

QUESTIONS AND ANSWERS ON THE PROSPECTS FOR THE EURO

1. **What is the current position on the Single Currency?**

In July 2012, the President of the European Central Bank (ECB), Mario Draghi, announced that the ECB was “ready to do whatever it takes to preserve the euro. And believe me, it will be enough.” Since then, the Single Currency crisis appears to have abated. His statement led to a steady decline in borrowing costs – bond yields – for Eurozone countries, particularly those such as Spain, Italy, Portugal and Greece which had previously been called upon to pay unsustainably high rates. There has been a reduction in the spreads in interest charges paid by the stronger and the weaker Eurozone members. Nearly all of the weaker euro countries have been able to return to the market rather than depending solely on ECB support. The perceived risks of default have clearly receded. Does this mean that the danger of the euro breaking up has disappeared and that its future is secure? In Mr Draghi’s view, “These questions are formulated by people who vastly underestimate what the euro means for the Europeans, for the euro area. They vastly underestimate the amount of political capital that has been invested in the euro.” No-one can doubt the determination of the EU political class to hold the Single Currency together. The issue is whether, despite all their determination, they will succeed in doing so.

2. **What are the Single Currency’s weaknesses?**

The major problem is that the action taken by the ECB to stabilise the Eurozone has involved the Bank underwriting more or less unlimited borrowing by financial institutions, primarily banks, in the weaker Eurozone member countries. While there is no particular problem about debt creation provided that debtors remain credit worthy, this condition is by no means fulfilled in much of the Eurozone. In

many cases, there is little or no economic growth combined with large public sector and national trade deficits which need to be financed, leaving the debtor economies with debts rising fast while their capacity to service them – let alone repay them – remains static. In the long term, this cannot be sustainable, particularly if there is no inflation – possibly even deflation as prices fall – making debts harder and harder to service and repay. For viability, there has to be some reasonable prospect of the debtor countries getting back to a combination of economic growth and lower deficits to get the growth in their debts back under control, but unfortunately there is little sign of this happening. Including accumulating interest charges, all the weaker Eurozone economies still have significant government and balance of payments deficits. To rebalance their economies, they all need much lower exchange rates but, of course, the Single Currency is designed to close off this option. This being the case, the only way to try to reduce deficits is to deflate the economy but this, in turn, generates no growth. The crucial issue for the Eurozone, therefore, is whether some way can be put in place of permanently transferring resources – either by providing more and more loans which are never going to be repaid or by straight subsidies – from the stronger to the weaker Eurozone members which is politically acceptable to all of them.

3. **What has to be done to make the Single Currency viable?**

In principle, it would be possible to make the Eurozone viable if all the countries in the Single Currency came together politically to form a single state, run on similar lines to the existing nation states in terms of taxation and redistribution. There would no longer then be loans to weaker areas but transfers of resources in the form of grants. There would have to be debt mutualisation, with the central authority having control of all national budgets and responsibility for all public borrowing. The ECB could then act as a normal central bank, responsible to one unitary government covering the whole Single Currency area. Because the Eurozone is now so unbalanced in terms of competitiveness, arrangements along these lines would involve massive annual transfers from the stronger constituent economies, particularly Germany, to the weaker ones. The problems with this approach, however, are clearly visible. There is no appetite across Europe for integration on this scale and there is no majority in Germany for permanently subsidising most of the rest of the EU.

4. **What could topple the euro?**

If the political and financial structures required to make the euro viable in the long term are, in practice, unachievable, what is likely to happen? Undoubtedly, there will be a huge political drive to hold the Single Currency together and, in the absence of the levels of integration really required for viability, this will take the form of requirements for more and more borrowing on the one hand and

unrelenting pressure for more austerity among debtor countries to reduce their need for additional loans on the other. This will then create the possibility for at least three separate, though potentially overlapping ways, in which the Single Currency might break up. One is that elections in one or more Eurozone countries produce outcomes which make it impossible for governments to be formed which are able and willing to sustain the regimes of unremitting austerity necessary to keep them in the euro. The second is that there ceases to be a majority in Germany and perhaps some of the other stronger Eurozone economies in favour of the scale of resource transfers and subsidies required to keep the Single Currency in being in substantially its present form. The third is that the markets take fright at the scale of the debt which is being created and the increasing likelihood of it not being serviced fully, let alone repaid. As a result they raise the interest rates which have to be paid by the weaker economies' debt to unsustainable levels. Despite all the political will which would be thrown into the balance to stop this happening, and while it is always impossible to be certain about the timing of development of this sort, there must be a reasonable chance of one or a combination of these events occurring during the next few years. Any one of them would lead to the Single Currency breaking up at least in part.

5. **What would happen if the Single Currency did break up?**

If the Single Currency did break up, it is just possible that this would happen as a result of Germany leaving the euro, although this does not seem very likely. If this event did occur, without Germany's export performance to support it, the euro, as the currency of the weaker members, would undoubtedly fall steeply in value internationally but euro debts would be payable in the devalued currency thus avoiding major defaults. Whatever the new German currency was called would then become much stronger, very probably causing the other northern euro currency countries to want to break away from it. A much more likely outcome, however, appears to be one of the weaker economies finding unending austerity unbearable and leaving the Single Currency so that it could re-establish its international competitiveness with its own new currency. As this would very probably involve an effective devaluation of at least a third – to regain lost competitiveness - and maybe a good deal more, defaults on existing debt would in these circumstances be inevitable. The outcome for the defaulting country, however, in the light of a large amount of international experience, would very probably be a relatively short period of difficult adjustment and increased inflation followed by a rapid recovery. If one country fell out of the Single Currency, would others then follow? It seems likely that some at least would especially if, after a year or so, whichever country had gone first was clearly doing much better than those remaining in the Single Currency, as would very probably be the case. Once any one country leaves the Single Currency, however, this comes about, it therefore seems likely that most, if not all the current Eurozone countries will revert back to having their own currencies.

6.A **Would the EU be better off without the Single Currency?**

The major problem with keeping the Single Currency in being is that it is extremely difficult to see how this can be done without year after year of austerity and slow or non-existent growth in the EU, with all the rising discontent that this will inevitably bring in train. The reality is that establishing the Single Currency - always a policy driven by politics rather than economic good sense - was a catastrophic error. The integrationist policies required to give it a reasonable chance of working successfully are almost certainly impossible to implement because of popular opposition to them. The determination of the EU political class to keep the euro in being is therefore, in the end, likely to turn out to be completely unproductive. The austerity which it has to generate to survive will undermine the democratic consensus needed to make its long term viability possible. The stark choice facing the Eurozone is therefore keeping the Eurozone intact at the cost of unending stagnation or letting it go at the cost of severe disruption for a period, but followed by much better prospects of higher economic growth and lower unemployment. In the medium to long term, going through the pain of break-up looks much the better option but the short term damage to the aspirations of those wedded to building a United States of Europe would be dire and potentially terminal for the EU as it is presently constituted

7. **Where would this leave the UK?**

Mercifully, the UK is not in the Eurozone, although we should not forget how close we came to joining it during the early 2000s. The big threat to the UK from the Single Currency, even though we are not part of it, is that, to fight for its survival, the Eurozone countries erect systems of governance within the EU from which the UK is effectively excluded. Although there are currently in place various mechanisms for stopping those not in the Eurozone from being outvoted by those who are in it, increasing use of Qualified Majority Voting is very likely to erode these safeguards. This trend will probably be augmented by non-euro countries joining the Single Currency, as their terms of accession binds them to do as soon as they can, putting the UK in a smaller and smaller minority of non-euro EU Member States. If, to protect the Single Currency, the EU becomes both more protectionist, less successful economically and more politically unstable, as seems likely, the pressure for the UK to leave the EU altogether is all too likely to become steadily stronger. Setting up the Eurozone was a calamitous mistake for the EU.