LABOUR EURO-SAFEGUARDS CAMPAIGN

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MORE QUESTIONS AND ANSWERS

ON THE FUTURE OF THE EURO

1. What is the current situation in the Eurozone?

The Eurozone appears to have stabilised to some considerable extent in recent months. The spread between borrowing costs in different countries has narrowed. Despite adverse events such as the outcome of the recent general elections in Italy, there is generally less of a crisis atmosphere. The determination expressed particularly by the Chairman of the European Central Bank that he would do whatever it took to defend the euro has helped to reassure the markets that the Eurozone is not about to break up. Indeed Latvia and Lithuania are about to apply to join the euro, following the example set earlier by Estonia. It may therefore be that the Single Currency will survive, at least for some while, but there are still huge risks. What is the future likely to hold?

2. What are the growth prospects for the Eurozone?

The Eurozone may not be on the point of collapsing, but this does not mean that there is not a very high price to be paid for keeping the Single Currency in being. The major problem is that the Eurozone economies are not growing. Allowing for population changes, even the very poor growth figures which have been achieved are insufficient to allow average living standards to rise much even in the Single Currency economies which are doing relatively well. In those which are doing badly, the situation is much worse. The Greek economy has contracted by well over 20% since 2007. In addition, there are appallingly high rates of unemployment, reaching over 25% across the board in Greece, with youth unemployment now running at well over 50%. The situation in Spain is nearly as bad. The reason why there is no growth is that all but a handful of EU economies are grossly uncompetitive. They cannot therefore generate enough exports to pay for their imports without their economies being severely depressed to keep their imports in check. Even this way of trying to achieve some equilibrium in foreign payment balances is fraught with problems, however, as such a high proportion of the exports of EU countries go to other EU members. The result is therefore that the performance of the whole Eurozone economy has spiralled down and it is now mired in depressed conditions with no end in sight.

3. What about borrowing?

There is also another major danger. The current relative calm in the Eurozone has been bought at the expense of huge loans, primarily by the European Central Bank (ECB), to both commercial and central banks in the weaker EU economies, and the volume of these loans is still steadily increasing. This has generated two large risks. One is that, if the Single Currency ever does break up, there will be huge losses to be taken by the ECB. The second is that there will be equally large losses to be written off by the German Bundesbank. This is because much of the money provided to the weaker economies is being used to finance private sector capital flight to Germany. As this happens, however, the impact of all private transfers to Germany is that the Bundesbank has to provide equal but opposite payment facilities to the central banks of the countries from which the funds are coming. The result is that it is not just the ECB but also the Bundesbank which has huge debts on its books denominated in euros which may end up by being massively devalued. If the Single Currency breaks up, therefore, there will be an enormously large requirement for refinancing both the ECB and the Bundesbank, using the borrowing covenants of whatever sovereign states are still sufficiently creditworthy to provide the financial resources which will then be needed. It is not clear that anything like sufficient creditworthiness in these circumstances is going to be available.

4. What are the political risks?

A combination of economic stagnation and mounting debt provides the background to the three main political risks inherent in the Eurozone's battle for survival. The first is that elections are held in the economies suffering most from economic stagnation which produce results which render the countries in which they are held becoming effectively ungovernable or at least unable to impose on their citizens any longer the conditions necessary for the euro to survive. This is likely to happen as centre right and centre left parties lose support to more extreme or single issue parties which no longer support their countries remaining in the Single Currency. The second risk is that the electorates in the more solvent Eurozone economies tire of providing unending support on the scale required to the austerity economies. It seems unlikely at the moment that the Germans, who are the main paymasters, will want to stop providing any financial assistance but whether they will be willing to do so on a sufficiently comprehensive scale – for example by underwriting debt mutualisation – to keep the Eurozone stable remains to be seen. The third risk is that the markets begin to think that the cost and difficulties in maintaining the Single Currency in being are so large as to be unmanageable, thus precipitating a crisis as borrowing costs rise to a point which is clearly unsustainable. It may be that none of these events – or any other development likely to derail the Single Currency - will occur, but the chances of the future holding no unfavourable outcomes of this kind do not look very strong.

5. What will the Eurozone's leaders try to do to overcome these problems?

Faced with these problems it is clear that the only way in which the Single Currency could be permanently saved by political action would be for rapid moves to be made towards the Eurozone countries coming together to form a fiscal union. This would require much larger powers at the centre than there are at the moment. The first moves in this direction may well be towards debt mutualisation – when all the countries in the Eurozone jointly and severally underwrite each others' borrowings – but even if this could be achieved, it is very unlikely that this on its own would be sufficient. Long term viability could only be achieved if much larger taxing and spending powers were located in Brussels rather than at national level. At the moment, only a little over 1% of all spending in the EU is channelled through the EU budget, compared to equivalent federal government spending in the USA of around 25% of GDP and almost 50% in the UK. The question then, however, is whether changes of this magnitude within the limited time frame likely to be available would be possible. Bearing in mind the diversity which in many ways has been Europe's strength but the lack of solidarity which is thus entailed, it seems very unlikely that democratic consent on anything like the scale needed would be forthcoming. Attempts to move rapidly in this direction, therefore, seem also likely to founder as a result of unmanageable political opposition.

6. Will economic convergence provide the solution?

Another possibility which EU leaders must be hoping will come to the rescue is that the impact of the Single Currency on the austerity economies will force them to become sufficiently competitive to get the flows of goods and services between all the countries in the Eurozone back into manageable balance. Although there are signs in some countries – particularly Ireland and to some extent Spain – of this happening, experience suggests that it is very unlikely that sufficient progress will be made to overcome the enormous differences in competitiveness which have developed. The cumulative effect of different levels of inflation since the Single Currency was established have been to increase export costs by 30% or more in several Eurozone economies compared to what has happened in Germany. It therefore looks dauntingly difficult to close gaps of this size by cutting wage costs and improving efficiency, especially as one of the major effects of the austerity programmes from which the EU is suffering is a decline in investment in new and up to date highly productive plant and machinery. On its own, therefore, it seems that this route out of the euro's problems is very unlikely to be sufficient.

7. What, then, is likely to be the future for the Eurozone?

The problem for the Single Currency over the coming years, therefore, is that all the strains caused by austerity, excessive borrowing and high unemployment will remain. These will generate the risks that either losing support for maintaining the Single Currency at national elections or market distrust will cause the Single Currency sooner or later to collapse. In the short term this is all too likely to precipitate much worse economic conditions than if the euro held together. In the longer term, however, this may be the only way to get most European economies to start growing again and their very high levels of unemployment reduced to more tolerable levels. In the meantime, the economies in many other parts of the world will very probably continue to expand quickly, leaving the Eurozone increasingly as an economic backwater. If the eventual demise of the Single Currency then generates a further major decline in output before recovery begins to materialise, the relative – but probably over the full period absolute – Europe's decline in influence and importance in the world will be very substantial and hard for many of its citizens to bear.

8. Where does this leave the UK?

Because the UK is not in the Eurozone we have considerably more room for manoeuvre than the Single Currency countries. The travails of the euro are, however, likely to have a severe impact on our economy. Although the share of our trade with other EU countries is declining as other markets expand much more rapidly, it is still easily high enough for stagnation in the Eurozone to have a strong depressing effect on our own export performance. If the euro does break up, the situation is likely to be even worse at least for a period of time as UK sales to the erstwhile Eurozone economies go into sharp decline. The turmoil caused by the Single Currency collapsing is likely to cause major changes in exchange rates among erstwhile euro based economies, including very heavy devaluations among the weaker Euro economies, exposing us to the risk that the UK exports become relatively even more uncompetitive than they already are. Clearly, the more British exporters switch attention away from the rest of the EU and towards the economies which are growing much more rapidly, the better, but the other EU Member States still account for almost half our total exports so we can ill afford to see this source of export income being further compromised. The big risk in all these developments is that the EU economic problems cause the UK's performance to remain for a decade or more one of seemingly endless austerity, high unemployment, rising inequality, stagnant living standards, increasingly unmanageable debt levels and a relative if not absolute decline in our status and influence internationally. There is a very high price to pay for the Single Currency.

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