Fundamental Flaws in the European Project

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The euro aimed at removing nominal exchange rate fluctuations in a wide free-trade area and was informed by a neo-liberal view of leaving policy entirely to market forces. In consequence, by way of its specific design, it removed three essential policy instruments at once from the domain of national policymaking – exchange rate management, monetary policy and fiscal policy– and it intrinsically weakened labour and welfare policy. These are the fundamental flaws in the design of the European project.

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Euro notes and coins were launched with great expectations in January 2001, the product of a decade of negotiations between the original participants, all 12 of whom were signatories of the Maastricht Treaty of 1993. For nearly a decade the experiment appeared to prosper. A common currency, combined with the "borderless travel" agreed earlier between Schengen area signatories, appeared to turn Europe from a disparate group of neighbouring states into a seamless giant whose combined population and gross domestic product (GDP) placed it at par with the United States (US).

Today, in contrast, the euro is under attack from the financial markets, with Greece on the verge of default, Portuguese and Irish Eurobonds demoted to junk status and Italian and Belgian bonds under speculative attack, with Spain next in line. What is more, the real fear is that a default in one country will trigger a domino effect and bring down some of Europe's major banks. Although the Greek and Portuguese economies account for only a small percentage of Euro Area (EA) output, were default contagion to spread to Europe's larger countries, the entire euro edifice could be brought down. Why has this happened? Are we witnessing the combined effect of a string of economic accidents, or were there potentially fatal flaws in the EA's original design?

In essence, our argument is that the euro aimed at removing nominal exchange rate fluctuations in a wide free-trade area, was informed by a neo-liberal view of leaving policy entirely to market forces. In consequence, by way of its specific design, it removed three essential policy instruments at once from the domain of national policymaking – exchange rate management, monetary policy and fiscal policy – and it intrinsically weakened labour and welfare policy.

While the loss of exchange rate flexibility for individual countries is part of the common currency construct, exchange rate management of the euro for the EA as a whole was made to fall outside the remit of the European Central Bank (ECB). Nor was the ECB allowed to act as "banker" for the EA in a manner analogous to the Bank of England (BOE) or the US Federal Reserve since it cannot issue its own bonds or engage in open market operations. Issuing government debt – in the form of national Eurobonds – is left entirely to the individual member states who must sell them on the financial markets; until quite recently, the ECB could not even purchase national bonds.[1] Indeed, for the ECB even to hold these as collateral against its short-term liquidity operations, national bonds must be well-viewed by the main credit rating agencies (CRAs). In the words of Thomas Palley (2011) "...the euro's architecture makes the bond market master of national governments. Given the dominance of neo-liberal thinking, this was an intended outcome of the euro's design."

Misleading View

While national exchange rate and monetary policies ceased to exist and EA regional exchange rate and monetary policies were also impaired, the general view is that fiscal policy, both at national and regional levels, survived the euro construct. But such a view is also misleading. Although there is European budget, there is no EA or European Treasury. And because the European budget amounts to only 1% of the region's GDP, and must be balanced annually by law, it cannot be used as a counter-cyclical instrument. Apart from its small "structural fund", the budget cannot be used either to effect transfers between rich and poor of the union.[2]

Famously, the decision to exclude fiscal policy from the EU or EA remit was one of the "great compromise" conditions insisted on by Germany during the Delors Committee negotiations culminating in the (1992) Maastricht Treaty.[3] Instead, national governments agreed to be bound by the twin rules – initially meant as qualifying conditions for euro-access but set in concrete in the Stability and Growth Pact (SGP) inserted into the 1997 Amsterdam Treaty – that government annual budget deficits must not exceed 3% and a national debt ceiling equivalent to no more than 60% of GDP must be observed. Admittedly, examples of violation of the national budget constraints can be cited for either large countries like Germany, France, Italy, in the early 2000s, or the smaller countries, most notably during and in the aftermath of the great recession of 2008. Yet, German and Dutch governments have sought to re-incorporate them in even tougher form in the Economic Stability Mechanism (ESM), the permanent bailout facility for the EA due to come on stream in 2013. The irony of these rules in their pre- and post-recession version is that, despite remarkable cases of fiscal discipline shown by countries such as Ireland and Spain prior to the 2008 recession, and despite a gigantic effort by all governments to rescue the financial system, all sovereign crises are now deemed the result of fiscal irresponsibility – that is to say, crises caused by breaking existing rules rather than by the rules themselves.

More crucially, debates about the SGP or, more recently, its folding into the future ESM, tend to overlook the underlying constraint imposed by a common currency arrangement without common or federal government. Fiscal policy becomes effectively dependent on the performance of the external sector and the financial behaviour of the private sector. As shown elsewhere (Izurieta 2001, 2003; Bell 2003; Godley and Lavoie 2007), a country tied by common currency that faces an external shock can only have two policy options: a contractionary spending adjustment which causes chronic levels of unemployment, or a fiscal stimulus to regain employment losses at the cost of triggering a financial crisis down the road. Beyond the analytics of fully consistent stock/flow analytical models as those cited, the reason is simple: unable to exercise exchange-rate or monetary policy, a country in distress without recourse to federal transfers or a lender-of-last-resort is at the mercy of the private market to finance its debt, the accumulated costs of which add to ever-increasing deficits. The large and obviously unaffordable borrowing costs of Greece and other peripheral countries of the EA are a sad example of this predicament.

Effect of Structural Rigidities

This analysis runs counter to the common belief that economies are self-adjusting mechanisms and therefore that, faced with an external shock, a one-off adjustment triggers a response sufficient to absorb the shock and bring the country back to a steady state. But in the real world, structural rigidities often prevail, and underlying conditions tend to pull economies in diverging directions rather than towards a textbook-familiar steady state equilibrium.

The proposition of divergent underlying conditions is nowhere more obvious than in the construct under which the EA was created and is an essential part of the explanation why the euro project is flawed. In a number of contributions, Flassbeck (2007, 2005, 2000) points to the inadequacy of real exchange rate regimes driving unsustainable external positions of trading partners in the global economy. More specifically, referring to the EA, Flassbeck questions "the long run viability of a monetary system with absolutely fixed nominal exchange rates but dramatically divergent real exchange rates" (2007: 43). After carefully dissecting the asymmetries created in the two Germanys after reunification, he singles out the tremendous pressure that German policymakers placed on trade unions to accept wage restraint in order for the country to "regain international competitiveness" (the "Bündnis für Arbeit" agreement of 1996).

The tendency towards wage-repression that started in the mid-1990s was aided by the fact that other European trading partners used the D-mark as an anchor to facilitate their smooth entry into the euro. It was this that prevented the domestic currency appreciation warranted by the deceleration of unit labour costs in the main surplus country, Germany, prior to the introduction of the euro. Indeed, the inauguration of the euro institutionalised Germany's advantage and created the seeds of an explosive situation: diverging trading performances between Germany and other EA partners, with diverging tendencies to real depreciation in the former and real appreciation in the latter.

To many observers, an easy remedy would have been adopting a similar pace of wage disinflation throughout the EA. This is the main motive behind calls for "labour market flexibility" that dominated the policy discourse in the EA in the years prior to the current crisis. But if it is difficult to overlook the socio-economic consequences of wages lagging well behind labour to productivity in a single country, it seems even more incongruous to ignore the fact that wage repression for the entire region imparts a recessionary bias to all.

In the absence of nominal exchange rate adjustment at the national level (precluded by the common currency), trade imbalances cannot be solved by means of "internal devaluation"; i e, wage repression at the periphery. Just as the China-US trade imbalance is best resolved by increasing aggregate demand in China and supporting development strategies elsewhere rather than by means of expenditure contraction in the US (the cost of which would be further recession), EA trade imbalances cannot be resolved by inducing recession. Nor can it be argued that all current account deficits within the EU could be offset by running surpluses with the rest of the world. First, such a situation would result in a real appreciation of the euro, thus eventually choking off the surpluses. Second, as Whyte (2010) has shown, the EA is simply too big for the rest of the world to be in deficit with all its members.

Club-Med Countries Not a Problem

It follows that highlighting fiscal irresponsibility in the Club-Med countries as the source of the crisis is beside the point. Such a simplistic argument is negated by the basic national accounting identity that says that the sum of public and private financial balances of a country must exactly equal the external balance. As long as net export performance is driven by loss of competitiveness resulting from wage repression elsewhere in a common currency area (and import requirements and transfers are somehow correlated with the growth of output), and as long as the private sector as a whole determines its own net financial balance (net acquisition of financial assets) for reasons of its own, *then* the net financial position of the public sector is determined down to the last penny.[4] In other words, if GDP tends to contract because of adverse trade performance and if private sector saving represents yet another leakage from the circular flow of income, a proactive fiscal deficit will be needed to maintain the pace of economic growth. A conservative budget merely adds to the contractionary tendencies while alleviating the trade imbalance.

Greece and Portugal, for example, may not be role models of budgetary efficiency, but with private sector investment and spending falling behind the pace of GDP growth, only sustained fiscal expansion could produce economic growth. Alternatively, recession-inducing fiscal discipline would not have improved matters either for these countries or for their partners in the region.

A contrasting case is that of Spain, which unlike Greece, combined poor trade performance with a lax financial structure leading to an over-leveraged private sector, of which (as in the US and the UK) the housing boom was a symptom. The combination of "twin deficits" of the external and the *private* sector meant that the public sector found itself running surpluses or very small deficits in the lead-up to the financial crisis.

Germany, meanwhile, running large trade surpluses on the back of a decade of flat wages, and with a private sector running savings surpluses of about the same size, would find itself not needing fiscal deficits. The adoption of the "debt brake" law (balanced budget) by German policymakers is in effect a way of institutionalising a wage-repressed export-led growth model. But such a model cannot work for all EA countries.

Clearly, the tremendous shock caused by the great recession has triggered a downward shift in the external position of these countries, as well as the rapid accumulation of public sector debt as governments rushed into bailing out the financial system to avoid a financial meltdown. Under the prevailing structural rigidities described above, it is no surprise that external deficit countries, if left to the mercy of "the markets", are now threatened by a severe and protracted recession.

Policy Action Required

Policy action is necessary if these trade imbalances are gradually to disappear. Crucially, labour productivity must increase faster in the deficit countries than in the surplus countries, an aim difficult to achieve unless proactive fiscal policy and infrastructure investment trigger a modernising wave of "crowding in" private investment. This means that Europe must redistribute investment resources from rich to poor regions. In addition, if higher labour productivity growth is to be achieved in the periphery, a "common wages policy" (not to be confused with a common wage) must be adopted which better aligns wage and productivity growth and sustains aggregate demand. This will not be achieved with wage disparities exercising a deflationary impact on the union. In the absence of national exchange rate realignment, adjustment must take place through a regional wage bargaining process.

Three conclusions follow from the above analysis. First, a common currency system will fail unless sustained by an active central bank, a common fiscal policy and common labour policy. The EA system will either break down under the pressure of social unrest or because of a debt explosion and ensuing sovereign-debt crisis.

Second, wage repression at the centre is an essential component of the euro crisis. Germany's net export success exactly mirrors "failure" in the peripheral countries, and deflationary pressure in the periphery is a major problem for the system as a whole.

Finally, a reasonably egalitarian income distribution reached through a common labour policy – where the distribution of productivity gains is agreed upon – must be an essential feature of stable long-run prosperity. The "wage flexibility" framework peddled by Brussels is dysfunctional.[5]

Without effective supranational fiscal and labour authorities and a fully functional central bank, the EA cannot resolve these problems – even if the contradictions are internally suppressed or else transferred to the rest of the world via the real exchange rate.

NOTES

1 During the recent credit crisis, the ECB has purchased national Eurobonds, but its holdings are tiny compared to (say) US holdings of its own (say) treasury bonds.

2 The notion of a union budget which could be used counter-cyclically was originally raised by MacDougall D and Commission of the European Communities (1977); more recently it has been revived by Goodhart (2007).

3 For critiques, see Irvin (2007), Bell (2003), Buiter, Corsetti and Roubini (1993), Godley (1992).

4 See Godley and Izurieta (2004) for the conceptual framework, as well as Galbraith (2009) for its validation in the macroeconomic analysis of the US economy.

5 Although income distribution appears to be more egalitarian in the EU than the US when looking at individual member-states, the same is not true of income distribution with Europe taken as a whole – as Galbraith (2009) has rightly noted.

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