveness of under-developed regions of a single currency area are so ineffective and expensive that they cannot contribute significantly to boosting competitiveness in problem eurozone countries. Thus, while it is a new phenomenon, a huge eurozone current account surplus is likely to continue.

In Chapter 5, we discuss the impact of the potential persistent undervaluation of the euro on Europe's trade relations. In this context we look at the perspective of a groundbreaking Transatlantic Trade and Investment Partnership (TTIP), which the European Union and the United States are currently negotiating. TTIP could potentially boost welfare and reduce unemployment in both economies, as well as in other countries. At the same time, the TTIP could help restore confidence in the future of Europe and the transatlantic community. However, given the eurozone's leading position in the global economy, there is no doubt that protracted policies suppressing the value of the euro and resulting in the eurozone's substantial trade and current account surplus will lead to tensions with the US and other trade partners. This may obstruct the approval of the TTIP by the US Congress or hinder the treaty's actual operation, resulting in its deterioration or termination.

In Chapter 6, we argue that if the eurozone countries had (or returned to) their national currencies, linked through adjustable currency bands (as proposed in Kawalec and Pytlarczyk 2013 a, and 2013 b), trade and current account deficits in countries in crisis could be eliminated through balancing imbalances among present eurozone members, without the necessity to generate a huge surplus by the eurozone as a whole. We argue that for Germany, a liquidation of its current account surplus through a controlled appreciation of its new national currency (within a currency band), would be much less harmful and dangerous than achieving the same goal by allowing for fiscal expansion and wage increases within the eurozone. This undermines a popular view that the EU needs a single currency to operate successfully in the world economy among big players like the US, China and India. The single currency forces the eurozone to try to desperately generate trade and current account surpluses, which may lead to tensions with main economic partners. This is likely to impede international trade and diminish the benefits that Europe could achieve from international cooperation.

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1. A weak euro can help the eurozone’s struggling members

Following the eruption of the eurozone crisis in 2010, many observers noted that a weakening of the euro could be the most effective macroeconomic tool via which the ECB can help the eurozone’s struggling member countries.

Even if they are in a crisis situation, individual countries within the eurozone cannot rely on currency adjustments to improve their competitive position and liquidate their external imbalances. In consequence, these countries are trying to restore competitiveness via the so-called ‘internal devaluation’ policy. The essence of ‘internal devaluation’ is using fiscal tightening to reduce domestic demand in the hope that it will result in a decrease in prices and wages. Fiscal austerity might be effective in decreasing domestic demand, but this translates mostly into a decrease in GDP and employment, as nominal wages are largely resistant to downward pressure (which will be further discussed in chapter 3).

Martin Feldstein (2011) claimed that forcing current account rebalancing in Italy, Spain and France by ‘internal devaluation’ would entail a decade or more of high unemployment and falling GDP, which would be a politically dangerous policy that wastes economic resources. He concluded that the best way to help the depressed eurozone’s economies would be to depreciate the euro, which would lead to an improved trade balance with countries outside the eurozone. He wrote that the euro’s decline can be caused either by a market momentum alone or by the ECB increasing the supply of euros, or even by statements made by the ECB president expressing a lack of concern about the declining euro.

Charles Wyplosz (2012) and Bernard Delbecque (2012) wrote that the eurozone needed a weak euro to stop the economic recession and support growth. Zsolt Darvas (2012) wrote that the ECB should use various monetary policy instruments to weaken the euro. He also said that the US, China and other major players should recognize that the euro should be undervalued for some years to help resolve the eurozone crisis.

Kawalec and Pytlarczyk (2013 b) wrote that if the defense of the euro ‘at all costs’ is continued, the eurozone is likely to conduct a policy of ‘weak euro’ in an attempt to build a substantial trade surplus in the eurozone as a whole, which may intensify global currency wars.

Jeans Nordvig (2013) observed that the ECB was facing the problem of record high unemployment combined with a strong currency. He did not expect the ECB to intervene directly in the currency market any time soon. He assumed that the ECB "*will likely play by the rules of the G7 as long as possible, and hence avoid verbal intervention as well for the time being.*" However, he anticipated that the ECB may be forced to become more aggressive on monetary policy to avoid excessive euro appreciation: "*The ECB may need to enter the currency war more actively to secure a more competitive euro in 2014, and thereby support a more robust economic recovery.*"

Jeffrey Frankel (2014) proposed that the ECB should undertake a direct, unsterilized foreign exchange intervention by buying US securities. He argued that this action would lower the foreign exchange value of the euro, and would therefore be the best way to restore the export sector of the eurozone's periphery countries. He pointed out that executing monetary expansion by buying foreign securities would also help avoid some legal and institutional problems that arise when the ECB buys bonds issued by the eurozone member countries. This is because the ECB's purchase of bonds issued by the eurozone countries in crisis has met with resistance, and has even been legally contested in the German Constitutional Court, on the grounds that monetary financing of profligate governments violates the laws under which the ECB was established. The acquisition of US securities would not raise such legal obstacles, as "*operations in the foreign exchange market are well within the remit of the ECB.*" [2]

On many occasions over the last several years, European politicians suggested that the euro should be weakened to help struggling eurozone countries. The most outspoken on this issue have been French political and economic leaders including consecutive Presidents Nicolas Sarkozy[3] and Francois Hollande[4], Prime Minister Manuel Valls[5], Economy and Industry Minister Arnaud Montebourg[6], and the Bank of France Governor Christian Noyer[7]. Spanish authorities, in their discussions with the International Monetary Fund (IMF), presented the view that more actions by the ECB were warranted to support the eurozone recovery, and that a weaker euro would help[8].

ECB President Mario Draghi has also expressed concerns over the impact of a strong euro on a weak eurozone economy, which raised the prospect of monetary action to weaken the currency[9].

[2] Regarding Frankel's opinion, our view is that direct foreign exchange intervention is likely to precipitate accusations of currency manipulation that could be raised by Europe's main trading partners, especially the US. Such accusations are however also likely to happen if the value of the euro is permanently depressed by monetary policy instruments, which we discuss in Chapter 5.

[3] Pearson (2011).

[4] Reuters (2013), Carnegy (2014).

[5] Reuters (2014).

[6] Matthews (2013).

[7] Meichtry (2014).

[8] International Monetary Fund (2014b, p. 29).

[9] Ranasinghe (2013).

For quite a while, in spite of a raging crisis in the eurozone and huge monetary stimuli by the ECB, the widespread desire for a weaker euro had not materialized. Ultimately, in the middle of 2014, a combination of the 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 (see Chart 1).

Chart 1. EUR/USD exchange rate

Source: https://www.ecb.europa.eu/stats/exchange/eurofxref/html/eurofxref-graph-usd.en.html

The euro exchange rate decreased from the monthly average of $ 1,37 in May 2014 to $1,08 in March 2015. This happened without direct foreign intervention by the ECB, but some day in the future the ECB might recall Jeffrey Frankel's arguments and use currency intervention to keep the euro exchange value low enough.

2. The eurozone is becoming the main source of global imbalances

In 2010, when the eurozone crisis erupted, the current account balance in the eurozone as a whole was close to zero, while there were huge current account imbalances in particular countries. Greece, Italy, Portugal, Spain, and France (referred together as "GIPSF") had current account deficits worth 1-10% of GDP and their aggregate current account deficit was 156 billion euro. At the same time, Germany had a current account surplus of 5,7% GDP, amounting to 147 billion euro. By 2014, the aggregated current account balances of all the GIPSF countries except France were in surplus, and the GIPSF as a whole had a surplus of 21 billion euro. So, during 2010-2014, GIPSF improved their aggregated current account balance by 177 billion euro, while Germany's surplus increased by 73 billion euro. In consequence, a huge surplus of 236 billion euro appeared in the eurozone as a whole (see tables 1 and 2).

Table 1. Current Account Balance: GIPSF countries, Germany and the eurozone (euro billion)

Country/Area	2008	2009	2010	2011	2012	2013	2014
Greece	N/A	-25,8	-22,5	-20,6	-4,6	1,1	1,6
Italy	-46,3	-30,4	-55,7	-50,4	-8,2	15,0	31,2
Portugal	-21,7	-18,3	-18,3	-10,6	-3,5	2,4	1,0
Spain	-103,3	-46,2	-42,4	-34,0	-3,0	15,1	8,5
France	-19,0	-16,1	-16,7	-21,2	-32,2	-30,3	-21,1
GIPSF	N/A	-136,8	-155,6	-136,9	-51,5	3,3	21,2
Germany	147,8	143,2	146,7	164,6	187,3	182,0	219,7
Eurozone (18)	-158,5	-21,7	-2,8	-6,9	151,1	214,0	235,5

Source: Own calculations based on Eurostat data

Table 2. Current Account Balance: GIPSF countries, Germany and the eurozone (% of GDP)

Country/Area	2008	2009	2010	2011	2012	2013	2014
Greece	N/A	-10,9	-9,9	-9,9	-2,4	0,6	0,9
Italy	-2,8	-1,9	-3,5	-3,1	-0,5	0,9	1,9
Portugal	-12,1	-10,4	-10,1	-6,0	-2,1	1,4	0,6
Spain	-9,3	-4,3	-3,9	-3,2	-0,3	1,4	0,8
France	-1,0	-0,8	-0,8	-1,0	-1,5	-1,4	-1,0
GIPSF	N/A	N/A	N/A	N/A	N/A	N/A	N/A
Germany	5,8	5,8	5,7	6,1	6,8	6,5	7,6
Eurozone (18)	-1,7	-0,2	0,0	-0,1	1,5	2,2	2,3

Source: Own calculations based on Eurostat data

A substantial current account in the eurozone as a whole is a new phenomenon. In 2014, the eurozone's CA surplus of about $ 300 billion was the largest among the world economies, and about 36% higher than in China (see Table 3).

Table 3. Current account and trade balance: China and the eurozone

Year	China				The eurozone (19)			
	Trade balance		Current account balance		Trade balance		Current account balance	
	$ billion	% of GDP	$ billion	% of GDP	$ billion	% of GDP	$ billion	% of GDP
1999	29,3	2,7	21,1	2,0	25,6	0,3	-35,3	-0,5
2000	23,6	2,0	20,5	1,7	-27,1	-0,5	-94,0	-1,5
2001	22,7	1,7	17,4	1,3	33,6	0,4	-24,3	-0,4
2002	29,8	2,1	35,4	2,4	84,5	1,1	43,4	0,6
2003	23,7	1,4	43,1	2,6	71,4	0,7	23,4	0,3
2004	27,3	1,4	68,9	3,6	77,3	0,7	73,7	0,7
2005	99,0	4,4	132,4	5,9	6,8	0,0	11,6	0,1
2006	173,7	6,4	231,8	8,6	-33,1	-0,4	-20,7	-0,2
2007	263,8	7,5	353,2	10,1	-0,2	-0,1	3,2	0,0
2008	296,2	6,5	420,6	9,3	-80,6	-0,6	-211,1	-1,5
2009	194,3	3,9	243,3	4,9	18,9	0,1	-16,6	-0,2
2010	183,9	3,1	237,8	4,0	-18,8	-0,1	13,2	0,1
2011	148,1	2,0	136,1	1,9	-23,2	-0,2	16,8	0,1
2012	225,6	2,7	215,4	2,6	109,0	0,8	171,1	1,4
2013	266,6	2,9	148,2	1,6	208,3	1,5	302,4	2,3
2014	371,1	N/A	219,7	N/A	258,7	1,9	299,0	3,0

Source: Own calculations based on: OECD, The World Bank, Eurostat, and State Administration of Foreign Exchange of the People's Republic of China data

Deutsche Bank strategist George Saravelos (2014) introduced a term "Euroglut" to name the phenomenon he characterizes as "*the global imbalance created by Europe's massive current account surplus.*" He says that Euroglut, which implies a significantly weaker euro, "… *will be the defining variable for the rest of this decade.*" He writes: *"… we expect Europe's huge excess savings combined with aggressive ECB easing to lead to some of the largest capital outflows in the history of financial markets*. (…) *Euroglut is a global imbalances problem. It refers to the lack of European domestic demand caused by the eurozone crisis. The clearest evidence of Euroglut is Europe's high unemployment rate combined with a record current account surplus. Both are a reflection of the same problem: an excess of savings over investment opportunities. Euroglut is special for one and only reason: it is very, very big. At around 400bn USD each year, Europe's current account surplus is bigger than China's in the 2000s. If sustained, it would be the largest surplus ever generated in the history of global financial markets. This matters.*"

In the following chapters we argue that the eurozone's huge current account surplus is likely to be persistent, and we will discuss some of its consequences.

3. Euro appreciation could aggravate the situation in the eurozone's struggling member countries

Several years after the outbreak of the world financial crisis (in 2008) and the euro crisis (in 2010), the eurozone as a whole is performing significantly worse compared to the USA and the EU area outside the Eurozone (non-euro EU area). GDP in 2014, compared to 2007, was 108% in the US, 104,5% in the non-euro EU area, and only 99,1% in the eurozone. The unemployment rate in 2014 in the eurozone was 4,1 percentage points (pp) higher than it was in 2007, while this difference was 1,6 pp in the US, and only 0,9 pp in the non-euro EU area.

Table 4. Eurozone, Non-euro EU area, and the US - Economic performance 2014 versus 2007

	GDP 2014 (2007=100%)	Unemployment rate		
		2007	2014	2014-2007
Eurozone 18	99,1%	7,5%	11,6%	4,1%
Non-euro (18) EU area	104,5%	6,7%*	7,6%*	0,9%*
USA	108,0%	4,6%	6,2%	1,6%

* Average of the unemployment rates for the individual countries weighted by the population number.
Source: Own calculations based on OECD and Eurostat data.

The situation inside the eurozone is very diverse. While some countries are doing reasonably well, there is a sizable group of countries undergoing deep economic, social and political crises (see Table 5).

Table 5. Eurozone member countries*- Economic performance 2014 versus 2007

	GDP 2014 (2007=100)	Unemployment rate (%)			Public debt to GDP ratio (%)		
		2007	2014	2014-2007	2007	2014	2014-2007
The Eurozone members							
Slovakia	113,3	11,2	13,2	2,0	29,8	53,6	23,8
Luxemburg	107,7	4,2	5,9	1,7	7,2	**23,3	16,1
Germany	105,1	8,5	5,0	-3,5	63,7	74,7	11,0
Austria	104,0	4,9	5,6	0,7	64,8	84,5	19,7
Belgium	104,0	7,5	8,5	1,0	86,8	106,5	19,7
Lithuania	104,0	4,3	10,7	6,4	15,9	40,9	25,0
France	102,3	8,0	10,3	2,3	64,4	95,2	30,8
Netherlands	100,1	4,2	7,4	3,2	42,7	68,8	26,1
Eurozone 18	***99,1***	***7,5***	***11,6***	***4,1***	***65,1***	***92,1***	***27,0***
Ireland	97,8	4,7	11,3	6,6	24,0	109,7	85,7
Estonia	97,4	4,6	7,4	2,8	3,7	10,6	6,9
Slovenia	95,9	4,9	9,7	4,8	22,7	80,9	58,2
Spain	95,0	8,2	24,5	16,3	35,5	97,7	62,2
Finland	94,9	6,9	8,7	1,8	34,0	59,3	25,3
Latvia	94,7	6,1	10,8	4,7	8,4	40,0	31,6
Portugal	92,7	9,1	14,1	5,0	68,4	130,2	61,8
Italy	91,1	6,1	12,7	6,6	99,7	132,1	32,4
Greece	74,2	8,4	26,5	18,1	103,1	177,1	74,0

*Without Cyprus and Malta
** data for the third quarter of 2014
Source: Own calculations based on OECD and Eurostat data

Following several years of internal devaluation policy, the eurozone crisis countries mostly liquidated their current account deficits, as demonstrated in tables 1 and 2 in Chapter 2. But this improvement is neither sustainable nor means that those economies are now healthy and have regained their strength.

Nordvig *at al.* (2014) estimate that the main cause of the current account improvement during 2008-2013 in the southern eurozone countries was actually weak domestic demand, which is associated with a decrease in GDP and employment.

Hans-Werner Sinn (2014) estimates that during six years of the crisis, from Q3 2007 to Q3 2013, the eurozone's straggling economies (with the notable exception of Ireland), did not manage to achieve any substantial depreciation in their real effective exchanges rates (measured by the GDP deflator relative to the trade-weighted average of their trading partners).

The case of Spain

When discussing the effectiveness of the internal devaluation, it is worth looking at the case of Spain, as it is the eurozone's fourth biggest economy, and one of the countries most affected by the crisis. Also, at the end of 2015, Spain will have parliamentary elections that might reshape the country's political landscape.

It is worth recalling that before the word financial crisis, Spain, unlike Greece, ran a prudent fiscal policy and complied with the Maastricht debt and deficit criteria better than Germany.

However, low interest rates and massive capital inflows from the north of the euro area resulted in a huge expansion of private debt, which boosted the construction sector and pushed up wages. It was estimated that in 2010, in order to restore the country's international competitiveness, Spain needed about a 30% real exchange rate depreciation,[10] which given the impossibility of a nominal currency depreciation, would require *ceteris paribus* a decrease in wages by such a percentage.

The IMF (2014, p. 8) draws attention to the fact that over 5 years, Spain improved its current account balance by 11% of GDP, from a deficit of 10 percent in 2007 to a 1 percent surplus in 2013. According to the IMF, this was an extraordinary achievement matched only by one similar current account improvement by an advanced large non-commodity exporting country: South Korea in 1997–98, following the Asian crisis. Spain's achievement, however, is said to be particularly notable, because it was achieved without nominal currency depreciation. South Korea's adjustment was facilitated by a large nominal exchange rate depreciation. During that adjustment, South Korea had only one year (1998) with a fall in GDP, but in the next year, GDP exceeded pre-crisis levels and the economy returned to robust growth. Spain, however did not have the option of nominal currency rate depreciation, and was sentenced to a policy of internal devaluation. As a result, in 2014, the sixth year of the struggle with the crisis, Spain's GDP was 5 percent lower than in 2007, and the unemployment rate increased by 16 percentage points to the level of 24,5%.

The IMF (2014) underlines that the internal devaluation policy in Spain has not caused a significant reduction in wages:

"*Over the six years of the crisis, wages have been slow to respond, putting the burden of adjustment on employment." (p.19)*

"The reality is that real wages are still above 2007 levels, despite the unprecedented loss of jobs." (p. 31)

"While Spain's real effective exchange rate (REER) did depreciate significantly based on unit labor costs, it largely reflected labor shedding. The CPI-based REER has not depreciated much." (p. 8)

The IMF's (2014) observation concerning REER requires special attention. Some observers take the data showing a remarkable depreciation of REER based on unit labor cost (ULC) in Spain, as well as in Greece, as an indicator of an improvement in competitiveness. However, ULC-based REER change could be a misleading indicator in a period when the country experienced a dramatic fall in employment levels. This is because, as one may reasonably assume, the jobs with a lower output/salary ratio are being liquidated first. So, shedding about 18% of the labor force, resulting in an unemployment increase from 8,2% to 24,5% (see: Table 5) should automatically result in a substantial decrease in the ULC, even if wages do not decrease at all.

It seems that with the current wage level in Spain, the current account can be balanced only if the economy does not utilize its potential, and the rate of unemployment stays at the 20-25%

[10] Goldman Sachs (2013, p. 7, Exhibit 11), Sinn (2014, p 119-122).

level. Without a substantial decrease in CPI based REER, a higher utilization of the country's economic potential (connected with a significant drop in unemployment), would automatically result in a reappearance of a substantial current account deficit.

Political risk

Jens Nordvig (2014) recalls the famous declaration by ECB President Mario Draghi in 2012: *"Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me , it will be enough"*[11]

These words were accompanied by the ECB's provision of unlimited long-term bank funding, and soon by the declaration that the ECB was ready to buy unlimited quantities of government bonds from the eurozone countries, should they have funding problems.

As a result of these bold steps, the eurozone is protected from market sentiments, although the euro crisis is not over. Nordvig (2014, p. 75) predicts that the next outbursts of the euro crisis will be political: *"Future crisis waves are likely to result from political conflict in some form, rather than from market breakdown."*

The eurozone is composed of independent states with democratic political systems. With prolonged economic stagnation and high unemployment, populist and anti-European movements have been going from strength to strength. The political landscape in struggling member countries is getting less and less predictable. Any general election in a depressed member country may potentially shake the eurozone.

The eurozone could hardly withstand a new recession

With the existing economic imbalances within the eurozone, the elimination of its current account surplus through the appreciation of the euro would aggravate economic conditions in the countries in crisis. However, the eurozone can hardly withstand a new recession. This could pave the way for populist and anti-European political movements coming to power in more and more European countries. And it would also result in a swelling of the public debt to GDP ratio. That is why the ECB, while doing 'whatever it takes to save the euro,' is likely to continue policies suppressing the value of the single currency.

4. Unjustified hopes for fixing internal imbalances in the eurozone

Calls for fiscal expansion and wage relaxation in Germany

Many observers believe that internal eurozone imbalances can be fixed, if only Germany decided to boost domestic demand by spending more on public infrastructure and allowing wages to grow faster.

[11] Speech at an investment conference in London, July 26. Quote after Nordvig (2014, p. 69).

IMF researchers Selim Elekdag and Dirk Muir (2014, p. 2) argue that *" ... higher German public investment would not only stimulate domestic demand in the near term and reduce the current account surplus, but would also raise output over the longer-run as well as generate beneficial regional spillovers."*

In the recent regular statutory consultations with the German authorities, the IMF urged the country to invest more in infrastructure in order to improve its long-term growth prospect, as well as, to reduce current account surplus and help weaker European economies (Harriet Torry and Bertrand Benoit 2015).

Nouriel Roubini (2015) writes: *" ...Germany needs to adopt policies – fiscal stimulus, higher spending on infrastructure and public investment, and more rapid wage growth – that would boost domestic spending and reduce the country's external surplus. Unless, and until, Germany moves in this direction, no one should bet the farm on a more robust and sustained eurozone recovery."*

However, Germans remember the suffering associated with the social security and labor market reforms during 'Agenda 2010', implemented in 2003-2005 by Chancellor Gerard Schroeder, which aimed to improve the country's then deficient competitiveness[12]. The proposal to deliberately diminish the country's competitiveness by increasing spending and relaxing wage discipline is sure to raise resistance in Germany. This is especially sensitive because the majority of German exports (63%) go to countries outside the eurozone (see: Table 6), so German companies have to compete against the whole world, not just with the firms from the southern European countries.

Table 6. Germany's export and trade balance: the eurozone and the world outside the eurozone

	Export				Trade balance			
	Total		of which (%):		Total		of which (%):	
	% of GDP	euro billion	to the eurozone	To outside eurozone	% of GDP	euro billion	eurozone	outside eurozone
1999	24,7	510,0	46,5	53,5	3,2	65,2	56,4	43,6
2007	38,5	965,2	44,3	55,7	7,8	195,3	60,4	39,6
2010	37,0	952,0	41,4	58,9	6,0	154,9	57,2	42,8
2014	39,0	1 133,5	36,8	63,2	7,5	216,9	29,8	70,2

Source: Own calculations based on Statistisches Bundesamt (Federal Statistical Office) and Eurostat data

Hopes related to a European fiscal and political union

Many observers claim that further integration, especially progress toward fiscal and political union, would provide the eurozone with alternative instruments – namely, wealth transfers – to improve depressed countries' competitiveness.

Kawalec and Pytlarczyk (2013 a, p. 37-38) challenge these expectations. They discuss the German and Italian experiences of stimulating the uncompetitive regions of southern Italy and eastern Germany. They observe that despite spending huge amounts of taxpayer money (amounting annually to 16% of regional GDP in southern Italy and more than 25% of regional

[12] See: Hans-Werner Sinn (2014, Chapter 3, The Other Side of the Coin, p. 82-104).

GDP in eastern Germany), the Italian and German economies have gained little. Given that the eurozone would probably be unable to provide its non-competitive members with such large annual transfers, such a strategy would be even less likely to work there. These examples show that structural policies aimed at improving the competitiveness of under-developed regions of a single currency area are so ineffective and expensive that they cannot contribute significantly to boosting competitiveness in problem eurozone countries.

Kawalec and Pytlarczyk (2013 a) also argue that although a fiscal union may potentially limit the risk of irresponsible budget policy, problems with competitiveness resulting from various sources will certainly emerge in the future in some of the eurozone member countries.

There will be a continuous need for a weak euro

As some member countries may encounter competitiveness problems from time to time, and restoring disturbed competitiveness will usually last many years, most of the time there will be some depressed member countries within the eurozone. Therefore, the risk of political upheaval in the most vulnerable member countries is likely to continuously force the ECB to conduct the policy of 'weak euro'. Thus, while it is a new phenomenon, a huge eurozone current account surplus may be persistent.

5. Permanent undervaluation of the euro would undermine relations with the US and other trade partners

It is worth asking about the potential impact of a persistent euro undervaluation and a current account surplus on the relationship with Europe's main trading partners, especially the US.
Over the past three decades, the US has *de facto* tolerated the behavior by its major Asian trading partners, which have built up large trade and current-account surpluses by suppressing the value of their currencies. But the US is unlikely to accept such conduct within free-trade zones. Indeed, a bipartisan majority in the US Congress is already demanding that the Trans-Pacific Partnership (TPP), a mega-regional free-trade deal involving 12 Pacific Rim countries, should include provisions barring currency manipulation.[13]
Discussions about currency manipulation have long focused on China, which is not part of the TPP, but could join it, or a similar arrangement, in the future. But the economy with the biggest current-account surplus today is not China, but the eurozone (as demonstrated in Chapter 2).
Some may say that as long as the ECB does not intervene by directly buying foreign currency assets, the eurozone does not qualify as a currency manipulator. Indeed, today currency manipulation is usually identified by direct intervention in foreign currency markets.[14] But if a leading world economy such as the eurozone continues to have an undervalued currency and a substantial current account surplus as a result of intentional actions, purposely using instruments other than direct foreign currency interventions, such behavior is likely to qualify

[13] See: C . Fred Bergsten (2014).
[14] C . Fred Bergsten (2014).

as currency manipulation sooner or later. This is because the essence of the notion of currency manipulation is an intentional action to suppress the value of the currency resulting in a substantial currency misalignment. Persistent trade and current account surplus could be regarded as evidence of a currency undervaluation.

Nouriel Roubini (2015a) and Kawalec (2015) argue that the continuation the ECB's monetary policy that weakens the euro, would inevitably result in trade and currency tensions with the US.

Protracted policies suppressing the value of the euro and resulting in the eurozone's substantial current account surplus may endanger the Transatlantic Trade and Investment Partnership (TTIP). Approval of TTIP by the US Congress might be obstructed, or the actual operation of the treaty hindered, which may result in its future deterioration or termination.

Failure of the TTIP negotiations would mean a lost opportunity. Studies suggest that the treaty could boost welfare and reduce unemployment in both economies, as well as in other countries.[15] In addition, as Kawalec and Pytlarczyk (2013 b) claim, the EU-US trade agreement could be instrumental in raising European morale after the prolonged crisis. TTIP could become a new flagship project which could help to restore confidence in the future of Europe and the transatlantic community.

6. A Europe with national currencies could have better trade relations with the rest of the world

Kawalec and Pytlarczyk (2013 b, p. 16) argue that if the eurozone countries had (or returned to) their national currencies, linked through adjustable currency bands, trade and current account deficits in countries in crisis could be eliminated through balancing imbalances among present eurozone members, without the necessity to generate 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.

It is also worth analyzing, from the perspective of Germany, the difference between two options that are considered here:

(a) Balancing imbalances among present eurozone members by return to national currencies and enabling exchange rate adjustments within currency bands (advocated by Kawalec and Pytlarczyk 2013 b), versus

(b) Doing it by fiscal expansion and relaxation of wages in Germany (that we have disqualified in Chapter 4).

[15] European Commission (2013) and Felbermayr *at al*., (2013).

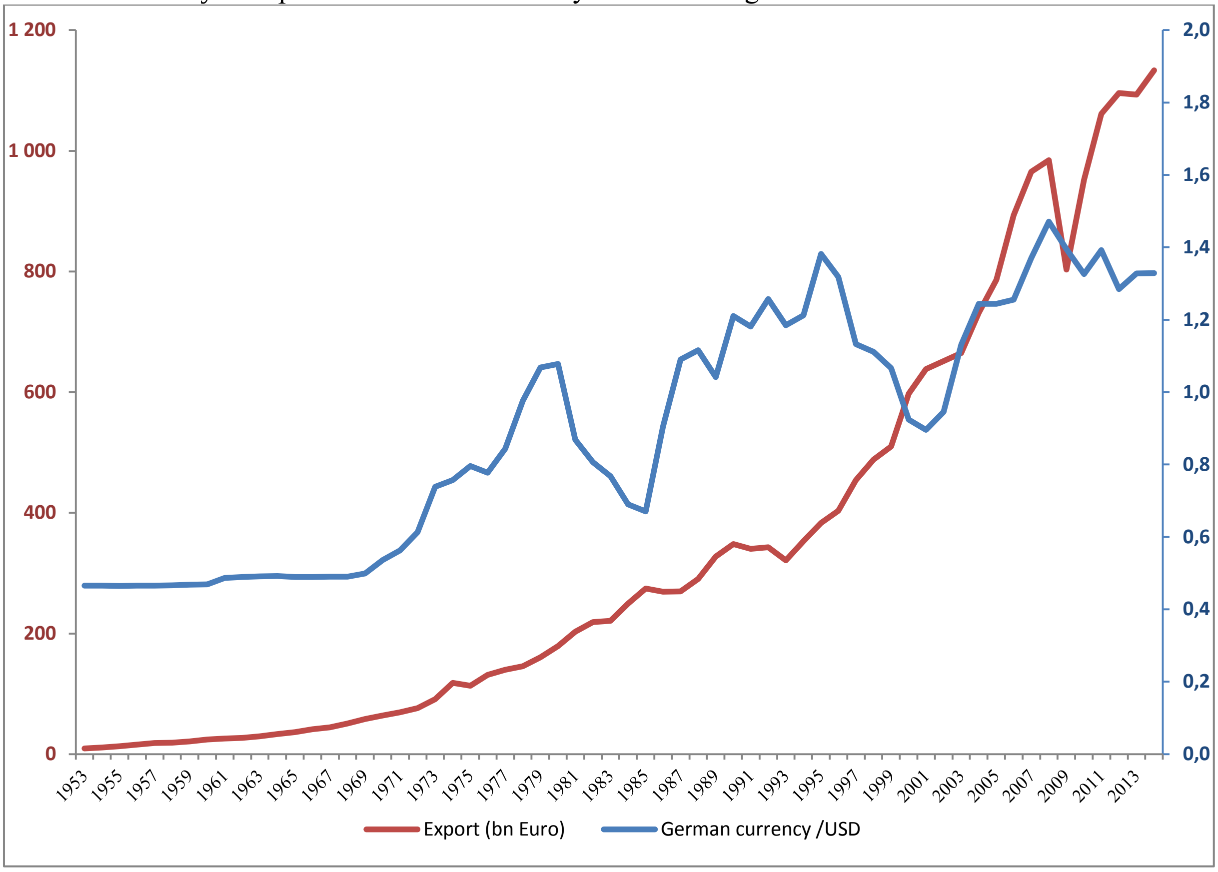
Both methods are expected to result in an increase in German wages, as denominated in the currencies of the foreign trading partners. However, in (a), this would happen by the appreciation of a new German currency, while in (b), via a nominal increase in wages across the German economy.

A big difference between these two methods would appear if, at some point in 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 experiences show 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 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. Chart 2 shows however, that 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 two directions played an important role in protecting the competitiveness of the German economy.

Chart 2. Germany' s export and German currency/USD exchange rate – 1953-2014



Export: 1959 to 1989, territory as before 3 October 1990; from 1990, territory as from 3 October 1990. Based on Statistisches Bundesamt (2015).
Exchange rate. Source: http://fxtop.com/en/historical-exchange-rates.php?A=1&C1=DEM&C2=USD&YA=1&DD1=01&MM1=01&YYYY1=1953&B=1&P=&I=1&DD2=01&MM2=01&YYYY2=2015&btnOK=Go%21 ; average yearly Deutsch Mark/USD rates converted into Euro/USD, at the conversion rate Euro= Deutsche Mark 1,95585.

Our analysis contradicts the popular view that the EU needs a single currency to operate successfully in the world economy among big players like the US, China and India. In fact, if the eurozone countries had (or returned to) their national currencies (linked through adjustable currency bands), trade and current account deficits in countries in crisis could be eliminated through balancing imbalances among present eurozone members, without the necessity to generate a huge surplus by the eurozone as a whole. On the contrary, the single currency forces the eurozone to try to desperately generate trade and current account surpluses, which are likely to spark currency wars with its main economic partners. This is likely to impede international trade and diminish the benefits that Europe could achieve from international cooperation.

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