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The Economic Consequences of the Euro

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32.
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31.
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30.

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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

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. - phrase) approach to monetary arrangements was deflation and unemployment in Britain, hyperinflation followed by economic collapse in Germany. 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 repand will in1(ai629(will 4(in1(ai629

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

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

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.

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

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.

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

... neutral money doctrine is false ...

... proper role of the ECB

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-

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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] *The Lords of Finance: The Bankers who broke the world*, provides a comprehensive and compelling account of these turbulent times.

[3]

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

[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