

The euro is unsustainable. It simply lacks the political and social embedding that a sustainable currency requires.

# *The Euro is bound to fail, and that could be a good thing*

**The euro was an idea informed by political and pragmatic interests. Those managing the European agricultural programs during the seventies began to dream of a common currency as that would make their lives so much easier.**

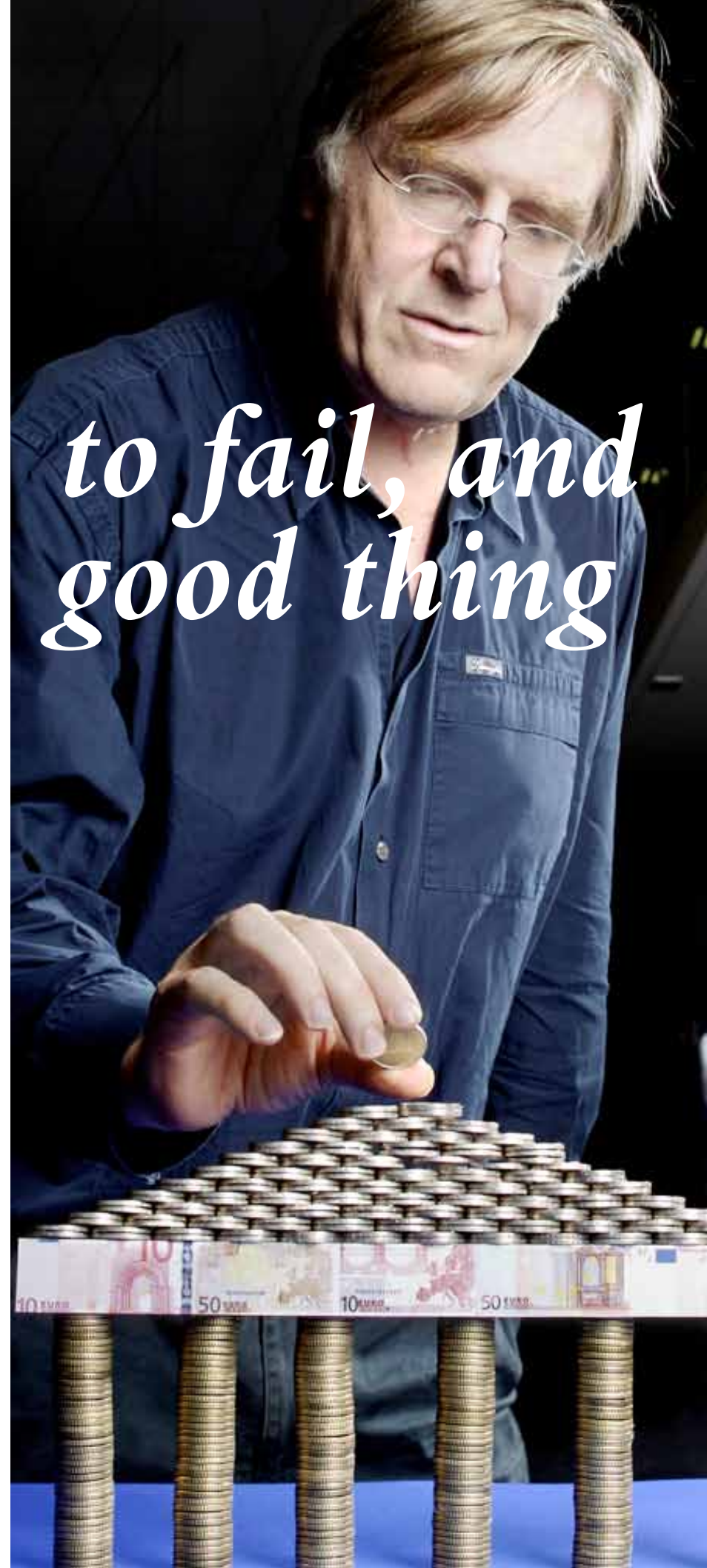
**T**op executives began to promote a common currency as they believed it would make their business easier. And the French began to push for a common currency in a move to regain the balance of power with the enlarged Germany. Economists abstained from the discussion of a common currency at the time. They did not write scientific articles about the subject, they did not discuss the pros and cons and were satisfied to refer to the optimal currency area literature in which economists such as Mundell had theorized the conditions of the optimal area for a common currency. Those conditions comprised factors like homogenous labor markets, evenly distributed inflation and the like. The common presumption was that Europe did not meet those conditions.

The announcement that the treaty of Maastricht included a proposal for a common currency came therefore as a

surprise. I was in the US at the time and shared amazement about the economic irrationality of the move with my American colleagues. Not only failed the EU at the time to meet the conditions of an optimal currency area, but the separate countries would also give up virtually all macroeconomic instruments to conduct stabilizing policies. How could they? Most importantly they would give up the possibility of changing their price by changing the value of their currency. How could European countries cope without such an option? Especially the southern countries had to devalue their currency from time to time in order to keep up. And how could these European leaders believe in such a strict regime of fixed exchange rates? Still fresh in our mind was the collapse of the Bretton Woods system in which many countries had pegged their currencies to gold in a fixed rate. Such a system works for a while but when economies diverge and the imbalances in their balance of pay-

ments become structural it is unsustainable. That much we knew. And that was what I wrote in several newspaper columns at the time.

The initiators of the treaty of Maastricht, the Dutch prime minister Lubbers and the chairman of the European committee Delors were fully aware of the need of a strong political union for the monetary union to succeed. They realized that a currency is a matter of faith and that faith comes with a well coordinated and firm economic policy. They saw that the US needed a forceful foreign policy to protect its dollar. So they included far-reaching proposals to solidify the political union of Europe. But those proposals were shot down by member countries so they had to withdraw them on what is become known as Black Monday in Dutch diplomacy. You might have guessed that with that foundation undermined they would also have withdrawn their proposal for a monetary



*Arjo Klamer*

union. They did not. Their gamble was, as Lubbers later would confess, that the monetary union would force that strong political union that was needed.

When I returned to the Netherlands another surprise awaited me. What seemed to me economic sense turned out to be political nonsense. In the beginning I found myself in the company of 100 economists or so who were to point out the economic nonsense of a common currency in the current conditions, yet we were quickly placed in the camp of eurocritics or, worse, eurosceptics. We had become political outsiders. I set up a forum to give space for people who were still interested in making sense but that discussion remained marginal. The common opinion was that the euro is a good thing for the Netherlands and for Europe. Only in Sweden and in the UK economic sense prevailed. >



To my chagrin most economists have moved to embrace the euro, at least have done so publicly. Did they do so to remain credible in the company of politicians, so I wondered? I had not seen the conditions change, so I have maintained throughout all these years that the euro has come too early and is unsustainable. Politicians and also economists with whom I debated the issue consistently declared my critique ill-founded and anti-European. When the euro lost value against the dollar they declared that this would help Dutch exports. When it regained its value, this was a sign of strength. Most decisive was the argument that because of the euro the economies of Ireland, Portugal, Spain and Greece were booming. The idea of a failing euro was inconceivable. One laughed when I made the prediction that the euro is unsustainable. Journalists wrote it down as a bold or finny statement that might discredit the economist making it. So I concluded that the euro had become an ideology. The euro had to be good, no matter what.

When belief turns into an ideology, no argument will change anything. No matter how overwhelming the case against is, no matter how convincing the arguments are, the reaction will be something like: "yes, you may be right, but I still believe that the euro is a good thing and will be there forever."

How different the situation is now. I realized that the tide was turning when the most fervent advocate of the euro, the former prime minister of Belgium Verhofstadt, declared early 2010 the euro moribund unless the European leaders would solidify the political union. So here was a European leader who dared to suggest that the euro might fail. I had not heard that before. It was getting serious. Trichet, the president of the European Central Bank and Barosso scared a few weeks later the European leaders with doom scenarios in case they would not take the necessary measures to save the euro. It has been the argument since.

If we do not do this, then the euro will fail and then utter disaster will be the result. So more or less as Lubbers and Delors had speculated when they pushed through the monetary union, the need for a closer political union would present itself some day. And so it did. It is now clear that the euro will fail unless certain conditions are met. The issue is now what those conditions are.

In line of my earlier arguments I would suggest that a great deal more is needed than balanced government budgets, an emergency fund, euro bonds, and a strict monetary policy conducted by an independent central bank. Such policies do not address, for example, the causes of the current crisis, such as the bubbles in the housing and real estate markets in Ireland and Spain. They do nothing to bring about harmonization in the labor markets, or to coordinate wage deals somehow.

One of the objectives has to be converging economies throughout Europe. For that objective other instruments are needed. When economies are diverging, as they are doing now, the EU needs something like automatic stabilizers. Within the national economies those stabilizers work by way of government expenditures programs and the tax system. See the US. When one of the states is doing badly economically, the tax payments to Washington will go down automatically and all kinds of federal expenditures will go up with a boost to its economy as a consequence. The EU lacks such a system because it does not dare to tax its citizens directly (we now pay in a sneaky way by way of value added tax) and it also does not have the funds to make much an effect by directing its expenditures to regions that do badly. When inflation is increasing the EU will need more than a strong central bank with a strict monetary policy. We have ample experience with that. Usually unions and employers need to be constrained as well and that is only possible

with a coordinated policy and strong pressure. We now see how difficult it is to get the people of Greece to change their ways of doing things. We also see that the actions that they get imposed circumvent the democratic process. Is that what Europeans want?

The EU also lacks a foreign policy and an army that it may need to secure its interests. Investors need assurance that the issuer of a world currency is willing to defend that currency. In case that the Arab countries hold large deposits of your currency, you have strong reasons to secure the stability and loyalty of those countries because as soon as they were to flood the market with your currency, you get into serious trouble.

Some people believe that overcoming all these hurdles is possible and desirable. I fear that their belief will turn out to be naïve and that the result will be exactly what we have tried to avoid: a divided Europe in conflict. A more hopeful future will be a series of open societies with many different currencies, none too weak, but also none too strong to dominate all the others. <



Arjo Klamer is professor of cultural economics at the Erasmus university