

# LABOUR EURO-SAFEGUARDS CAMPAIGN BULLETIN

MAY 2013

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## YET MORE QUESTIONS AND ANSWERS

### ON THE FUTURE OF THE EURO

#### **1. What is the current situation in the Eurozone?**

Only two months ago – indeed when the last Labour Euro-Safeguards Campaign Bulletin was in final draft – it appeared that the Eurozone was still enjoying a period of relative tranquillity on the back of the promises by the Chairman of the European Central Bank (ECB) that he would do “whatever it takes” to keep the Single Currency together. Then came the news that Cyprus needed a massive bail out in relation to the size of its economy, although the sums involved later became even larger than those originally cited. Cyprus was followed by a crisis in Portugal, as the country’s Supreme Court ruled that some of the cuts proposed by the government were unconstitutional. Next Slovenia hove into view as yet another country whose banks were in serious trouble. At the same time, the situation in Greece is going from bad to worse, Italy for weeks had no government to agree further austerity measures, Spain is teetering once more on the edge of insolvency and the economic prospects for France are looking more and more dire.

#### **2. What has caused this sudden change for the worse?**

The reason for the future for the euro now looking much bleaker than it did only a few weeks back is that the assurances given by the ECB that everything necessary to hold the Single Currency together would always be done suddenly had to be put to the test. The trigger was the impending insolvency of the two major banks in Cyprus. Both of them had hugely extended positions, amounting in aggregate to far more than the Cypriot annual GDP, greatly exacerbated by loans to Greek banks which also looked increasingly vulnerable. The amount of money then needed to bring the major Cypriot banks back to solvency was more than the creditworthiness of the Cypriot government was capable of underpinning. This is why external help was required. When this point was reached, however, neither the ECB, nor the Bundesbank, nor the International Monetary Fund (IMF) was willing to provide without hesitation all the credit

support which was needed to secure the liquidity of the stricken banks. Instead, conditions were imposed which ensured that depositors were to take some of the losses. These originally included not only major depositors but also large numbers of people and businesses with less than €100,000 in their accounts. Subsequently, these smaller depositors were excluded from losing the 9% of their bank balances which had previously been proposed, but at the cost of making the losses by larger depositors correspondingly greater. Many of those with larger balances are going to lose up to 60% of all the money they had entrusted to these banks

### **3. What have been the consequences of these developments?**

The reason why what has happened in Cyprus is so crucial is that it has shown that the EU and its Central Bank together have neither the political will nor the financial mechanisms in place to do what needs to be done to make the euro a viable Single Currency in the long term for all the Eurozone countries. With exchange controls still in place in Cyprus, it is clear already that Cypriot euros are not worth the same as those in Germany. Furthermore, if the Troika – the ECB, the EU and the IMF – are not prepared to back fully the banks in Cyprus, which generates only about 0.2% of EU GDP, what chances are there if a similar crisis erupts in a much larger country? To hold the line on the Single Currency, at the very least, there needs to be debt mutualisation, meaning that every Eurozone country stands 100% behind the bank liabilities in any other. For this to be possible, however, Germany would have to agree to allow its creditworthiness to be put on the line, and there is no sign that the German electorate is willing to see this happening. What Cyprus has shown is that, far from the authorities being willing to do everything necessary to hold the Single Currency together, they are only willing to do so to an extent strictly limited by the willingness of the IMF and the ECB, but not the Eurozone countries collectively, to shoulder the necessary burdens. The IMF and the ECB on their own are clearly even less likely than the Eurozone as a whole to have the financial firepower available to cope with more bail outs for major Eurozone economies. Without major changes in attitudes and policies, which seem very unlikely to materialise, the likelihood must therefore have increased that the Single Currency will not survive for more than a relatively short further period – maybe months, maybe years, but not for ever.

### **4. What is likely to be the future of the Single Currency?**

While it is always exceptionally difficult to forecast the timing of future events, it is usually easier to predict the general direction in which developments are likely to move. There are now at least three existential threats to the continuity into the indefinite future of the Single Currency. The first – highlighted by the currency crises in the weakest Eurozone economies – is the incapacity of these countries' governments to sustain the creditworthiness needed to guarantee the security of their banks' depositors. This means that they have to rely on outside support which cannot be relied on without draconian conditions being imposed. This leads on to the second danger which is that the austerity which is the

consequence of the harsh conditions generated by Eurozone bail outs will produce increasingly unmanageable social and economic conditions, which in turn get reflected in the rise of political parties which are not prepared to accept the policies required to hold the Single Currency together. Governments will then get elected which are unwilling to accept more and more austerity to maintain euro membership. It is clear that many of the austerity countries are already approaching this state of affairs. The third threat comes from the markets since all the debt being created to hold the euro together has in the end to be financed by individuals and companies willing to lend to Eurozone banks and Member States. At the moment, there is still enough creditworthiness within the Eurozone for this to be possible. It is, however, far from clear that this situation is going to prevail for all the foreseeable future.

## **5. Are there other threats in the offing associated with the instability of the Single Currency?**

While it appears likely that the Eurozone's mainstream political leadership will continue for as long as it can to do everything it deems possible to hold the Single Currency together, it seems all too likely that the consequences are going to be extremely damaging both to the Eurozone countries in particular and very probably to the world in general. An almost certain prospect for the countries within the Single Currency is that they will have little or no growth as long as the euro lasts. This is because the imbalances between the competitiveness of the stronger and weaker Eurozone economies is bound to leave the weaker ones with permanent deflation which in turn will pull down the economic performance of the whole Eurozone area. Little or no growth will, in turn, exacerbate the already manifest trends towards political fragmentation. As it is the moderate left and moderate right parties which have been the strongest proponents of the Single Currency, and it is they who are doing most to keep it in being, they are the ones whose support is likely to haemorrhage as social and economic conditions stagnate or worsen. Their place is all too likely to be taken by parties with decidedly non-centrist agendas – at worst with platforms based on xenophobia, intolerance, racism and populist irrationalism. If these two trends both materialise – and it is hard to see how either can be avoided – Europe will become more and more marginalised in the world as both its economics and its politics become mired in increasingly obvious failure.

## **6. What could be done?**

If the prospects for the Eurozone are as poor as this, what steps could be taken to cope with the situation in which the Eurozone now finds itself? The response of the Eurozone's leadership has been to see the only solution as being to concentrate more power at the political centre and to weld all the separate Eurozone countries into a single state. If this could be done, the argument goes, it might then be possible to have sufficient taxation and spending powers in place to redistribute enough resources to hold the Single Currency together. The problem here is that moving towards this sort of solution would involve political changes which it would almost certainly be impossible to get the

Eurozone electorates to accept. Trust in the European Union, its policies, record, institutions and politicians is much too low for this kind of centralisation of power to be possible with any kind of democratic consent. Any attempts to foist such an outcome on electorates without their endorsement are, on the other hand, almost certain to engender a reaction which makes their implementation impossible. In these circumstances, what may well happen is that tentative efforts for partial centralisation of powers will be made but on nothing like a sufficient scale to provide a realistic economic solution. If this happens, the break up of the Single Currency is almost certain to occur.

## **7. What should be done?**

If the analysis in the preceding paragraphs is correct, almost certainly the least damaging way ahead would be for the Eurozone leadership to recognise that the strains within the Single Currency are so great that they will become insupportable sooner or later. It would therefore be better to arrange as orderly an abandonment of the Single Currency as soon as practical. Keeping it in being for as long as possible, if this involves years of stagnation combined with constantly increasing volumes of bank and sovereign debt, which are never going to be repaid, will mean that the longer the Single Currency lasts, the worse the consequences of it collapsing are going to be. The likelihood is, however, that the Eurozone's political leaders will nevertheless do all they can to stop the Single Currency breaking up. Of course the implications of the deficit countries leaving the euro will be devastating in the short term, but recovery will surely follow as it always does once economies become competitive again.

## **8. What should the UK do?**

The UK's position outside the euro shields us from the worst of the dilemmas faced by the Eurozone countries, but we still have a huge interest in doing all we can to avoid most of Europe suffering from economic stagnation and political fragmentation. The danger is, however, that – in the EU but outside the euro – we have only a marginal amount of influence on how events unfold. We are then likely to find ourselves watching largely impotently as the EU political class spends the next few years fighting an unwinnable battle against increasingly insuperable odds to hold the Single Currency together. If this happens, the almost inevitable consequence will be both economic and political developments within the Eurozone which will look increasingly unattractive to the British electorate – and no doubt to many other Member States as well. The Single Currency, although implemented in the hope of binding the countries making up the EU together, may finish up by being the cause of it breaking up.