You can participate in the debate here

The Euro : Chronicle Of the Currency Crisis Milton Friedman Foretold

Interest rate differentials between European government bonds and credit default swaps score new records almost every day. Greece, Ireland, Portugal and Spain face increasing difficulties in financing their public debt. Financial markets fear the situation is untenable and are becoming nervous. Politicians and the ECB all with their own preferences and interests feverishly search for a solution. The dispute between Sarkozy and Trichet is not likely be resolved soon.

Who pays the piper?

Political leaders favor a scenario of debt restructuring with a rigorous "haircut" for the bondholders, including the already shaky bank sector. Banking circles and the ECB obviously shun such a scenario. For Trichet the idea that an EMU member state would fail to fulfill its obligations is unthinkable. It would undermine the credibility of the euro project even further. An earlier proposal to create European bonds as a funding vehicle for individual member states has already been dismissed. For obvious reasons, banking circles favor a solution in which the European taxpayer would come to the rescue and would guarantee faltering government bonds.

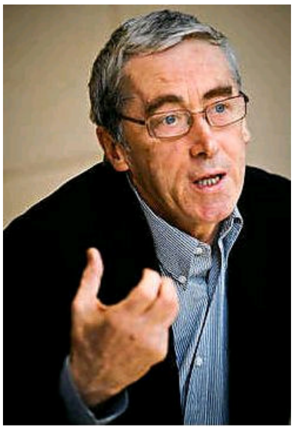
Both solutions have serious drawbacks. A debt restructuring would definitely compromise the financing capacities of defaulting nations for decades to come. Likely after such a debt restructuring the next in line after the PIGS (Belgium, Italy, France...) may soon become the next suspect. A haircut would rise the risk premium and bond yields, increasing the risk of the euro crisis spreading all over Euroland.

On the other hand, The ECB option of an unlimited guarantee is contrary to the European treaties and brings unlimited exposure to unknown risks. The ECB's proposal also meets opposition from the German public opinion. Many fear that more surprises could be hidden behind the empty state coffers. Banks could need additional state support and unfunded pension debt is becoming an unbearable burden in several countries. Moreover the European safety net may cause the moral hazard of proliferation of lax fiscal policy elsewhere.

Euroland’s choice is indeed one between cholera and the plague. But that's only the most acute problem. In the longer term, the question arises how to avoid a repetition of future euro crises and how we can prevent Milton Friedman's prediction that the euro would fall apart at the first external shock from becoming true.

De Grauwe’s Keynesian misdiagnosis

In a CEPS publication “*What kind of Governance for the Eurozone*”, Paul De Grauwe analyzes possible scenarios. As appropriate for a scientist, he starts by analyzing the causes of the euro crisis. On the basis of obvious data he demonstrates that excessive debt accumulation - particularly in the private sector - is the key factor leading to the euro crisis and that the bursting of housing bubbles in Ireland and Spain was the impetus. De Grauwe concedes partial responsibility of the monetary policy, but categorically rejects the inflationary low interest rates as the fundamental cause of the overall credit euphoria. Italy also enjoyed a sharp fall in interest rates since the euro was introduced and their credit euphoria was hardly noticeable, the argument goes. So the low interest cannot be the essential cause, De Grauwe concludes, without any further investigation into the cause of the divergent developments in these countries.



The essential difference between Ireland and Spain on the one hand and Italy on the other was that at the time of the introduction of the euro, Italy was stagnating at a growth rate of 1.7% at most. Spain and Ireland on the contrary were booming since years with GDP growth rates of 4.7 and 11% respectively. Their inflation was also twice as high as the average EMU rate. For slow-growing nations such as Italy, the incentive of a low interest rate came as a welcome stimulus. For the booming Irish economy, the rate cuts had the same effect as a stimulant drug on a child with an ADHD condition. Such medicine had to lead to disaster. Every right-minded housewife knows it, but apparently not so our political an monetary authorities. They simply disregarded the contra-indicative growth differentials and Milton Friedman's explicit warnings. They ignored the world's top financial expert and proceeded with their political euro project to dethrone the dollar as a reserve currency anyway.

Animal Spirits or Political Madness ?
Forgetting about the differential growth and inflation rates at the start of the euro is an intellectual dishonesty aimed at disguising the role of this monetary blunder as the fundamental cause of the Irish and Spanish real estate bubbles. Through exclusion, De Grauwe then comes to the traditional Keynesian explanation for the credit euphoria: "Animal Spirits"; the "silly citizens'" irrational spending behavior funneled by successive waves of irrational optimism and pessimism. According to the Keynesian-interventionist doctrine, these animal spirits are the explanation for the boom-bust cycles, and consequently require tempering by "rational" governments. It is the fundamental Keynesian justification for massive government intervention in the economy through monetary and fiscal policy.

Forgetting about the growth differentials at the start of the euro project has the crucial outcome of condoning the monetary blunder of the single currency and of justifying even more state intervention on the same wrong track.

The reality is that not animal instincts, but the inflationary interest policy caused the Irish and Spanish spending spree. The introduction of the common currency provided Spanish and Irish consumers and businesses with unlimited access to cheap credit on top of their excellent economic environment and outlook. Their response was as rational as it was predictable. The Irish and the Spanish factored the artificially low interest rates into their investment calculations. The opportunity of unlimited cheap credit lead them into excessive investment in real estate. Not animal instinct, but inappropriate monetary policy lies at the basis of their calculations and buying decisions.

Differential growth rates
In substance, the current eurocrisis can be summarized to the systemic flaw that a single monetary policy for economies with highly different growth rates is not sustainable and leads to the leveling down of growth prospects. On average, the growth deficit due to the single currency can be estimated at a yearly 2 to 3% [(1)].
For Spain and for Ireland particularly, the introduction of the euro caused an abrupt end to a most prosperous period of 20 years of unprecedented growth.

Flaws built into the euro from the start have become acute, Soros told a seminar, warning that the euro crisis could destroy the 27-nation European Union.

As both a differential interest rate policy and a change of exchange rates are unfeasible in a monetary union, De Grauwe now recurs to the third instrument of monetary policy in order to contain future growth differentials. In order to control excessive credit expansion and the emergence of new bubbles, De Grauwe advocates differential reserve requirements. He proposes to impose higher reserve requirements to banks of fast-growing economies. This idea would indeed be most appropriate if only the practical realization would not presuppose restrictions on the free movement of capital. The promotion of the free movement of capital was the prime objective and justification politicians used to justify the euro project. Or how the single currency increasingly gets entangled in its own contradictions.

Real solutions

The very fact that renowned financial experts now take differential monetary policies into consideration indicates that even the euro-believers start to assume the harmful effects of a unitary monetary policy and that they no longer exclude differentiation. However, solutions which cause new harmful effects for the prime objectives or the monetary union are counterproductive. Today millions of euro-citizens suffer heavily for the monetary madness of the single currency. Most deplorably, the architects of the euro project failed to provide an exit scenario as well as emergency exits for lagging or leading countries that want to leave. It is high time the responsible authorities seriously start conceiving the practical modalities of such an exit.

Sooner or later our monetary authorities will have to recognize that money creation out of thin air cannot promote sustainable growth. Their manipulation of interest rates far below the natural equilibrium level only leads to excessive debt accumulation. Interest rates are the starting point of all economic calculations. The interest level is not only conclusive in the choice between saving and consumption, but also in the choice between labor-intensive and capital intensive investments. Forging this basic measure only leads to wealth destructing distortions. Too low interest rates lead to savings deficits, excessive debt accumulation, excessive expulsion of labor from manufacturing processes, and to inequitable and counterproductive redistribution from savers to big spenders. The eternal dream of (nearly) free money is an illusion. The interest rate level is sustainable only if it leads to the equilibrium between saving and consumption at which every generation pays for its own consumption without coercing their heirs or other nations to pay the piper.

Paul Vreymans
http://workforall.net

(1) LESSONS FROM 20 YEAR GROWTH DIFFERENTIALS IN EUROPE, De Vlieghere and Vreymans, 2006, In this research into the causes of growth differentials in the EU the authors found that all other things equal, countries having stayed outside the EMU, had significantly higher growth, estimated at 2.57% in their multiple regression analysis. http://workforall.net/WFA_study_English.pdf page 35-36)