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The Economic Consequences of the Euro

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Director's Note

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This paper considers the current economic crisis in Greece and argues that the governance structure of the Euro is exacerbating the crisis with the potential to turn what is a liquidity crisis (following the flight of private capital) into a solvency crisis. The inability to use state-backed money requires the European Central Bank to fulfil its role as a central bank and accept responsibility for the solvency of member countries. The paper argues that current policy responses are the polar opposite of what is required.

The author of this paper is Assoc Professor Colin Rogers, School of Economics, University of Adelaide and Senior Research Associate at the Centre. The views expressed in the report are the views of the author.

Michael O'Neil
Executive Director
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July 2011

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The Economic Consequences of the Euro

Overview

The latest scare surrounding Greek debt wiped $A25bn off the value of Australian equities on 15th June 2011. The question that naturally arises is why fiscal problems in far-away Greece can have such an impact on the Australian economy. How is it possible for such a small economy to send such a big shock-wave around the world? Part of the answer lies in the slow global recovery and heightened risk aversion and uncertainty that characterises financial markets in the post global financial crisis (GFC) environment. But more fundamentally the Greek crisis does indicate a serious structural flaw in the design of the Euro that could bring the experiment with monetary union undone. A Greek default could push the Euro-zone back into recession and send a shock-wave through the highly integrated global financial markets as Australians realised on the 15th June 2011. To make matters worse the European elite, represented by the European Central Bank (ECB), European Commission (EC), national finance ministers and prime ministers, are in denial about the risks they face. This makes for a potentially deadly cocktail when hubris collides with reality as it did early in the 20th century when Britain attempted to return to the gold standard at the pre-World War I parity. In fact many economic historians have noticed the eerie similarity between the two events.[1]

So the short answer to why a crisis in tiny Greece can send shock-waves around the world is that it is a symptom of a far more serious problem that afflicts the Euro-zone as a whole and not just Greece. Cascading disorder in Greece could and would spread quickly to Ireland and Portugal and possibly other Euro-zone economies and destroy the credibility of the ECB and the EC. The long answer requires an understanding of how the design of the governance structure of the Euro in the 21st century has managed to embody all the flaws of the gold standard abandoned in the 1930s. In particular, the flawed design of the governance structure leads inevitably to self-fulfilling bad outcomes as the rational protective response of private sector lenders automatically converts a liquidity crisis into a solvency crisis. That the early 21st century finds sovereign members of a monetary union facing insolvency is just staggering and points to intellectual failure on a grand scale. The intellectual failure, as always, is the root cause of the problem, as it leads in addition, to policy responses that are the polar opposite of what is required. Having created the pre-conditions for the crisis the governance structure for the Euro then almost automatically induces perverse policy responses. As Eichengreen (2010) put it, it seems that the ECB and the EC rarely miss an opportunity to make matters worse!

The purpose of this Economic Issues Paper is to explain how this came about and to examine what options are available to salvage the situation.

A brief history lesson

... remember the lessons of history ...

As economic historians delight in reminding us, those who do not study the lessons of history are bound to repeat its mistakes. The Europeans are about to re-learn that lesson. Unfortunately, the economic and personal costs of what amounts to a colossal intellectual failure will fall, as always, on those least able to bear it. To understand the predicament into which the Euro has thrown the monetary union it is useful to briefly review why the post-World War I attempt to return to gold failed in the 1930s.

At the risk of oversimplifying, the attempt to return to gold in the 1920s was doomed from the start because the special conditions that had existed prior to 1914 were no longer in place post 1918.[2] In particular the distribution of gold reserves between Britain, Germany, France and the United States was no longer in balance. Instead gold reserves were higher in the United States and significantly depleted in Britain and Germany. Also France devalued its exchange rate and proceeded to run trade surpluses further draining gold from the rest of the world as it accumulated gold reserves. Britain, by contrast, went back on gold at the pre-war parity despite wages and costs at least 10 per cent above pre-war levels. The net effect of this 'feather-brained' (Keynes's phrase) approach to monetary arrangements was deflation and unemployment in Britain, hyperinflation followed by economic collapse in Germany. The 'roaring twenties' in the United States where a series of asset-price bubbles culminated in the stock market crash of 1929, and rising prosperity in France as it accumulated gold reserves. So not only were several key economies moving out of step, some booming and some in recession, the misallocation of gold meant that each economy was forced by the system to either inflate (if booming) or deflate (if in recession). But rather than a general price and wage inflation the United States experienced a stock market or asset-price bubble. But the theory suggested that only by the adjustment of price and wage levels could some form of global equilibrium be attained. This was, in fact, the way the gold standard was supposed to work under the specie-flow mechanism described by David Hume in the 18th century. Unfortunately, this adjustment process did not always work as expected and when it did it worked in asymmetrical fashion by placing the burden of adjustment on deficit countries. Surplus countries had less pressure to adjust while deficit countries attempted to mitigate the negative social effects of falling prices and wages and rising unemployment, by the counterproductive policy of raising interest rates to attract foreign gold deposits.[3] That policy response inevitably made domestic conditions worse. Britain was in depression well before the Great Depression began in 1930.

... the burden of adjustment on deficit countries ...

In the period after the collapse of the United States stock market bubble in 1929 the global deflationary pressure emanating from the gold standard was intensified by a series of banking collapses that originated in Europe and then spread to the United States and Britain. By 1931 it was apparent that the global economy had collapsed into the Great Depression as banks failed across the United States and the Bank of

England was forced to borrow $400m in gold from private United States and French banks only to see it evaporate in a couple of weeks. In effect Britain had run out of gold by early September 1931 and had no alternative but to abandon the gold standard on the weekend of 19-20 September 1931. In other words *Britain was insolvent*. It simply had insufficient gold reserves to pay its way under the existing gold standard. Now *insolvency* was not supposed to be a possible outcome under the gold standard but clearly it was there for all to see.

... the liquidity crisis turns into a solvency crisis ...

But this possibility should have been obvious from the start. If gold is to be the international medium of exchange then all countries must have access to it and its supply must grow in step with world growth. If that does not happen the global banking system will economise on gold, as it did, by substituting paper notes and credit. That is fine so long as everyone expands in step. But once someone lags behind, as they inevitably will, those with insufficient gold to back their paper and credit will find that a *liquidity crisis* can readily transform into a *solvency crisis*. Germany, under the weight of reparations payments, and Britain, under the weight of the misguided attempt to return to gold at the pre-war parity were the laggards in the 1920s.

... higher interest rate are the opposite of what is required ...

This means that the fatal flaw in the gold standard is that countries that cannot produce gold at the required rate, through mining or trade, may inevitably face a solvency crisis and not just a liquidity crisis. In addition the automatic policy response induced by the gold standard was for deficit countries to raise domestic interest rates in a vain attempt to attract gold deposits. But that response was the polar opposite of what was required to restore domestic growth and employment as Keynes pointed out.

The lesson that monetary economists took from the experience of the 1930s was that gold should be abandoned and replaced with state backed money. As usual Keynes (1936) was the leading exponent of this view and supported the nationalisation of the bank of England in 1946. Many other countries then followed suit and created or nationalised central banks and directed them to act in the public interest by maintaining price stability and high employment. But the fundamental objective of the creation of state-backed money was twofold: to break the link from a liquidity crisis to a solvency crisis and to prevent the automatic implementation of perverse domestic monetary responses that made matters worse by pushing up domestic interest rates.

... key lesson of the 1930's is ...

To sum up, the key lesson learnt in the 1930's is that state-backed money is required to eliminate the possibility of sovereign insolvency and the implementation of perverse policy responses. If the monetary system does not have that capacity then it always runs the risk that a liquidity crisis will readily transform into a solvency crisis. It also suggests that perverse policy responses will be almost inevitable. Yet that is precisely the predicament into which the Euro has blundered.

The Euro as the new gold standard

Alan Greenspan once remarked that central bankers still act as if they are on the gold standard. That may indeed have been his mental state but the United States, and everyone else, has unequivocally been on state-backed monetary systems since 1971 when Richard Nixon closed the gold window and brought the Bretton Woods system to an end.[4] Unfortunately it also seems to be the mental state of Mr Trichet and the ECB board.

... Euro is the new gold standard ...

That situation persisted until 1999 when all those economies that adopted the Euro gave up their state-backed money in favour of the Euro. This may still turn out to have been a fatal mistake as it is now clear that all the *Euro members face a situation where a liquidity crisis can readily transform into a solvency crisis*.[5] So in that sense the Euro is the new gold standard. The problem facing, Greece, Ireland, Portugal and other periphery economies is that they, like Britain and Germany in the 1920s, are out of step with other key economies and running trade deficits with their Euro-zone partners. Under the current crisis conditions they are insolvent because they cannot create Euros. In that sense they are in a totally different situation from countries like Japan, UK or the US that retain their state-backed money. Rating agencies that propose to downgrade debt issued by countries with state-backed money, using the problems of Greece under the Euro as a justification, are just dead wrong.[6]

To acquire Euros now, Greece and other crisis economies have three options: (i) they can borrow in private markets at exorbitant interest rates, or (ii) borrow from the European-IMF stability facility, at lower but still too high interest rates, but in exchange for imposing austerity packages that destroy confidence and increase unemployment, or (iii) borrow from the ECB. To date the ECB strategy is to force them to use option (ii) despite the fact that the ECB allowed option (iii) during the GFC under the guise of liquidity support. *The ECB has so far not offered solvency support*. The problem with this strategy, option (ii), is that it does not address the fundamental problem at the core of the crisis; the fact that Greece, Ireland and possibly Portugal *are insolvent* and others, e.g. Spain, may follow if any one of these three collapses.

... no option but to create state-based money ...

To sum up this part of the story it is now clear that the Euro governance structure has put in place a system that mimics the effects of the gold standard because it creates the possibility that states can become insolvent once they give up their ability to create their own state-backed money. The architects of the Euro seem to have been blithely unaware of this possibility when they created the ECB and the Euro.[7] Having created the possibility that states can become insolvent it is then a simple step to see that a *liquidity crisis* can become a *self-fulfilling solvency crisis* as De Grauwe (2011) and others have explained. But once in the crisis why haven't the ECB and the EC been able to find a solution? The short answer is that the ECB still thinks it is on the gold standard so they find themselves trapped into implementing policies that make the situation worse, much to the frustration of potential supporters of the Euro like Eichengreen (2010).

Clearly, judging by ECB and EC statements, current policies, including the fiscal austerity packages, are indeed intended to restore confidence and growth to the crisis economies. The problem is that these policies seem to be the polar opposite of what is required. So what is going on here? The logic of the ECB-EC position can be explained by examining the economic theory that lies behind the objectives they set for the ECB and the Growth and Stability Pact (G&SP) put in place at the time of the Maastricht Treaty on the founding of the Euro. The ECB was established to act as a central bank more or less in the mould of the Bank of England or the Federal Reserve. As such it was tasked with the creation of Euros and the maintenance of price stability and high employment. Where it's take on economic theory came in and greatly distorted thinking was the claim that the achievement of price stability was sufficient to achieve all its other objectives and/or was the only contribution it could make to the achievement of those objectives.[8] This vision reflects a widely accepted but quite wrong belief that monetary policy should and can act only to maintain price stability because it has a neutral effect on growth and employment. Allowing flexible labour markets is then all that is required to ensure growth with full employment.

... current policy responses are the polar opposite ....

Unfortunately reality is somewhat different. The Panglossian view of the world that underpins the institutions of the Euro is precisely the view that led to the failure of the gold standard. A consequence of this Panglossian view is that not only has the institutional structure of the Euro created the conditions for the crisis it has also ensured that the current policy responses are the polar opposite of what is required. As under the gold standard, the ECB and the EC are imposing deflation or 'internal devaluation' of some Euro-zone members. But in the 1930s it became apparent to even the most unobservant economist that deflation was not a viable road to recovery.[9] Yet, today in the 21st century European leaders are imposing 'internal devaluation' as a solution to the Euro crisis. As Eichrengreen (2010) remarked, quoting Talleyrand, the ECB and the EC have a lot in common with the Bourbons on their return to the throne of France in 1815: 'they have learnt nothing, and they have forgotten nothing'.

So, as if repeating some sort of mantra, the ECB continues to argue that fiscal austerity programs in Greece, Ireland and Portugal must be intensified as this is the only way to restore *confidence and growth*.[10] Unfortunately for the ECB the Greek people don't seem to believe in Panglossian economics, Baker (2010). Although the Greeks are on weak moral ground as a result of previous government malfeasance the same cannot be said for Ireland, Portugal or Spain where unemployment is at or approaching Great Depression levels. Consequently, if the ECB and EC continue on their current trajectory we are on course for a repeat of the *Economic Consequences of Mr Churchill* and ultimate failure of the Euro experiment, Keynes (1931, pp. 207-230).

Can anything be done to save the Euro?

... prospect of a looming debt trap ...

Having acknowledged that solvency is the problem the options for solving it and the constraints that exist under the Euro structure become clearer. Greece, Ireland and Portugal can only escape the doomsday path on which the ECB has launched them if they can grow faster than the interest rate they are paying on their debts.[11] Currently, growth estimates and the interest rates charged for EU-IMF stability funds all indicate that these economies are headed into a debt trap. So the first thing that could be done would be to cut the interest rates on the EU-IMF loans. That is the easy bit and although helpful is not sufficient. Unless growth at something close to potential can be restored to Greece, Ireland and Portugal the future for the Euro looks bleak. So can that be achieved under the current ECB strategy?

The short answer is no. The question must be answered in the negative because the current European mindset, dominated by the ECB and Mr Trichet (2011, a, b, c) is convinced that the road to recovery lies in more and more austerity, with tighter and more automatic enforcement of the S&GP rules on all members. But this strategy will make it impossible for Euro-crisis economies to growth fast enough to stabilise let alone reduce their debt burden. Not only does deflation increase the real burden of that debt, the contraction and loss of employment that accompanies the depression inevitably reduces the ability of these economies to achieve their budget and debt targets as the tax base contracts. This explains the failure of Greece to meet its first bail-out targets. Essentially, as Eichengreen (2010) explains for the case of Ireland, the current strategy of EU-IMF loans does not attack the debt-trap and insolvency problem, it merely ‘kicks the can down the road’ in the hope that something will turn up in future to salvage the situation.

... Greece is the exception, but ...

De Grauwe (2010) also points out that the ECB strategy of increasing austerity is based on the wrong diagnosis that treats the Greek case as typical of all the crisis countries. That is simply NOT the case. Greece is the exception and was guilty of malfeasance but that is not true of Ireland, Portugal or Spain. In their case public finances were reasonably well managed and it was the growth in private debt driven largely by property market bubbles that caused the problem when governments came to the rescue during the GFC. As the recycling of Euros from surplus members also dried up these governments had no option but to convert private debt into public debt to prevent financial collapse. But that left them with debt and deficits well in excess of the G&SP targets and a level of debt that they could not service. In other words, Governments and the ECB acted, as they should have done during the GFC, to prevent the liquidity crisis from resulting in financial collapse. As a result the private debt in Ireland has been converted into public debt and the Irish government is chastised by the ECB and EC for violation of the S&GP criteria! Yet in 2004 Trichet (2004) held up Ireland as a model for other Euro members! The ECB therefore needs to explain how, under its watch, Ireland has transformed from a model citizen to a sinner.

To sum up we can say that the ECB has a view of objective reality that is at odds with objective reality, but it is a view so entrenched at the ECB and in the Euro-community that it could destroy the Euro.

So what is the intellectual failure common to the gold standard and the Euro on which this view of objective reality is based? A recent speech by Christian Noyer (2011), member of the ECB board, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements has spelt it out. It consists of six principles of monetary policy that have not been shaken by the global and Euro crises. The first key principle is what economists call the *natural rate hypothesis* and its corollary the *long-run neutrality of money*. The other five are simply implications of this hypothesis being largely concerned with the importance of inflation targeting and anchoring inflationary expectations. Now for the sake of non-economists it is necessary to explain the 'natural rate hypothesis' and the implied long-run neutrality of money. In short it is economist-speak for Panglossian economics. But a slightly longer explanation is more revealing.

... neutral money doctrine is false ...

The natural rate hypothesis and the long-run neutrality of money are ideas usually associated with Milton Friedman but they represent a long standing, but false, belief that money is merely a veil that obscures real transactions and that in the long run money is entirely neutral in its impact on real economic activity. That is the basis for the belief at the ECB that all they need do is maintain price stability, inflation of 2 per cent or less, and all will be well (ignoring the current crisis which has been caused by malevolent forces outside of the Euro-zone).[12] The fact is that the neutral money doctrine, although widely believed by economists, is false. It was false at the time of the gold standard and it is false at the time of the Euro. The gold standard was an institutional arrangement that had inherent flaws that were invisible to those who believed in Panglossian economics. The Euro has the same flaws because it is based on the same intellectual failure – belief rather than critical faculty.

... proper role of the ECB

The monetary and financial governance structure of the Euro-zone cannot therefore be constructed on the belief that it is neutral in its long-run effect. And yet that is precisely what has been done. There was no recognition that ECB responsibility extended beyond price stability.[13] The ECB is also responsible for financial stability and that extends well beyond the provision of liquidity in a crisis. Central banks were nationalised or created after World War II precisely to stop a liquidity crisis from morphing into a solvency crisis. Thus if the ECB is to fulfil its role as a central bank it must accept responsibility for the solvency of all members of the Euro. The ECB neglected its duty during the property bubbles so it cannot now abrogate its duty to ensure solvency of Euro members if it wishes to save the Euro. But this exactly what it has done behind the smoke-screen of Greek malfeasance!

... lessons with the gold standard have not been learnt ...

Thus it seems that the important lessons of the debacle with the gold standard have not been learnt and fundamental design flaws now afflict the governance structure of the Euro-zone. This places serious obstacles in the way of attempts to save the Euro because we are dealing not just with technical and accounting matters, whether Greece will default or not, but also with a sort of cult or mass psychosis that afflicts the European elite and dictates the way they think about and try to understand their predicament.[14] Until that psychosis is broken there is little hope for the Euro. To date I see no signs that this is happening. If anything there is s strengthening of resolve on the part of the ECB that will either drive Greece and perhaps others from the Euro or at best condemn them to a decade or more of stagnant growth and discontent.

Nevertheless, the way out of the muddle should be clear on the analysis presented here. As was the case during the liquidity crisis during the GFC that was successfully countered by the ECB, *the ECB must now guarantee the solvency of all Euro members*. The EB cannot simply draw the line at liquidity support in the case of sovereign members of the Euro-zone. Having taken over the functions of national central banks a key element of which was to prevent liquidity crises from morphing into self-fulfilling solvency crises, the ECB has no alternative but to guarantee the solvency of all members of the Euro. In short the ECB must stop pretending that it is on the gold standard and come to terms with precisely what its functions should be. Only if this can be done is there any hope for the Euro.

Concluding remarks

The experiment with the Euro was based on a grand vision to produce prosperity and peace in Europe. The objective is laudable and supported by everyone of goodwill.

... re-thinking the existing governance structure ...

The execution of the project was, however, based of flawed economic reasoning as encapsulated by the natural rate hypothesis of 'Panglossian' economics. That led to the implementation of a governance structure that made it inevitable that at some point a sovereign state would find that what initially appeared to be a liquidity crisis rapidly morphed into a solvency crisis that it was powerless to prevent. That sovereign states in Europe find themselves powerless to prevent a solvency crisis in the 21st century is testimony to the bankruptcy of Panglossian economics. That same mistaken view of objective reality induces the ECB and the EC to now enforce a policy response that makes matters worse by increasing the possibility that Greece and other debtors are forced into a debt trap and will default.

All the improvements made to economic governance of sovereign states after World War II, of which the creation of sovereign central bank was crucial, have been given away with membership of the Euro. Countries who did not adopt the Euro avoided this fate. Consequently the world is re-learning the lesson that the financial and monetary architecture is anything but neutral.

On this analysis the prognosis for the Euro is not good. So long as the European elite remains wedded to its false vision of Panglossian economics, progress to resolve the crisis will be slow and the risk of failure considerable. Ultimately, the successful implementation of a monetary union requires political union as many have noted and some believed would be hastened by adoption of the Euro.[15] The current crisis has now placed that objective in jeopardy by generating political resistance in both creditor and debtor members of the Euro. Any hope of political union seems even more remote.

... low interest rates loans to avoid debt trap and spur growth ...

Yet on the analysis presented here the way out of the muddle is clear. The ECB MUST accept responsibility for the solvency of all member states and stop pretending that it is on the gold standard. Once the European community can see that as a way forward the air of crisis will dissipate and cooler heads can find a way to get public finances back on track across the crisis countries. Low interest loans from the ECB should be part of the package as there will then be no need to continue with the charade of debt-trap loans from the IMF-EU stability mechanism.

Unless the ECB is prepared to acknowledge its full responsibility for the solvency of all Euro members, which means abandoning its belief in Panglossian economics, the population of Europe is in for a rough time.

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End Notes

1 Several commentators have noted the similarities between the Euro and the gold standard, e.g., Eichengreen and Temin (2010) and Chancellor (2010).

2 Liaquat Ahmed's (2009) *The Lords of Finance: The Bankers who broke the world*, provides a comprehensive and compelling account of these turbulent times.

3 Keynes (1936, p. 339) described the situation that developed in Britain as follows:" Under the influence of this faulty theory [what we call Panglossian economics] the City of London gradually devised the most dangerous technique for the maintenance of equilibrium which can possibly be imagined, namely, the technique of bank rate coupled with the rigid parity of the foreign exchanges. For this meant that the objective of maintaining a domestic rate of interest consistent with full employment was wholly ruled out."

4 Those who recall the Triffin (1961) paradox will remember that the Bretton Woods system was bound to fail because of the fixed link between the US dollar and gold was not sustainable.

5 Goodhart (1999) sounded an early warning that the concept of money underlying the traditional analysis of optimal currency areas and their application to the Euro was flawed.

6 The situation in the US is, as usual, a little different because they have a self-imposed debt ceiling. If political deadlock prevents an increase in the ceiling the US will have committed an act of gross stupidity.

7 Trichet (2004) praised the performance of Ireland and held it up as a model for the Euro to follow because it showed that producing budget surplus did not inhibit growth. As usual Mr Trichet seems to have the direction of causation the wrong way around. Ireland was experiencing a property bubble fed by borrowing from German and other European banks. The property bubble inevitable fed a cyclical expansion in tax revenue that has disappeared after the bust.

8 Bibow (2005) clearly exposes the implications of the ECB's Panglossian view of economic theory.

9 As Keynes (1931) noted in the preface to *Essays in Persuasion*, by 1931 almost no-one believed in the Treaty of Versailles, the pre-war gold standard or the policy of deflation. Yet here we are in 2011 watching the ECB impose just such a policy on some members of the Euro! Tilford (2011) provides a comprehensive critique of the ECB policy of internal devaluation or 'increasing competitiveness'.

10 Trichet (2004) clearly stated this view before the crisis and continues to re-state it as if the crisis had not occurred, Trichet (2011b, c).

11 As De Grauwe (2011) points out, all these economies face a debt trap as the interest rate on their 'bail-out' funds exceeds their growth rate. This situation is likely to persist into the future as 'austerity' packages depress rather than stimulate growth.

12 For example, Trichet (2011a, 2011b) continually tries to portray the Euro crises as a consequence of the broader global crisis and to pretend that the Euro-zone is just like the US economy when it obviously is not. The US is a Federal System and a single sovereign state while the Euro-zone is a monetary union of *sovereign states that have given up their ability to create money*.

13 Noyer (2011) now acknowledges responsibility for financial stability but does not exhibit any awareness of the need for ECB responsibility for solvency of Euro members.

14 The fact that Trichet (2011c) is caught in a mind warp is apparent from his answers to questions about the possibility of a Greek exit from the Euro at his numerous interviews. His favourite expression is: "It is not a working assumption that anybody considers"!

15 See the reviews by De Grauwe (2006).