[Why Left-wing Advocates Of An End To The Single Currency Are Wrong]

Andrew Watt, *Social Europe Journal*, 10/07/2013

Until recently those advocating an end to the euro area and the return, in some form or other, to national currencies have tended to be on the political right. Their main concerns have been what they see as the slide towards a "transfer union", the bailing-out of allegedly spendthrift governments, and the undermining of the independence of the European Central Bank and its commitment to price stability. Supporters of these positions had largely been sceptical from the outset about abandoning the D-Mark and other "hard" currencies and throwing them into one basket with the softer money of countries seen as having what was euphemistically called a different stability culture. Looking at the political program of the new anti-Euro party in Germany, *Alternative für Deutschland*, reveals some other issues: resentment of the bailing out of financial institutions at the tax-payers' expense, and also the belief that the crisis measures imposed on the deficit countries in the name of saving the euro bring unnecessary hardship and/or threaten social and political breakdown.[1]

On the European Left, criticism of the way that the Euro crisis has been approached has been very different. Left-leaning economics commentators and left-of-centre political parties have criticised the focus on the supposed misbehaviour of the crisis countries, the systemic failings of the euro-area architecture and thus the need for solutions based on European solidarity, the need for expansionary fiscal programmes rather than austerity, and for the central bank to play much more active role in restoring economic growth. Saving the euro and getting back to balanced growth as soon as possible have been undisputed policy goals.

This is changing, however. In Germany the party *Die Linke* seems increasingly to be moving to a position of favouring an orderly break-up of the euro area. Moreover, a number of progressive economists – unlike those on the Right, with a history of advocating monetary integration in Europe – have come to the conclusion that the euro project is doomed and only its orderly resolution can save Europe from years of depression and immiseration, if not worse. Their position overlaps with the right-wing critics at least on the latters' secondary concerns: the plundering of taxpayers and the suffering of the populations in the crisis countries in southern Europe.

Having consistently taken issue with liberal-conservative critics of the euro since the outbreak of the crisis, I now turn to the critique of the anti-euro position on the left. I believe it is misguided. First of all I briefly set out the position of these critics. I then show that both in economic terms and from a normative left-of-centre political perspective these positions should be rejected.

Left-of-centre arguments for the dissolution of the euro area

As a basis for analysis I refer primarily to the recent study by Heiner Flassbeck and Costas Lapavitsas for the Rosa-Luxembourg Foundation[2]. Both are highly respected scholars and are completely above suspicion of being driven by parochial or nationalistic sentiments. They have a long track record of supporting, in principle, monetary integration in Europe. I have much sympathy with their disappointment with and analysis of that project. Nevertheless I believe their conclusions to be profoundly misguided.

Following an analysis of the causes of the crisis with which I am very largely in agreement, the authors conclude (all quotes from pp. 37f.) that "the original divergence (between member states – AW) and the overall direction of the adjustment programmes are destabilising the monetary union to an extent that survival of the union itself is seriously put in question. (…) Therefore disintegration and eventual collapse of the union have to be considered seriously." This prediction – i.e. that existing structures and policies make disintegration likely – is transformed into a policy recommendation in subsequent paragraphs: "Given the obvious inability of the European institutions to appropriately manage the currency union, realistic observers have to admit that currency union was too ambitious a goal. (…) Europe has to retreat if it is to progress again." A managed end, in short, is to be preferred to an explosion that can no longer be prevented.

The recommended form of this retreat is to re-establish the European Monetary System (EMS) – the fixed-but-adjustable exchange rate regime that preceded the euro – for those countries that want to leave the common currency. They should remain in the EU, but the revised EMS would "allow countries to peg their new currency at a reasonable rate to the euro". The authors claim that the

EU has a moral and practical obligation to offer exiting countries such a "safe way out". If countries are able once again to revalue and devalue their currencies, the core idea underpinning European integration, namely free trade, would once again be permitted to flourish. They would regain the policy autonomy to avoid damaging deflationary policies.

While this point is left rather implicit in the Flassbeck/Lapavitsas analysis, some politicians have been less reticent in claiming that it is the strictures of the euro that are driving neo-liberal policies in the crisis-hit countries; in a recent call for a new monetary system in Europe, Oskar Lafontaine, who draws heavily on the RLF study, identifies the euro as the reason for the destruction of the welfare state in southern Europe, undermining democratic procedures[3], but also for tax and wage dumping by Germany and other core countries.[4] It is strongly implied, although the mechanism is not explained, that there would be greater likelihood of labour-friendly policies if the possibility of exchange-rate adjustment were reintroduced.

Heiner Flassbeck and Costas Lapavitsas identify three transitional problems on the way to this new, better equilibrium: avoiding the collapse of the banking system caused by bank runs, problems of monetary circulation (making new notes and coins available), and avoiding an excessive depreciation. They take the view that these would be either merely temporary or could be solved, by means of capital controls, and the aforementioned resuscitation of the EMS. In contrast a "transfer union" is rejected, not necessarily as undesirable, but as politically unfeasible.

Eight reasons to differ

There are at least eight main reasons to reject the calls for dissolution of the euro area and its replacement with some version of the European Monetary System. I will attempt to substantiate them below. Three reasons boil down to the argument that the *future* costs of continued membership of monetary union are likely to be much lower than posited by critics and that there is no inevitability about a collapse of the euro area. Four reasons boil down to the argument that the posited benefits of an EMS-type exchange rate regime are much less considerable than claimed. A final argument asks what the populations and left-of-centre parties in the crisis countries of southern Europe want for their countries.

Future costs of retaining EMU lower

First, the costs of the misguided, one-sided adjustment forced on the countries of the euro area periphery in terms of lost output, unemployment and attacks on welfare states and wage bargaining systems have without doubt been enormous. It is vital to realise, though, the simple fact that this damage has been done. It constitutes a sunk cost. Something has, however been attained for this excessive price. There has been a considerable narrowing of competitive imbalances between the core countries, especially Germany, and the periphery. Such adjustment could and should have been achieved at a much lower price (via expansionary measures and faster wage and price increases in the core). Europe – and particularly the crisis countries – have, as it were, overpaid for a good: a narrowing of competitive imbalances. But this important good has nonetheless been achieved. The figure shows the adjustment of unit labour costs (1999 = 100, 2013 and 2014 according to Commission forecasts. Source: AMECO database).

It is readily apparent that a very substantial correction has occurred in the crisis countries, and that the problem is the non-adjustment of Germany, even if the Commission may be over-optimistic about 2014.[5] Thus demand-deflating policies are no longer called for by the need for competitive rebalancing. It is therefore not correct to imply that this process will accelerate or simply continue without end, while the pain that has already been inflicted is irrelevant to the decision of whether to maintain or dissolve EMU.

Second, there are a number of reasons to anticipate not a continuous worsening of the crisis, but rather a gradual stabilisation and subsequent improvement. The first is the aforementioned progress in competitive adjustment. In 2008 net *imports* represented around 15%, 10 and 6% of GDP in Greece, Portugal and Spain respectively. Spain had a trade *surplus* of more than 1% of GDP already last year while for Portugal a similar result is expected in the current year. By 2014 the Commission, perhaps optimistically, expects a balanced trade position even in Greece. The second is that, albeit very belatedly and much too slowly, a limited adjustment is taking place in the core countries, and even Germany. The pace of wage increases is picking up somewhat, although not enough[6]. Also expect this year's federal election to be one in which parties compete on spending promises (in the current context this is welcome).[7] Substantial sums are being proposed for flood-damage repair and investment in water management. The third is that even the most obtuse European policymaker has accepted, privately if not publicly, that austerity does not work. As a result the austerity screw is being loosened across the continent. All the large countries – France, Italy, Spain, Netherlands – are being allowed by Brussels to loosen the austerity corset. Some growth initiatives are planned, for example in the area of youth unemployment, even if they are inadequate and smack of a public relations exercise. Nevertheless, it is important to understand that it is the *change* in the stance of fiscal policy from one year to the next that impacts upon demand. This means that merely stopping cuts implemented the previous year (indeed, even reducing their magnitude) is enough for fiscal policy to have a net positive impact on demand in the current year. The fourth is that monetary policy belatedly became more expansionary in late 2012 with the announcement of OMT and the consequent narrowing of spreads. In view not least of low and declining inflation rates further measures are to be expected, indeed the most recent decision by the ECB Council offered explicit "forward guidance" that interest rates will be kept low, and efforts will be undertaken to reduce the still high effective lending rates in peripheral countries. Finally there are signs that the US economy – provided it avoids European-like mistakes of imposing damaging fiscal austerity – and more recently the Japanese economy are returning to strength, easing the intra-European adjustment process by boosting overall demand for European exports.

In a nutshell, then, there are a number of reasons to believe that the stagnation in the core and the nightmarish contraction in the periphery of the euro area are, slowly and belatedly, coming to an end. This is reflected in slowly improving leading indicators, such as purchasing manager surveys and confidence indicators.

Third, regarding the longer-run functioning of the euro area, it is also important to recognise that the fact that bad policies were pursued in the past in the euro area does not mean that this will continue to the same extent in the future. While it is correct that the architecture of the euro area is faulty it remains the fact that the deficit countries, for instance, failed to use the counter-cyclical tools at their disposal in order to reign in the boom. That is a mistake that need not be repeated. Mercantilist policies by Germany – which, like the critics, I see as crucial in the development of the crisis – were, ultimately a policy choice. It is true that the Stability and Growth Pact imposed constraints on low-growth, low-inflation countries that did not apply to the periphery. Yet we know well that France and Germany openly fluted those rules in the early 2000s. Yet only Germany embarked on mercantilist polices; France did not. Moreover, there has been some positive "policy learning". In principle the Macroeconomic Imbalance Procedure falls in this category, although it is highly deficient in the way that it is operationalised.[8] Some progress has been made and more is expected in the area of financial market regulation and banking union. (Yes, there is a worrying problem of non-performing loans in the banks of many countries in the euro area, but note that this problem will not go away, and might well worsen, merely by changing the currency.) Admittedly, of great concern is the tying of national fiscal-policy hands by national debt brakes via the fiscal compact and the proposed competitiveness pact. Ultimately, debt-brakes are misguided and will prove unworkable. I expect their shelf-life to be rather short; the above-mentioned, welcome, easing of fiscal constraints is a sign of this.

Risks of transition and benefits of exchange-rate flexibility

On the other hand, fourth, advocates of euro area break-up fail, in my view, to square up to the scale of the likely costs of transition to a new regime. Flassbeck/Lapavitsas address the likelihood of bank runs. What they appear not to have considered is the probability that a planned exit by one country will cause bank-runs not only domestically but also in *other* countries whose populations and politicians may be determined to stay in the euro. It is far from clear how a single euro-fatigued member, or a small group of countries can leave without precipitating a stampede for the exit by the citizens of all potential exit-candidates and by investors world-wide holding assets in such countries. But this challenges the whole idea of an orderly exit. The second concern is a massive devaluation that leads to huge inflation, monetary chaos and an immediate import stop. It is far from clear to me that other EMU and EU countries, or the ECB, will feel obliged, as claimed, to intervene to permit a managing realignment of exchange rates. (If the ECB is not taking effective action now, why should we expect it to do so as part of an attempted orderly break-up?) In any case, setting up such a system takes time, which policymakers will not have because the first signs of concrete preparations for exit will precipitate bank runs. There is also the formal point that there is no legal provision for a country to leave the euro, which the Treaties specify as the currency of the EU, which all countries, except those with an explicit op-out, are expected to join. However, in the teeth of a crisis I do not suppose that this non-rule is, so to speak, worth the paper it is not even printed on.

Let us look, though, beyond the immediate transition phase, and heroically assume it can be successfully managed. We next need to consider – fifth – the impact of initial exchange-rate movements. It needs to be recognized that the impact of a substantial depreciation and appreciation of peripheral and core countries' respective currencies, which would probably initially overshoot, is substantial. In the peripheral countries there will be inflation and severely reduced imports and living standards: one should not be under any illusion that depreciation is a free lunch for workers. (If nominal wages rise in line with prices, maintaining real wages, there is no competitiveness improvement, and the country could have remained within the euro area.) In the core countries there is a substantial wealth loss (due to devaluation and defaults) on all financial claims on the exiting countries. Apart from its direct effects on welfare, this would likely precipitate severe problems in the financial sector. More importantly, core-country exports would be hit massively, with likely repercussions for employment and wages there (see also point 7 below).

If we now assume that these ructions can also be overcome, we turn to the operation of alternative exchange rate regimes to replace the euro. This is argument six. A system of fully flexible exchange rates, while it would return full autonomy over monetary policy to national governments, has historically never been very appealing as fluctuating exchange rates were an impediment to trade as well as price and output stability. These problems led to the creation of the EMS, which, as indicated, is apparently favoured by many euro critics. But in some ways the EMS inhibited national autonomy to a much greater extent than the euro. The EMS was anchored by the D-Mark, the currency of a single country, with the central banks of other European economies essentially shadowing Bundesbank monetary policy. When the latter, as in the early 1990s, chose policies that suited Germany's needs (at least in its assessment) but not those of the rest of Europe, these countries were pitched into recession, with no recourse via European-level institutions. Even when things were running smoothly, currencies thought likely to depreciate against the D-Mark had higher inflation, higher nominal and also real interest rates: the latter dampened growth and posed problems for government finances. It is not inconceivable that a better-functioning monetary system could be devised, but it is incumbent upon the euro critics to set out a superior architecture and show that political majorities can be found for its implementation.

Seventh, left-wing critics rail against the neoliberal policies deployed in the European Union and, especially, in the euro area countries most affected by the crisis. I take the same view. It is far from clear, however, that such policies are as closely tied to the euro as is claimed. It is true that the leeway for the EU Commission to dictate national policies is somewhat greater for euro area members than those outside. But pressure has been applied on those countries as well. And in any case the role of national politics is more dominant than is widely believed: consider the United Kingdom, which benefited from a major currency depreciation and has enjoyed considerably more active monetary policy support for its economy, yet has embarked on one of the most extreme austerity programmes. More fundamentally, the existence of a binding exchange-rate constraint does not tell us much about the welfare and other policies a country pursues: consider the case of Austria whose currency was long pegged to the D-Mark and subsequently joined the euro but maintains to this day a strong collective bargaining regime and welfare state provisions. Last but not least, in those countries facing a substantial currency revaluation after euro break-up a neo-liberal backlash would be expected to reduce wages and social standards in an effort to recoup lost competitiveness. In short, the fight against neoliberal policies needs to be fought irrespective of the exchange-rate regime; the latter does impose constraints in certain situations, but the two issues are not systematically linked.

And then there's democracy

A final, eighth, argument can be briefly mentioned here. Part of the critique of the operation of the euro area and also of the crisis management stratetgy is that it is undemocratic. There is a whole debate about this that I do not want to engage in here. However, it is relevant for the argument at hand that calls for dissolution of the euro area ignore the fact that this strategy is rejected by most progressive (and also liberal) opinion in the crisis countries themselves. To my knowledge, splitter parties aside, it is only the Cypriot Communist Party amongst broad-based left-of-centre parties that unequivocally supports exit from the euro area. And even if it were the democratic wish of one country to leave, if I am right that its exit would lead to a rapid break-up through contagion effects, then the democratic wish of other countries to remain within the monetary union would be trampled on roughshod by the financial markets.

Conclusion

I have argued here that the breakup of the euro area is far from inevitable. Its survival is not contingent, as critics claim, on policies for massive reflationary programmes, as desirable as these would certainly be. Suffering will continue, but it will attenuate. There are certainly risks and further serious policy mistakes are possible. But in an improving overall economic environment, limited policy adjustments which have to some extent begun already and for which there are reasonable grounds for expecting that more will be implemented should suffice to ensure a gradual resolution of the euro crisis and a return to stable growth.

I have also sought to show that the transition costs to a new regime are uncertain – after all we have no precedent for the break-up of a monetary union of this type – and probably extremely high. Moreover the return to an ESM has also substantial long-term costs without the promised benefit of facilitating welfare-enhancing social policies.

Finally I have pointed out the parties representing the supposed main beneficiaries of a new currency regime, working people in the crisis countries, by and large are opposed to this policy. And any form of disorderly break-up would not respect democratic wishes in the slightest.

Let me end by re-emphasising my complete agreement with euro critics on the Left that the crisis-resolution strategy that has been pursued has been disaster. A vast amount of, to a considerable degree unnecessary, suffering has been caused. The euro is without doubt a flawed project. Much of my intellectual efforts in recent years have been devoted to identifying these weaknesses and proposing alternatives. A starry-eyed believer I have never been. But the calls for an end to monetary union, even if well-intentioned, are misguided. The fight for a monetary union that promotes the goals of a decent life for all its citizens, particularly the least well-off, is still on, and it is a fight worth continuing.

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[1] https://www.alternativefuer.de/pdf/2013_Wahlprogramm.pdf/ The first bullet point of the summary given on the party's homepage reads (in my translation): "We call for the orderly dissolution of the Euro-currency area. Germany does not need the euro. Other countries are harmed by it."

[2] Flassbeck, H., C. Lapavitsas (2013) The systemic crisis of the euro – true causes and effective therapies', Study for the Rosa-Luxembourg Foundation (RLF), http://www.rosalux.de/fileadmin/rls_uploads/pdfs/Studien/Studien_The_systemic_crisis_web.pdf/

[3] A left-wing critique of the euro focused much more on the "democratic deficit" of European policies is that of Wolfgang Streeck. I touch on these important issues only in passing here, focusing rather on the economic arguments. See http://www.blaetter.de/archiv/jahrgaenge/2013/april/was-nun-europa/

[4] See his recent interview in Handelsblatt, http://www.handelsblatt.com/meinung/gastbeitraege/gastkommentar-plaedoyer-fuer-ein-neues-waehrungssystem/8240638.html/

[5] An important exception, it is true, is Italy in which unit labour costs have continued to rise.

[6] The WSI's most recent study of collective agreements shows wage increases of 2.9% for new agreements in the first half of 2013, compare with rises averaging 2.6% for existing agreements. From a rebalancing perspective, such increases remain inadequate, however. http://www.boeckler.de/2877_43507.htm/

[7] Handelsblatt calculates the cost of the measures being mooted for the election program of the CDU – yes that is the party of the iron chancellor Angela Merkel – at EUR 28.5 bn or about 1% of GDP.

[8] See http://www.social-europe.eu/2013/04/eu-commission-makes-a-mockery-of-imbalance-procedure/