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The Euro Paradox: How to Break Out of the Trap of a Common Currency?

Abstract

1. Saving the European Union and the Single European Market should be the overriding goal of European policy

Europe should be proud of its achievements in the second half of the twentieth century. After the terrible experience of two world wars, the creation of the European Union and the Single European Market were

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The authors are signatories of the European Solidarity Manifesto http://european-solidarity.eu, signed by a group of economists and public intellectuals from several countries of the European Union.

remarkable political and economic successes. It brought Europe peace and economic development. Today, the future economic prosperity of European countries, including Poland, depends on saving the European Union and the Single European Market.

2. A common currency is a dysfunctional and destructive solution for Europe

One of the key factors threatening the European Union today is the set of negative consequences – often running counter to expectations – which are happening as a result of introducing the common currency.

The lack of a national currency turned out to be very painful in times of crisis

When the eurozone crisis hit in 2010 it was estimated that the southern eurozone countries, i.e. Greece, Spain, Portugal and Italy, should reduce their wages by 20–30% in order to regain international competitiveness. If these countries had not belonged to the eurozone, such a rapid improvement in competitiveness could have been accomplished by a depreciation of their national currencies, without damaging economic activity and employment levels. This is what happened in Poland, for example. At the end of 2008 and the beginning of 2009, the Polish zloty depreciated by 30%. Thus, although wages in Poland in the domestic currency remained unchanged, in terms of euros or the currencies of other trading partners, they decreased by 30%. This improved the competitiveness of Polish companies. This was probably the most important factor that enabled Poland to be the only EU country that enjoyed positive economic growth in 2009, at the height of the world financial crisis.

The eurozone countries in crisis could not regain their competitiveness by simply letting their currencies depreciate, because they do not have their own currencies. Consequently, these countries have been trying to restore competitiveness via a so-called „internal devaluation," which is really just an ordinary deflation policy aimed at reducing domestic prices and wages. The main tool of this policy is fiscal tightening, i.e. increasing taxes on the one hand and reducing government expenditures on the other, including a reduction of pensions and a wage cut in the public sector. It was assumed that this would weaken domestic demand, forcing a reduction in private sector wages and thus restoring the international competitiveness of these countries. However, as demonstrated by economists, wages in companies are inflexible downwards. As a result of the implemented internal devaluation policy, wages declined only slightly, while gross domestic product (GDP) decreased and employment fell. In 2014, real GDP in Greece was 74% of its level in 2007, the last year before the outbreak of the global financial crisis, while the figure was 91% in Italy, 93% in Portugal, and 94% in Spain. For comparison's sake, this same ratio was 105% in Germany, 107% in the U.S., and 123% in Poland.

A frightening analogy with the deflation policy during the Great Depression

There is a disturbing parallel between today's „internal devaluation" policy in defence of the euro, and the deflation policy applied during the Great Depression in the 1930s in order to defend the gold standard, which finally collapsed. Today, economists explain that clinging to the gold standard was a key factor in the deepening and spreading of the Great Depression internationally, which led to the demise of democracy in many countries and nearly caused the demise of democratic capitalism throughout the world. 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.

Currency devaluation is not a cure, but in times of crisis it is hard to do without

Currency devaluation is not a miracle solution that can replace healthy macroeconomic policy. However, successful adjustment programmes aimed at restoring economic balance usually include currency devaluation, which lowers unit labour costs, easing the recessionary impact of fiscal and monetary tightening. Whereas in a democratic system, attempts to restore a large competitiveness gap through a deflation policy – without changing the exchange rate – often end up failing.

3. The lack of adjustment mechanisms in terms of national currencies cannot be effectively compensated for

A fiscal union at the eurozone level will not substitute for the lack of national currencies

It is a fallacy to believe that progress in the construction of a fiscal union, and in particular the creation of a substantial central budget, will equip the eurozone with economic policy instruments that will effectively substitute for the lack of currency adjustment mechanisms at the national level.

A fiscal union does not provide any instruments that could substitute for an exchange rate adjustment and improve a country's competitiveness. Southern Italy is a beneficiary of annual financial aid amounting to 16% of its GDP. Over twenty years, East Germany has been receiving annual transfers worth more than 25% of its GDP. Despite these huge transfers, unemployment levels in southern Italy and East Germany continue to be significantly higher compared to other parts of these countries. In the US, poor states and dependent territories have been receiving annual net federal transfers amounting to 10% of their local GDP for a period of 20 years. However, such huge transfers have not enabled them to escape from the trap of underdevelopment.

In fact, an attempt to improve the competitiveness of non-competitive regions within a currency union through fiscal transfers is a contradiction in itself. Inflows of funds actually serve to undermine countries or regions that are trying to regain competitiveness through a policy of internal devaluation. While an internal devaluation policy is intended to diminish domestic demand in order to decrease domestic prices and wages, incoming fiscal transfers increase domestic demand and contribute to wage and price increases, thus making it more difficult to regain competitiveness. Thus, a fiscal union does not create the instruments needed to resolve the problems of non-competitiveness in some regions, but rather is a way to collect the resources needed to finance the continually occurring deficits in less competitive and underdeveloped regions.

Maintaining international competitiveness is essential for a member state whose economic development is at a lower level to be able to develop faster than richer EU countries

EU member states with a lower level of economic development, as measured by GDP per capita, have the opportunity to grow faster than richer EU countries (as seen in Poland) provided they maintain international competitiveness. With their own currency, such countries have a greater ability to protect their international competitiveness and, with sensible macroeconomic policy, they can reduce the gap between themselves and the richest countries. When a country in the eurozone loses its competitiveness, regardless of the reason, a fiscal union will not help. Transfers financing the deficits of non-competitive countries will make it difficult for them to recover their competitiveness. Thus, a fiscal union may lead to a deepening division of the eurozone into competitive countries that generate a surplus in their current account and deficit countries that require constant support.

Making the labour market become more flexible, while desirable, is no substitute for exchange rate adjustment

Even in the US, where the labour market is significantly more flexible than in Europe, there is no nominal wage decline in the regions affected by higher unemployment. The factor that solves the problem of high unemployment in non-competitive regions of the US is not „internal devaluation," i.e. local wage adjustments, but the emigration of people of working age to other parts of the country.

New competitiveness problems will arise in the future in the eurozone countries

It is unreasonable to believe that the dramatic competitiveness problems in some eurozone countries are of such a unique character that strengthening the institutional architecture of the eurozone will ensure such crises will be avoided in the future. Competitiveness problems will appear as long as there is no shock absorber in the form of a flexible exchange rate, and interest rates are too low for some of the countries in relation to the needs of those countries' economies. A fiscal union may limit the risk of irresponsible budget policy, but it will not prevent problems with competitiveness for reasons that cannot always be predicted in advance, and which may be difficult to avoid. One example is Finland, which, until recently, was regarded as one of the eurozone's most robust and innovative economies and topped global competitiveness rankings. In recent years, it has been struggling with the problem of structural non-competitiveness and is stuck in economic stagnation. In 2014, Finland's real GDP was only at 95% of 2007 levels.

Neither long-term stagnation nor mass emigration is an acceptable solution for the nation-state in Europe

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 for the well being in their own countries. That is why member states should not abandon difficult to replace instruments for improving the economic situation in their territory, which are related to their own currency.

4. Continuing to defend the euro at all costs weakens the European economy and threatens the cohesion of the European Union

The focus of European policy on defending the euro leads to destructive effects within the European Union and damages relations with its trading partners

Today's policy of defending the euro at all costs is responsible for a situation in which southern Europe is experiencing an economic depression comparable to the worst years of the Great Depression. Attempting to overcome the dysfunctionality of the eurozone through increased centralisation and an evolution towards a fiscal union cannot bring the expected benefits. At the same time, such actions lead to a growing dissatisfaction among the citizens of member states. This creates political tensions, which could lead to the disintegration of the European Union and the common market.

The inability to eliminate the imbalances within the eurozone has led to attempts to remedy the deficiencies of poorly performing countries by weakening the euro and generating a trade surplus for the entire zone. Such a situation exposes the eurozone to conflicts with major trading partners and may prevent Europe from reaping the benefits of the development of international trade.

5. The eurozone should be dismantled in a controlled manner in order to save the European Union and the common market

The Euro trap

The paradox and trap of belonging to the eurozone lies in the fact that countries in crisis and in dire need of their own currency cannot safely abandon the common currency. If a country in crisis were to announce its exit from the eurozone, its citizens would immediately seek to withdraw their bank deposits in euros before they were redenominated into the new currency, which would be likely to weaken against the euro in short order. Such a run on banks could lead to a collapse of the economy.

A remedy for the euro trap: Germany should leave the eurozone first

The situation would look rather different if a country like Germany, which enjoys a stable competitive position, were to leave the eurozone. Hence, the proposition formulated by the signatories of the European Solidarity Manifesto is to conduct a controlled dismantlement of the eurozone, starting with the exit of its most competitive countries. The euro could then remain, for some time, the common currency of the least competitive countries, but eventually all countries would return to their national currencies or would form common currencies within homogeneous groups of countries. The Manifesto emphasises that the proposed solution would be an expression of European solidarity. A weaker euro would improve the competitiveness of the countries of the South. The authors of this book present a scenario for a controlled dismantlement of the eurozone, offering an example of the concept outlined in the European Solidarity Manifesto.

The main elements of the proposed strategy

The proposed strategy enables the dismantlement of the eurozone in an economically and socially optimal way. Its main elements are as follows:

1. The decision to dismantle the eurozone and to replace the euro with an alternative currency coordination system should be consensus-driven.
2. The process should start with the exit of the most competitive countries.
3. Only domestic contracts should be converted into new currencies in exiting countries.
4. Once the euro ceases to exist, international contracts in euros will be converted into contracts in the basket of currencies of the countries that belonged to the eurozone at the moment of its dismantlement.
5. For a certain period, the European Central Bank should remain the central bank for all the former countries of the eurozone.
6. A new system of currency coordination should be agreed upon.
7. Countries in crises and their banks should continue to receive support and debts should be reduced as necessary.

The special role of the European Central Bank during the transition period

Preserving the European Central Bank for a certain period of time as the central bank for all former eurozone member countries could play a key role in the success of the strategy of a controlled dismantlement of the eurozone. The ECB would be in charge of designing, preparing, and implementing the controlled segmentation of the eurozone. If the ECB were made the central bank responsible for the monetary policy for all currencies and the proposed new currency coordination system, it could lend credibility to the adopted currency bands and limit currency fluctuations, in particular the excessive appreciation of a new German currency. This would eliminate the danger of currency wars. The proposed role of the ECB would demonstrate that the segmentation of the eurozone is part of the orderly transformation of the European currency system and that it would be carried out under the control of the European institution most respected by financial markets.

The currency system will cease to hinder development, the Member States will be able to embark on a path of economic growth more easily, Europe will avoid conflicts with trading partners, and Germany will avoid a „hard landing"

The return of the eurozone countries to their national currencies, with flexible exchange rate corridors, will make it possible to solve the problem of imbalances within the current eurozone without generating a huge surplus on the current account. Countries in crisis will find it easier to embark on a growth path. Europe will be able to better exploit the potential of its economy, without coming into conflict with its main trading partners. The German trade surplus will be contained, but in a much more gentle and safe way than if other potential methods were to be implemented. This way Germany will avoid a hard landing, which could happen at some point in the event that the massive trade surplus persists.

Saving the most valuable achievements of European integration requires vision, courage and political leadership

Whether the proposed scenario of a controlled withdrawal from the project of a common currency will be implemented depends on political will and the development of the situation in the eurozone. It seems the country most likely to propose such a concept is France, widely considered the intellectual father of the euro.

If pro-European and pro-market EU leaders are not the ones to carry out the eurozone dismantlement, it will most likely be done by their anti-European and anti-market successors. In the latter case, the European Union and the common market will be destroyed.

If the European elite continues to defend the euro at all costs, then instead of a controlled dismantlement carried out in the spirit of European solidarity, we can expect a unilateral exit from the eurozone of one of the countries stricken by crisis. Such an event would not be dictated by concern about the sustainability of the European Union, but it would be the result of the internal pressures of an embittered society, exhausted by prolonged economic depression and high unemployment. Such a solution would be economically much more expensive and its political repercussions far more serious.

6. Poland should strive to maintain the EU and the common market, but it should not join the eurozone

Maintaining the European Union in (at least) its current composition, including the UK, and preserving the common market are in Poland's vital interest. Freeing the European Union from the trap of a common currency through a controlled dismantlement of the eurozone and establishing an alternative currency coordination system in Europe would be a preferred solution for Poland. This would allow those eurozone countries that are now facing competitiveness problems, and underperforming with respect their potential, to flourish and consequently boost economic growth across the EU. This would be salutary for Poland's economic performance as a participant in the common market.

That eurozone countries continue to maintain a suboptimal solution in the form of a common currency should not be a reason for Poland to give up its own currency, because such a step would jeopardise the country's opportunity for development.