The euro and the EU financial and economic crisis

Speech held by Stefan de Vylder at the Team, People's Movement No to the EU and ABF Alternative to the EU seminar, 8 June 2010 in Stockholm

My presentation consists of ten questions and answers (…) Some of the questions are very easy to answer. We tried to answer them back in 2003 before the Swedish euro referendum. We were then very concerned about the EMU. The euro project was based on political prestige rather than economic analysis. And today it has turned out that we were more right than we expected. It has become even worse than we thought.

But the good thing is that today we can answer some of the questions that were more difficult to answer in 2003.

Let me show you the first question, which was very much discussed in 2003. <u>What is an optimal currency area?</u> I will not go through all the theory, just make a few remarks. What are the main requirements for an optimal currency union? Some of them belong to economic policy making: in order to make a currency union function, you need to have rather homogenous economies and a certain coordination of fiscal policies. Another requirement is that you a have well-functioning mobile labour market. We can compare with the US for example. I don't think the US is an optimal currency area, but it would be difficult or even absurd to break it up today. The US has many advantages over Europe when it comes to labour mobility; people move between different states to a far higher degree than people in Europe move between different countries. The US also has a federal government with fiscal policies covering all states. It has certain national safety nets as well as a strong sense of national unity which the euro zone does not have. So it is easy to argue that the US, while it may not be an optimal currency union, is far better than the European monetary union.

This is the first conclusion. The EMU is not an optimal currency union.

The next question<u>: Is it costly to stay outside the currency union</u>? Back in 2003 the advocates of a Swedish membership in the euro zone argued that it would be a disaster for the Swedish foreign trade to keep the *krona.* That we would lag behind other countries. Now it has turned out that Sweden has a huge trade surplus. Around seven per cent of GDP during the last five years, which is extraordinary. So apparently it has not hurt our exports very much to stay out of the euro zone.

Britain, Sweden, Poland are examples of members of the EU which have not joined the euro zone. Britain does have huge problems when it comes to its fiscal deficit, but most countries outside the euro zone are better off than countries that are in the union. If you look at indicators such as the size of the fiscal deficit, the current account deficit, unemployment, expected rate of growth this year etc. you will see that the countries outside the EMU are doing a little better. They are not doing fine - we have had a global financial crisis. But they are doing slightly better; with lower unemployment, lower fiscal deficits and an expected higher rate of economic growth. So apparently it has not been a disaster to stay outside the EMU. On the contrary, it appears that it has been a wise policy.

We can look at other countries, Canada for example. There was discussion in Canada many years ago if it should adopt the US dollar. Now I think almost everybody in Canada agrees that it was excellent not to join the US currency. Canada is, in all possible respects, doing much better with its own currency than the US. To have, like Sweden or Canada, a small currency bordering to a dominant trading partner and monetary union does not appear to be harmful.

Does the fact that the members of the EMU are highly heterogeneous create strong tensions within the union? This was one of our main arguments in 2003. We argued very strongly in favour of a small and homogenous union. If we start to include countries which are very different in terms of international competitiveness and economic structure, economic policies, even demographic factors, it turns out that if you have a monetary union with all these heterogeneous members, sooner or later you will have an increase in tensions, economic and political tensions between member countries. So what we said at that time was that this currency union is heading for trouble.

In good times it does not matter very much whether you are a member or have your own currency. In good times you can do pretty well whether you are in or out. But the real test is when you have a crisis, or when enough time has elapsed so that you can see how different countries diverge, which signifies that they should not have a common currency or a common rate of interest. And as expected, tensions within the euro zone are mounting.

Does a common rate of interest within the monetary union reduce the risk for asset bubbles? Before the latest financial crisis, bubbles developed in almost all economies. House and stock prices increased very rapidly. Now, if you have a common rate of interest, could that reduce the risk for asset bubbles? I would say quite the contrary. The problem with a common rate of interest is that it is a common rate of interest that in the best of cases is adapted to the average of the member countries, but not to each individual country. If we look at the good years 2003-2007 that preceded the crisis we can see that some countries that really should have had a high rate of interest benefited from a low nominal rate of interest within the EMU. I am thinking of Spain, Ireland, Greece and several other countries within the EMU. But they were benefiting from a low rate of interest that was more in line with the needs of the German economy. Actually Germany would have needed an even lower rate of interest because of the German crisis after the unification in the 1990s, when Germany had a rather severe economic crisis, with a high rate of unemployment but a low rate of inflation. So really, Germany should have had an even lower rate of interest, but Ireland, Greece, Spain and other countries with a higher rate of inflation than Germany should have needed a higher rate of interest. I want to emphasise that this a logical consequence of a monetary union, namely that the real rate of interest, i.e. the rate of interest minus the rate of inflation, is by definition highest in precisely those countries that would need a lower rate of interest. Germany had a high rate of unemployment but a very low rate of inflation, so it needed a lower real rate of interest to stimulate the domestic economy. Ireland, Spain and other countries had, on the other hand, a higher rate of inflation those years, so they actually had a negative real rate of interest; inflation exceeded the nominal rate of interest. The real rate of interest was negative in the booming countries and as a result, asset bubbles developed at a much faster pace than in other countries. This is an in-built perverse effect of the EMU. It has nothing to do with the competence of the European Central Bank (ECB). It is an in-built thing we can’t avoid. So really, the more you need a lower rate of interest the higher will your real rate of interest be and vice versa. This should be clear to everybody that discusses the virtues of a common rate of interest, that it leads to perverse, procyclical consequences.

Is a membership of the EMU likely to improve macro-economic management? Well, we have seen a lot of mistakes in macro-economic management all over the world in the last ten years. All governments are able to pursue bad economic policies. But when we look at the record of the EMU, could we say that the stability pact and the disciplining forces of the ECB and Brussels authorities have been a guarantee against mismanagement? No. All of us can see that this was not the case. There has been huge macro-economic mismanagement in virtually all EU member countries, but it was even worse in some of the members of the EMU. Why is that? One reason is the lack of pre-emptive reactions from the financial markets. I don't think that the financial markets are always right, please do not misunderstand me. The last years – or decades - have revealed a number of markets failures precisely in the financial sector. But at least when you have markets that can determine the value of your currency, there exists the possibility for the markets to see when there is a case of severe macro-economic mismanagement.

For example, if the southern European countries had had their own currencies in 2005, 2006, 2007 etc., at least some clever speculators could have observed that the countries were losing their international competitiveness and realised that this was not sustainable. We would have expected attacks against the Greek or Irish currency. In this sense I am in favour of speculation because sometimes speculators, who are not victims of political prestige, will be able to identify a severe misalignment in the currency rates. For example, Sweden in the 1990s tried to play the game of the monetary union before the EMU was created. We had a fixed rate of exchange for several years, while we at the same time had a much higher rate of inflation that most other countries in Europe. What happened, of course, was a disaster. Some people blamed speculators like George Soros, who was accused of having destroyed the Swedish currency. But I am quite happy that the speculators won the battle against the stupid Swedish politicians, who defended a fixed rate of exchange in Sweden. Our four major national political parties stood up as one man. It was a patriotic duty to defend the value of the *krona*. Shortly before we were forced to allow the *krona* to float, the Central Bank´s rate of discount was raised to 500 per cent in order to defend the fixed rate of exchange. A journalist asked: 500 per cent, isn't that rather high? No, said the macho head of our Central Bank, the sky is the limit!

You can imagine the cost for the Swedish economy of politicians and central bank managers trying to defend the fixed rate of exchange. There were huge costs incurred. But unfortunately there are still politicians who try to repeat the same mistake of fixed exchange rates in a world with free capital movements. That is a recipe for disaster. Certainly the financial markets would have realized a little bit earlier that something was seriously wrong in some of the countries, especially in Ireland and the southern European countries. They didn't do that because they trusted the euro. Of course Greece and Ireland would never abandon the euro! So there was no speculation against the countries whose economic policies were not sustainable. I normally do not defend the efficiency of financial markets, but sometimes they can figure out that something is seriously wrong in a country. There were few signs of that until very recently. And the so-called stability pact has been a joke for many years, ever since France and Germany decided that we, the big countries, do what we want. There was no stability and discipline within the EMU.

Are large currencies a good insurance against financial crises? In Sweden those who wanted us to join the euro zone argued: 'Look at Sweden with our small currency, it is stupid to have this dangerous and highly volatile little currency. We should join the safe haven of a big currency'. You can discuss what is an optimal currency area, but at least we can say today that the financial crisis has demonstrated that having a big currency is no guarantee against financial crises. Where is the present crisis most severe in the world? It appears to be in the three largest currency areas in the world: the US, EU´s monetary union and Japan. China might today have passed Japan as the third largest currency area. But anyhow, remember that the financial crisis hit most severely the three largest currency areas, or monetary unions. Of course it is not a guarantee against financial crisis to have a big currency.

Neither is a small currency a guarantee against macroeconomic mismanagement. Stupid economic policies will always have a cost, and I think that our Icelandic guest could dwell on how the Icelandic disaster developed. But the key question is: <u>Is it easier or more difficult to cope with a crisis if you have your own currency</u>? From a Swedish perspective, thanks heaven we are not a member of the EMU with its fixed rate of exchange. And it would have been an unmitigated disaster for the Icelandic economy not to be able to let the currency float.

Fixed exchange rates are dangerous. I think of the Swedish experiences in the 1990s. I have also done some research on financial crises in other countries; I must admit that I have developed a somewhat masochistic interest in such crises. It started back in the 1980s, when I worked a lot in Latin America, where financial crises were common. Since then I have been trying to look into almost all major financial crisis: Mexico, Argentina, the Asian crisis in 1997, Russia 1998, or Sweden in the 1990s. These are big financial crises, which share many characteristics. A common pattern is that countries have experienced with a fixed rate of exchange but have sooner or later failed to defend it, after having incurred very high cost, as in Sweden. But if you have your own currency, if you have the possibility to set your rate of interest, and to let your currency depreciate – or appreciate! You are then in a much better position to cope with the crisis once it has happened than if you are a member of a huge currency area where you have one currency and one single rate of interest. So my point is that while any country can run into a financial crisis, it happens more often in countries with a fixed rate of exchange and, even more important, it is much easier to cope with the crisis if you have your own currency and your own monetary policy.

Well, many voices say today: look at what we said, the creation of the <u>EMU requires strongly coordinated fiscal policies, social policies and labour market policies.</u> <u>Does it, really?</u> Yes, in a way I think that is true in the sense that unless you have a close coordination of economic policies a monetary union will not work very well. But those who argue in favour of a strong centralisation of economic policy-making to Brussels or to Frankfurt and the ECB will run into problems. Few people in Europe would like this to happen. I don't think that Europeans in general would like to see their fiscal policies being taken over by an non-accountable, undemocratic bureaucracy in Brussels or Frankfurt. Let alone our labour market and social policies. We all have different traditions in Europe, which is excellent. One of the best things with Europe is its pluralism in the sense that we have tried and experienced different kinds of policies, social policies, labour market policies, a lot of different policies, and certain things have worked well and then we have learnt from each other and so on. But the idea of centralising and make economic policy-making almost identical in all European countries goes against the best of our traditions, and also against the will of the people of Europe. So I think that although a monetary union would require a closer coordination of economic policies it would really be the road to political disaster. We do not want it. And I don't think our political leaders will accept it. I don't think for example that Germany will accept a close coordination of Europe's economic policies. So I don´t think this is the road forward. Enhanced supervision of macroeconomic imbalances, yes. But not centralised decision-making.

Has the Greek crisis demonstrated that the European member states and authorities are good at coping with crises? I think this question is very easy to answer: No. We have followed the Greek tragedy for months now. It is just enough to read the newspapers to realize that what we have seen is really a weakness of the European Union authorities to cope with the crisis. A lot of arm twisting between Germany and the other countries and political tensions that are growing and growing. It is absolutely appalling what the Greek newspapers say about Germany and Germans and vice versa, that is, what German politicians and media say about Greece. It is a tragedy for Europe that we are starting a sort of bullying of each other as a result of mounting political tensions within the monetary union.

The EU and EMU authorities have demonstrated that they are not good at handling crises. They have proved to be both slow and incompetent. I don't think I need to say anything more than this.

I am coming to the last question now: which of the countries in the euro zone is the biggest threat to a restoration of stability? Many people would probably argue it is Greece. Greece has been an ideal scapegoat, hasn't it? The Greek retire at 53, if we are to believe our politicians and media (which we shouldn't). They drink a lot of wine, they don't work very hard, and they have also cheated with their public finances, and so on. They are the ideal scapegoat. Let's take the Swedish newspapers, most of them have only highlighted the problems of Greece and not the profound, structural problems of the EMU, which is absolutely absurd.

But is it really Greece that is the biggest problem? I won't give you a lot and figures, but only a few data to indicate some of the macroeconomic imbalances within the EMU.

The euro zone has 16 member states which together have a deficit on their current account, i.e. basically exports minus imports, of around 70 billion US dollars. That is not very much for a huge economic empire like the EU. But if we look at the figures a little more in detail we will see why the deficit is so small. It is because the surplus of Germany is so large. Germany alone has a surplus on its current account of 175 billion US dollars. The other surplus countries are the Netherlands, which has a surplus of 45 billion US dollars and Austria with a surplus of around 10 billion dollars last year. If we look at the other 13 countries, that is the EMU countries minus Germany, the Netherlands and Austria, it turns out that the total deficit in these countries is almost 300 billion US dollars. And that is a lot of money. So what the average data shows is that is that while the EMU's aggregate external account is rather balanced, behind this rather nice picture there are huge differences between Germany on the one hand and most other countries on the other hand. What does this mean? It means that the big problem is the erosion of the international competitiveness of 13 of 16 member countries of the euro zone. If we look at the situation from this perspective, we could argue that the biggest problem is not Greece, it is Germany.

I am not blaming the German political leaders for having pursued a responsible macroeconomic policy. They have, for many years and with great success, tried to restore their international competitiveness. They have pushed down wages, which most Germans didn´t like, but against much opposition from the trade unions they have reduced real wages and costs, and they have since the formation of the EMU enhanced their international competitiveness and created a huge surplus in their foreign trade balance. The other side of the coin is that it is the other EMU countries that have suffered from the German success story. You can not save the euro zone without doing something about the German surplus.

I won't go into detail now but will end by saying that the euro is at present weakening on the financial markets, as it should be. It is weakening versus other currencies in the world like the US dollar. But that doesn't help Greece, Italy, Portugal and Spain very much. Around 75 per cent of the problem countries' foreign trade is with other members of the euro zone, which means that they don't gain very much in international competitiveness if the euro is falling. Because they mainly trade with other members states. The main beneficiary is Germany, whose exports are much more diversified and sophisticated, compared let's say to Portugal. So I see no solution unless Germany either embarks upon inflationary policies, which is highly unlikely, or leaves the EMU, which means that there would hardly be anything left of the euro project.

I am not criticizing Germany. I am just pointing out that most commentators forget that a key problem in the euro zone is the amazing competitiveness of Germany, which means that the competitiveness of the other member countries has eroded during ten years. Now they are stuck with the common currency and there is no way to get out of this other than leaving the euro zone, or through extremely tough and unpopular nominal wages decreases. I will not guess about the future. But a couple of years before the big financial crisis broke out, I suggested, half jokingly, that Italy would leave the euro zone in April 2013. I did not say exactly which day, but I forecast that the internal tensions within the euro zone would grow and grow. But it may not be Italy that will leave first. It may be Greece that is pushed or forced out. But my guess today is that if the crisis is being aggravated further, the Germans might say: 'We are fed up with bailing out other member states. We have a strong economy. We can manage with our own currency, as we have done in the past'. And that would be the end of a project which, as I said before, was built on political prestige rather than on sound economical analysis.

Thank you for your attention.