The European Monetary Union Is not Unsinkable

Written by Richard Rousseau, Contributor | 10 August 2012

Twelve years ago the former Danish senior economic adviser Donald Olgaard, compared the structure of the European Monetary Union (EMU) to the Titanic. Referring to Denmark's fixed-exchange-rate policy, he concluded that it would probably be better to stay in its own (albeit much smaller) boat, but fastened with a rope to the Titanic, than to be aboard the gigantic ship. Denmark could cut the rope in the event that the Titanic hit choppy waters and bumped into any major obstacles.

Today there seems to be a widespread consensus—even among economists, which is a feat—that the structure of EMU cannot be maintained in its present form. The iceberg is about to hit and without a radical change there is a high risk that many EMU countries may have to jump on lifeboats—and sooner rather than later.

It is not the accumulation of state debts per se that is tearing the Eurozone apart but fundamental problems in the very structure of the EMU. German Chancellor Angela Merkel and former French President Nicolas Sarkozy, though, refused to stoically tackle these structural problems and preferred to rely on a fiscal pact that was adopted in January and signed in Brussels on March 2nd. Merkel, who had a key ally in France until Sarkozy was defeated in the second round of the presidential election on May 6th, has kept repeating that the fiscal pact, which binds Eurozone countries to keeping their deficits below three percent, was "non-negotiable" and would "last forever." Sarkozy's successor Francois Hollande, plans to renegotiate the fiscal pact to make it a "growth pact."

Greater Austerity Will Not Solve the EMU Problem

The first class passengers on the luxury liner are still playing the music. Merkel, two months after signing the pact, still dances unabashedly to the tune of stronger fiscal discipline and the greater restraint in public spending. Government leaders of other EMU countries dance merrily in step. Meanwhile, countries outside the EMU are more hesitant about joining in, knowing that austerity and budget cuts are not in themselves a fix for all the many ills plaguing the Union. However, whatever class they are travelling in, most ultimately feel attracted by the fine orchestra.

David Cameron, the British Prime Minister, is the exception. He has put the interests of the City of London, a leading center of global finance alongside New York City, above the fate of the common European currency; he is right to assume that the suggestion that the EMU is unsinkable is wide off the mark.

Although the chandeliers have started to sway ominously, the mood on the European ship is still rather cheerful. The problem does not appear to be so all-encompassing in the eyes of European leaders. For them, the solution is to bring financially undisciplined southern European countries into line. Signs of more fiscal discipline are now apparent with the formation of a technocratic government in Italy and the election of two new conservative governments in Spain and Portugal. Greece, in a situation of economic prostration, is another story that has yet to be read to the end. Now European leaders—so they think—have only to ensure that troubled countries limit their future public spending and

threats to the EMU will progressively vanish. The message is simple: “EU members must—like Germany—learn to live within their means.” But will the stringent fiscal discipline policy—the price to pay for the needed changes—ensure that the EMU steers clear of the threatening iceberg, or at least secures enough places in the lifeboat for its second class passengers?

Two Fundamental Problems

Merkel and Sarkozy’s proposed fiscal pact for Eurozone countries is likely to drag out the economic downturn, or even make it more protracted and deep. The sky-high public debt levels—not only in Greece and Italy but also Germany and France—are not the fundamental problem. They are but symptoms of growing and more fundamental structural problems affecting the EMU. First and foremost, countries with an unregulated banking sector have contributed to the deepening of the crisis, which faces the entire European economy. Yet no one can agree on how politicians can tackle a banking system malfunctioning in a concerted fashion. Second, so long as the north continues to rack up balance of payments surpluses, while the south accumulates balance of payments deficits, it is unlikely that southern European economies will be put on a sustainable growth path.

The unregulated banking sector undermines the entire European economy. The Greek, and to a lesser extent, Italian governments have for a long time kept their public spending at dangerous levels. The ballooning public debt has ultimately made them extremely vulnerable, especially in a time of economic crisis. In spite of that, the financial markets and major banks have continued to grant loans to these governments at low interest rates. A lack of fiscal oversight, combined with poor domestic governance, has created a toxic cocktail, and the 2008 world economic crisis made it a time bomb ready to explode. The irresponsible behavior of Greece and Italy had nothing to do with so-called deficiencies in the EMU and the single currency system. The problem, at least in principle, was rooted in internal Greek and Italian conditions, but if a number of prominent German and French banks had not granted risky loans as a lifeline, bankruptcy would have been avoided, and with it, the internal political breakdown in Greece. The crux of this problem is not debt, but rather European banks’ irresponsible lending to countries, which did not have the means to pay the loans back. The resulting threat of Greek or Italian state bankruptcy is pulling several large European banks down. Other EMU countries are also facing budget constraints and cannot afford the extra weight of bailing out the southern countries or dealing with the adverse consequences of a default on their debts.

The banks’ irresponsibility can easily be separated from the problems of the single currency. Instead of proposing a new treaty to bring back financial stability in Europe—and putting the blame on southern European governments for the current dire situation—Merkel should have long been aware that her country’s own banking system was helping undermine the European economy and the Eurozone as a whole. The political handling of this issue has great implications for public finances and fiscal responsibility. The current threat is the greatest faced by the European economy in many decades. The solution to the problem will have to be national in character, and any way out should not be confused with the future of the common European currency.

It was precisely because the question of the future regulation of private banks was not answered that David Cameron withdrew from the negotiations on a new treaty on the European monetary system. He could not obtain satisfactory answers when he asked hard questions about the regulation and a possible tax on financial transactions, two crucial questions for The City.

Balance of Payments Imbalances Killing Growth

The growing trade imbalance between various countries is another structural problem creating tensions within the EMU. Both surpluses and deficits have grown significantly between 1998 and 2008. Germany, the Benelux countries, Austria, and Finland have increased their current account surpluses while others, notably Greece, Spain, and Portugal, have experienced a dramatic worsening of their balance of payments positions. The evolution of the multilateral trade pattern within the Eurozone also reflects the balance of payments difference between northern and southern European countries. Since the establishment of the EMU in 1999, Germany has improved its competitiveness through offering low nominal wage increases and significant improvements in the export sector's productivity. German industrial production costs have decreased by approx. 0.5 percent per year, which amounts to a 10 percent decline over a ten-year period. On the other hand, in southern European countries production costs have increased by two percent annually. This is not a dramatically high yearly increase, but over a ten-year period it amounts to 20 percent.

Therefore, since 1998, the cost of producing goods has become 30 percent higher in southern European countries than in northern European ones. Germany, but also Austria and the Netherlands, have made significant improvements in their relative competitiveness. Obviously, these production costs differences have had consequences for balance of payments sheets and for Europe's economic development as a whole.

Spending Cuts Negatively Impact Growth

The 2008 global recession revealed how fragile the southern European economies had become in the wake of reduced competitiveness and their huge external debt burden. These countries then experienced the largest increases in both unemployment and interest repayment rates. It is at that moment that the balance of payments situation became crucial for these economies. Countries with current account surpluses are able to finance their public deficits with domestic credit. Germany, the Netherlands, Austria, Sweden, Denmark, and Finland, all in that situation, can finance their public deficits at low interest rates. On the contrary, countries that have accumulated substantial foreign debt (not to be confused with public debt) must usually pay higher interest rates to finance their budget deficits.

EMU countries that have lost competitiveness, such as those on the Mediterranean coast, have thus been caught in a vicious circle: falling exports, declining tax revenues, rising unemployment, and high interest rates. These trends have all come at a time when they need to find a way to restart their economic growth. In short, southern Europe has been caught in the so-called debt trap—interest rates on public and private loans exceed the rate of economic growth. In 2012, the interest rates for southern European countries still far exceed their projected growth rates (which were actually negative between 2008 and 2011).

Debt levels in these countries will continue to grow—an obviously unsustainable situation. EU requirements on public saving will not change the fact that interest rates exceed actual and expected growth in southern European countries. The now obligatory budget cuts will only hinder economic growth and create even higher unemployment and political-economic instability.

The Fiscal Pact Will Not Save the EMU

The EMU countries are now drifting apart. The southern European flank cannot restart its growth with its own resources. This realization is slowly beginning to gain ground in the political and economic debates, in Germany especially. If the northern European countries continue to pursue their neo-mercantilist policy, the EMU will soon fall apart. If the common currency is to survive, then all countries must aim for balance of payments equilibrium. It is not possible to have all EU

members achieving a balance of payments surplus at the same time—a fact that should lead to a treaty obligation to reduce both deficits and surpluses on balance of payments.

But there is no provision in the proposed fiscal pact to ensure that equilibrium between surplus and deficit countries is a requirement. Rather, Germany is swinging a stick—without offering many carrots—and insisting that other countries should follow suit and adopt a policy similar to its own, something that is impossible. When southern European countries had their own national currencies they had the option of devaluation when pressed to restore their competitiveness. This was not a straightforward solution because it contained the seeds of an inflationary spiral.

But is there any other alternative to devaluation when trading partners are unwilling to compromise to find a solution? When everything has been taken into consideration, this is precisely the issue that now has to be faced. Almost certainly, Germany will not take on the responsibility for restoring trade balances within the Eurozone. It is of course understandable that the German business community does not wish to surrender its competitive advantage, especially for the benefit of less disciplined EMU members. Regardless, Chancellor Merkel should stand above the fray and adopt a long term vision for EU economic development and prosperity. Questions remain, however, as to whether she is truly willing to bear the burden of rescuing the euro, and whether the proposal fiscal pact is the right way of doing it.

Richard Rousseau *is Associate Professor and Chairman of the Department of Political Science and International Relations at Khazar University in Baku, Azerbaijan and a contributor to Global Brief, World Affairs in the 21st Century, and to The Jamestown Foundation.*

This article was originally published in the July/August edition of the Diplomatic Courier.