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The crisis of the euro and its future

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«The euro: a currency without a country. The second major structural weakness of EMU is that it created a currency without a country, i. e., without a government with the full powers of a government to back up the value of the currency»
Paul De Grauwe, European Monetary Union, 2011d

1. - Can the euro run?

Politically, the existence of the euro, its structure and its features are based on a pragmatic "realpolitik" and somewhat cynical, accepted by all those who want to occupy the political centrality. For the vast majority of actors in the political spectrum, the euro has become a dogma of faith and it is very unlikely to reach into question, rather the opposite (Bagnai, 2012).

However, from an economic point of view, it seemed clear from the outset that its benefits were limited compared to the costs that could be huge. Some recognized American economists, as Dornbusch (1996), Krugman (1997) and Feldstein (1998), stressed the difficulties of a monetary union that did not meet the requirements to be optimal in the sense of Mundell (1961) and because it was made mainly for political reasons without regarding to the great differences in the economic structures of the countries (Jorung and Drea, 2009). From the UK, important economists as Kaldor (1971) or Godley (1992) pointed the operational difficulties which could find a monetary union without having carried out previously the political union of the countries that participated. Countries where they held a bigger critical position on the monetary union and the euro today they still are not part of the euro zone even though they are within the European Union such as Denmark, the UK and Sweden.

2. - The euro: problem and cheating.

The euro's original sin is the separation between fiscal policy and sovereign currency. No state has the euro as its own and sovereign currency. The European states become, in part, in the equivalent of a federated state from USA: they are users of the currency (the euro) but are not the issuers of it. In addition, you can not use the fiscal policy of the Treasury, which in Europe does not exist in a strict sense. The countries that have maintained their own sovereign currency and the Treasury did not have these problems.

This situation has several consequences, especially in the peripheral countries of the euro zone. The first is that if there is a recession probably will be a hellish vicious circle: there will be a rapidly increasing public deficit and public debt in these countries, so they must seek funding through the European Central Bank and the financial markets, which will increase interest rates and risk premiums, and this will mean more public deficit and public debt. The second is that, in the absence of a European Treasury (and its own and sovereign currency) states must be responsible for the problems of their financial systems and this can create difficulties of solvency. And the third is that taking account of the passivity of the European Central Bank, there is a massive movement of capitals from any peripheral countries of the euro zone to the core countries of it (Germany in particular), which depending on how things go, it might be posed to seek refuge in other countries and other currencies.

The euro has therefore been a death trap for the economies of the euro area and especially for its peripheral countries, because as forming part of this area and do not have, therefore, the power to issue its own and sovereign currency, they are faced with the danger of suffering a solvency crisis and of having a bankruptcy. The European states, which before had the sovereign power to issue their currency, since they work with the euro they are only users of the currency (Godley, 1992; Kelton i Wray, 2009; De Grauwe, 2011a, 2011b; Wray, 2011; Papadimitriou i Wray, 2011a; Lavoie, 2011; Papadimitriou i Wray, 2012). The euro, which had to lead to a European political union, has led us, in fact, to the dependence of the states of the euro area respect the European Central Bank and the private financial markets to finance public deficits and debt of these countries, particularly of the peripheral ones.

3. - The reasons of the euro crisis.

The peripheral countries of the euro area have suffered a growing fragility because of the increase of the debt of its private sector abroad. The crisis is related mainly with the external deficits and the public deficit and public debt, which as we mentioned are a consequence and not a cause of the crisis. Moreover, the austerity policies that these countries are forced to apply not only exacerbates the deficit with the outside but also the public deficit and public debt.

A currency too strong, like it was the euro in peripheral countries from 1999, make deficits of the current account balance and the corresponding foreign borrowings to finance them. These structural deficits of the peripheral countries have been funded by external surplus countries, especially Germany, who thanks to the fixed exchange rate that means the existence of the euro could have a market, that of the European countries, to sell there most of their products (Chen et al., 2012).

The reform of the labor market in Germany (Hartz reforms) with the corresponding decline in real wages and unit labor costs, allowed a lower increase in relative prices and a real exchange rate favorable with respect to the peripheral countries. Meanwhile, these countries were growing their external deficit and external debt, which were financed by loans easily and cheaply that came from the central countries, and especially Germany. However, these increases were growing, too, interest rates and risk premiums debt of the peripheral countries. In a system of fixed exchange rates such as the Euro, adjustments must occur in the labor market by increasing unemployment and emigration: the "internal devaluation."

The dangers of this policy had been established many years ago by some disciples of Keynes (Meade, 1957; Kaldor, 1971), which, however, advocated for a policy of cooperation with a common path of growth from the balance of foreign trade and, therefore, of the balance of payments in the medium term.

Because of the increasing deregulation and financial liberalization and the fixed exchange rate that means the euro countries are unable to control the currency in which they borrow, especially the private sector. In peripheral countries, the private external debt increases with the arrival of foreign capital flows which raise the domestic liquidity and credit to the private sector. This lowers interest rates, increases GDP and employment and improves the fiscal balance, but also raises the relative prices and the real exchange rate and thus worsens the competitiveness of exports. Thus, the peripheral countries have current account deficit, capital inflows and external debt, while the core countries, especially Germany, have surplus capital outflows and credit position with respect to the outside. Rising relative prices and decreasing real exchange rates promote real estate and financial bubbles in peripheral countries. When this situation became untenable, there is a break (or reversal) of capital flows towards peripheral countries, bubbles burst and, consequently, private debt becomes public debt due to the large decrease in public revenues and the large number of resources devoted to rescuing financial institutions. It's called "cycle-Frenkel Rapetti" (Bagnai, 2012; Kregel, 2011; Frenkel i Rapetti, 2009).

Moreover, underlying causes of the crisis originated in the eighties of the last century when, from the policies that started the Prime Minister Thatcher in the UK and President Reagan in the U.S., who later had many and important imitators- they began a growing inequalities in the distribution of income and wealth in developed countries, reaching up today. This causes the progressive impoverishment of the vast majority of people, especially people with low and middle incomes, and calls into question the very existence of the middle classes (Sylos Labini, 2003; Fitoussi i Saraceno, 2010; Corsi i Guarini, 2010; Krueger, 2012; Stockhammer, 2012). A first consequence is the increasing inability of the developed economies to generate enough consumer demand to meet the needs of the economy. At the same time, both the middle class and the lower-middle class borrow more and more (taking advantage of the deregulation of the financial system and the policy of low interest rates) to try to maintain their levels of income, wealth and consumption (Rajan, 2010; Treek, 2012). This explosive borrowing encourages both real estate and financial bubbles until that private debt becomes too big, the credit stops, bubbles burst and the crisis comes to financial institutions, which are also involved and are heavily in debt. Finally, that impacts on the real economy entering into a recession process, decreasing economic activity and increasing unemployment. We are in a situation where the explosion of the housing and financial bubbles means that the private sector (households, businesses and financial institutions) has started a process of deleveraging, necessarily slow and costly, triggering a decline in aggregate demand and a deflationary spiral.

4. - The public deficit and public debt are a result of the crisis.

In 1963 James Tobin (Tobin, 1963) told us that the public deficit was the result, not the cause of the economic crisis. Later, Wynne Godley and his followers (Godley i Izurieta, 2004) told us that the public deficit could only be controlled if it was possible to control the net savings of the private sector and the balance of the external sector. But the latter two can not be monitored directly by the public sector, and even less in a situation of monetary union. Consequently, the public deficit can not be directly controlled by the public sector and, therefore, rules as that of the Maastricht Treaty that puts the public deficit ceiling in a maximum of 3% of GDP are, of course, impossible to fulfill or require a deflationary policy for the entire world economy.

The same Wynne Godley and Marc Lavoie (Godley and Lavoie 2007) have shown that endogenous characteristics of the euro area will lead to growing deficits, both in the external sector and in the public sector to peripheral countries, and simultaneously symmetrical surpluses in the core countries, particularly Germany. This situation would only be sustainable if the European Central Bank was willing to accumulate debt bonds of the peripheral countries at a low interest rate and whether financial markets accepted increases in ratios of the public deficit and the public debt to GDP of these countries. But those two things are impossible indefinitely. Therefore, the peripheral countries are forced to make budget cuts and deflationary policies ("internal devaluation"), resulting in a decline in GDP and increased unemployment. It does not seem, for now, that it will raise the alternative of a federal European political union, with actual political, economic and budgetary power. Nor internationally coordinated economic policies by: 1) achieving at the same time, lower interest rates and higher growth rates, and 2) simultaneously achieve the goals of expansive fiscal policies, growing the GDP and reducing unemployment (Pasinetti, 2000).

5. - Which are the conditions for the functioning of the euro?

For years, in the European Union and in the euro area in particular, there was a symmetry between excess saving (trade surplus) in Germany and other core countries and the lack of saving (trade deficit) of peripheral countries. Excess power saving countries financed the lack of savings in the peripheral countries. This situation was maintained while the peripheral countries had significant growth, spurred by financial and real estate bubbles, but they were no longer attractive to the core countries of the euro zone, when in these countries began the crisis.

Before and during the crisis, Germany puts some conditions for continued funding peripheral countries. On one hand, they want to have the right of veto for fiscal transfers within the euro area. In addition, they want that European countries introduce the balanced budget rule in their constitutions. Finally, through the European Commission and the IMF imposes harsh and rigid austerity policies to the peripheral countries. This is what has been called the Fiscal Compact.

In this situation, it is possible to consider different scenarios in the EU and in particular in the euro area. The first is the failure of some of the peripheral countries because they are unable to repay the debt. The second is that some of the peripheral countries decide to leave the euro zone, which would be a crisis, perhaps irreversible, in the process of European integration. The third scenario is a change in background characteristics, structure and functioning of the euro area. A modification to greater financial solidarity between countries, the issue of Eurobonds and their purchase by the European Central Bank, the implementation of a tax on financial transactions, coordinated economic policies for economic growth, search more symmetry in the adjustment mechanisms of central and peripheral countries. All this would require there to be a real political union and a European government (Godley, 1992; Kelton i Wray, 2009; Auerback, 2011; De Grauwe, 2011a; De Grauwe, 2011b; Papadimitriou i Wray, 2011a). A fourth alternative are possible partial actions to transfer part of the state debts in Eurobonds issued by the

European Central Bank, along with: 1) an economic recovery program with funds from the European Investment Bank (EIB) and 2) recapitalization and taking toxic assets by banks to ensure liquidity from the European Central Bank, which should take seriously the role of lender of last resort (De Grauwe, 2011b, 2011c, 2013a).

It lacks a clear project and a strong leadership in the European Union. If we add to the difficulties and consequences of the "internal devaluation" in peripheral countries that are forced to apply it, coupled with the growing asymmetry between countries, central and peripheral, and finally a redistributive policy against employees and debtors - collar workers and middle class that consume- and in favor of creditors, the situation is not exactly exciting. Hence the question of whether it makes sense for the peripheral countries to continue in the euro zone, and if the core countries of the euro zone may start to have problems.

In this sense, it seems that are increasing the supporters of replacing the mercantilist model of growth, based on external demand, for a model of growth based on domestic demand. This would necessarily mean: 1) the appropriation of the monetary and fiscal policies, and also of the exchange rate policy for the states or for a real and democratic European government; 2) the control of capital movements; 3) an increase in real wages, which would reduce the income and wealth inequalities that have grown in recent decades, and 4) an increase in the consumer demand (Tilford, 2012).

6. - The United States of Europe are a chimera?

Why the U.S. work well with a single currency, the dollar, whereas in Europe the euro has so many problems to be accomplished properly? It had been brought out three basic elements: the existence of a unique labor market that provides a great mobility for American workers, the existence of a Federal Treasury and a federal fiscal policy and system with a budget representing about 25% of GDP (in the EU represents only 1%), and the fact that U.S. states have voluntarily imposed from long ago, the balanced budget rule.

An important issue is the major differences between the countries of Northern Europe and Southern Europe. Northern countries are generally quite competitive, they have innovative companies, an skilled workforce, they are transparent and have little corruption, and they appreciate the effort, the work, the achievements, the skills, etc., of the people. In contrast, the southern countries tend to be less competitive, less innovative, they have a less skilled workforce, they have more corruption and less transparency and cronyism and nepotism are too much valued; and all with a high degree of participation and social involvement. There are very large historical and cultural differences, and with the passage of time they have not diminished at all. All this makes very difficult the existence of a united Europe. In addition, the process of European integration, the EU in general and the monetary union in particular, have not been any example of democracy in the classic sense of the word. On the contrary, what we now have is more dependence on the European Central Bank and the financial markets, which no one has chosen democratically (Scharpf, 2011; Wray, 2009).

7. - Are we already in the twilight of the euro?

Austerity policies, in a situation of significant public debt, carried to a redistribution of income from taxpayers to the creditors. Taking into account that peripheral countries have very important external deficits and a big public debt in public hands, mainly foreign, the real problem in the euro area is the lack of adequate mechanisms to address trade imbalances of the zone. This situation leads these countries to a long recession and stagnation, which could lead to a failure of the euro (Zezza, 2012).

Some authors have noted that there is an excessive austerity in the euro zone and that this was caused by the behavior of financial markets (De Grauwe i Ji, 2013a). First, since the beginning of the debt crisis, financial markets are driven by fear and panic that have shaped the evolution of risk premiums, and those feelings have moved the European authorities (and the authorities of many countries in the euro area). Second, these feelings of fear and panic have imposed excessive and too fast austerity policies, which caused major recessions; they can not ensure the return of the debt and the sustainability of public finances and they are producing a lot of suffering, especially in peripheral countries. And, thirdly, the resistance of the northern countries of the euro zone to stimulate their economies can not allow overcoming deflationary trends and leads to a double-dip recession. All this means significant risks to the continuity and sustainability of the euro and the euro zone (De Grauwe i Ji, 2013b).

Experts talk more and more, even from the economic orthodoxy, of the error that led to the channeling of the euro, and the possibilities that the euro could cease to exist or that some countries, especially those in the periphery, could cease to be part of it. Some experts have recently explained their opinion in this sense, with different reasoning and degrees of intensity, and in some cases referring in particular to Spain, among others, Professor Jordi Gali (Galí, 2012), Martin Wolf from the Financial Times (Wolf, 2012, Matthew Lynn from the Wall Street Journal (Lynn, 2012), Patrick Artus from Natixis (Artus and Castillo, 2012), or a report from the Bank of America Merrill Lynch (Woo and Vamvadikis, 2012). It must be said, however, that the possible collapse of the euro or the exit of a country from the euro zone make fear, just as current things that are unknown normally produce scary. There is no doubt that if we arrived at one of these circumstances that would mean some costs but would have also some advantages. And in many cases, objections to an exit (or a failure) of the euro are much more emotional than rational, and certainly almost always are the result of a conservative and conformist ideology.

Some economists have talked openly about the possibility, or even the desirability, of leaving the euro, such Bagnai, 2012, Boottle, 2012, Sapir, 2011, and Tepper, 2012, and they have offered various arguments that explain why the exit of the euro should not mean any disaster or any insoluble problem. First, most of the peripheral countries with public debt problems have a primary public surplus, that is, the public deficit and the public debt are derived mainly from interest payments. Secondly, out of the euro would allow recovering monetary sovereignty and the recovery of its own currency, which would end with the threat of a bankruptcy and would allow having lower interest rates. Third, this situation would permit to reintroduce the obligation of banks to buy debt of the country. Fourth, if the household saving is relatively high, it will reduce the risk of failure. Fifth, it has been shown historically that it is possible to leave a monetary union without causing any catastrophe: in the last hundred years sixty-nine countries have made it. And finally, it would allow us to recover a very powerful instrument of economic policy as the flexibility of the exchange rates of currencies.

What should therefore be on the agenda for the exit of a country of the euro zone? First, it should to withdraw the euro currency, to re-establish a sovereign and own currency and to recover the exchange rate policy as an instrument of economic policy. Then to restore the principle of the central bank as an instrument of the Treasury and then to regain the full control of fiscal policy, which should be counter-cyclical in nature and not pro-cyclical. Finally, it should adopt a coordinated and symmetrical policy of exchange rate between countries to be able to combat potential persistent imbalances in the balance of payments, both deficits and surpluses. As said Meade, (Meade,1957) compatibility between free trade and full employment can only be guaranteed if every member of a free trade area has its own balance of payments, in the medium and long-term, balanced in respect to the rest of the world. In short, we need an External Compact policy rather than a Fiscal Compact policy.

In my opinion, and concluding, austerity policies imposed in the countries of the euro zone, especially in the peripheral ones, will not overcome the crisis and especially the crisis of the euro and the euro zone and they are a dangerous idea (Blyth, 2013). From the economic policy point of view there are only two alternatives: either real progress and background in European political union towards a true United States of Europe with all that means in terms of fiscal and budgetary union, federalism, and so on; or the inevitable end of the euro, with its disappearance or with the abandonment of the euro by the countries of the European periphery. Any other alternative is a false solution to the problems that today has the euro zone, which only could cause more suffering without alternatives to the working and middle classes in these countries. I think it's difficult to explain it better that De Grauwe, 2013b: «The euro zone is in the toils of an existential crisis that slowly but inexorably is destroying its foundations. The only way to stop these existential challenges from taking over is to convince the financial markets that the euro zone is here to stay. [...] a signal to the markets that the member countries [...] are serious about their intention to stick together. Without this signal, the markets will not quiet down, making and end of the euro inevitable».

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