

# Euro Sums Don't Add Up

Will Europe fail if the euro collapses? Many believe it will, and are trying to save the euro. Our author holds a different view: If the euro is to be used as a tool to preserve European integration, the eurozone must be reduced to a core of countries that are equipped for long-term stability, allowing the remaining EU members to return to the more flexible European Monetary System.

TEXT FRITZ W. SCHARPF

The euro crisis is dividing Europe: In Greece, Ireland, Portugal and Spain (the GIPS countries), there are mass protests against the austerity programs dictated by Germany and the troika comprised of the European Central Bank, the EU Commission and the International Monetary Fund. In Berlin, Frankfurt and Brussels, the fault is seen to lie solely with the GIPS, who

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## The sinners must comply with draconian austerity dictates

have lived beyond their means and breached all the rules of the Stability Pact. However, because of the belief that Europe will fail if the euro collapses, and that it will do so if even one of the GIPS declares

bankruptcy, the sinners must be rescued at any price. But to receive the financial aid they need, they must comply with the troika's draconian austerity dictates.

This interpretation of the situation, which prevails particularly in Berlin, is less than accurate. Frivolous fiscal policies in Greece have certainly contributed to the present crisis. In Ireland and Spain, however, following the introduction of the euro, the governments reduced their sovereign debt far below the Maastricht limit – and far below the German level. Also, in contrast to Germany, until the onset of the international financial crisis in 2008, they balanced their budgets and even achieved surpluses.

In Ireland and Spain, sovereign debt was not the cause but an effect of the financial crisis, as the state sought to rescue banks (just as in Germany) and safeguard jobs. The fact that debt levels escalated far faster in those countries than in Germany and that the financial markets responded with prohibitive risk premiums is attributable to imbalances prior to the



crisis, the responsibility for which lay not with the fiscal policies of the GIPS but primarily with the European Monetary Union itself and the monetary policy of the European Central Bank.

The monetary union may have come about in response to French pressure, but Germany ensured that the European Central Bank (ECB) and its monetary policy were based on the model deployed by the Bundesbank in the 1970s. The independent Central Bank was tasked not just with safeguarding monetary value, but with facilitating economic growth without inflation, provided only that the fiscal policies and wage policies of the social partners remained within the framework specified by monetary policy.

This, in principle monetarist, model had generally worked very well in Germany because the Bundesbank oriented its monetary and interest rate policy toward the inflation risks and toward the growth potential of the German economy; because there was close communication between bank and government; and because Germany's economically savvy trade unions were able to integrate the annually announced monetary policy targets into their assessment of the scope for wage bargaining.

Naturally enough, these prerequisites could not be reproduced when the model was transferred to the European level. The monetary union began on

judgment of American economists in particular, the eurozone did not qualify as an optimal currency area in which macroeconomic development could be successfully controlled by centralized and uniform monetary policy.

The advocates of monetary union had expected that the Union itself, coupled with easier trading conditions and the free movement of capital in a single currency area, would encourage convergence and rapidly smooth out the remaining differences. And at first it seemed they were right: inflation rates dropped, state deficits were reduced and interest on sovereign debt fell everywhere to the German level once the financial markets no longer had to worry about the risk of devaluation.

Unlike Germany in this case, countries that had previously been forced to pay high risk premiums now profited from the growth stimulus of a steep reduction in the cost of borrowing, which also made it easier to comply with the deficit rules contained in the Stability Pact. In contrast to previous concerns, the initial risks did not lie in the fiscal policies of the member states. They lay, instead, in monetary policy that had been left solely to the independent European Central Bank.

To reduce inflation rates to meet the Maastricht criterion, the states joining the eurozone had been able to rely on the restrictive monetary policies of their national central banks. In the end, they came close to (but did not quite match) the low German level. Upon joining the monetary union, however, they lost all influence over monetary instruments. And the ECB, which was now responsible, aimed its money supply and interest rate policies at the eurozone as a whole rather than at the problems of individual states.

In doing so, it was indeed able to successfully limit the average euro inflation rate. For countries whose inflation or growth rates were above or below the eurozone average, however, the ECB was not and is not in a position to assume the function that the Bundesbank fulfilled for the German econ-

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## The risks initially did not lie in fiscal policy

January 1, 1999 with eleven members – including Ireland, Portugal and Spain, with Greece not being granted membership until 2001. Even though all of the member states had made heroic efforts in the 1990s to meet the Maastricht criteria for entry, the economic, political and institutional differences within the euro group were so great that, in the



omy. Its uniform monetary policy oriented toward the euro average is too restrictive for some countries and too lax for others. For both groups, the effects of its monetary policy are thus misdirected, as one sees its economy overheat, while the other is driven into recession.

The first victim of misdirected monetary policy was Germany, which entered the monetary union with the lowest rate of inflation and its economy in a downswing. The nominal ECB interest rate was too high for this situation, whereas for the GIPS, with their significantly higher inflation rates, it was too low. For this reason, the real interest rates (after adjusting for inflation) that determined business decisions in Germany were particularly high, whereas in the GIPS, they fell below zero from time to time.

The already weak consumer and investment demand in Germany was further depressed by excessive borrowing costs, while the extremely low real interest rates in the GIPS stoked domestic demand. Germany, as a result, slipped into a recession between 2001 and 2005, with steeply rising unemployment, while strong economic growth financed by borrowing in Ireland, Spain and Greece caused unemployment to fall.

In the first half of the decade, Germany was the “sick man of Europe.” Without the monetary union, monetary policy would have countered this situation, and an expansive fiscal policy might have stabilized employment. Given that these options aimed at domestic demand were precluded (Germany was already in breach of the Stability Pact as a result of its recession-induced reduction in revenue and increase in expenditure), all that remained was the supply-side Hartz IV policy and a flight into exports. The latter was made possible by the extremely restrained wage policy of the trade unions, under which wages in Germany fell in real terms.

In the GIPS, on the other hand, credit-fueled domestic demand not only stimulated demand for imports, but drove up wages and unit labor costs\*. The ensuing loss of international competitiveness caused

increasingly negative current account balances. Without the monetary union, these deficits would soon have been corrected, whether by a balance of payments crisis or by falling exchange rates and higher risk premiums. In the euro zone, however, there was no exchange rate risk for investors, and current-account deficits were readily financed through capital inflows from surplus countries like Germany. This resulted in increasing macroeconomic imbalances in the eurozone.

It took the international financial crisis to put an end to this vicious circle. While banks in the creditor countries were forced to write down or

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write off US securities, banks in the debtor countries were unable to refinance themselves. In both cases, governments had to take on debt to save their banks and safeguard jobs. The global credit crunch – and the bursting of the real estate bubbles in Ireland and Spain – thrust the credit-dependent economies of the GIPS into a particularly deep crisis, causing sovereign debt levels to escalate even in countries that had previously been rock solid. Now, at last, the rating agencies and financial markets began to doubt the solvency of the GIPS. Consequently, fresh borrowing was available only at exorbitant risk premiums.

It is this problem that the rescue programs for Greece, Ireland and Portugal have so far addressed. But providing access to affordable credit merely buys time. And the necessary reduction of extreme levels of sovereign debt will not be enough. The true magnitude of the challenges becomes clear only when one considers the development in real effective exchange rates. This shows how dramatically the inter-

\* In economics, unit labor costs are the quotient of employee compensation and gross domestic product.



national competitiveness of the GIPS has decayed since the start of the monetary union. If this deficit is not corrected, no rescue program can alter these countries' dependence on loans or transfers from abroad. There are only two ways in which it can be corrected: either by nominal devaluation or real devaluation.

Nominal devaluation, which also presupposes a drastic "haircut" for these heavily indebted states, has been categorically ruled out in the political discussion thus far because it would require the country

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### A nominal devaluation is categorically ruled out in the political discussion

concerned to at least temporarily leave the monetary union, and because such an event would rhetorically be equated with the failure of European integration. If such a decision were nevertheless to be made, the country's exports would immediately become cheaper, its current account would return to balance and its dependence on inflows of capital would cease.

Admittedly, the rising cost of imports would push up prices and real incomes would fall. However, the gain in international competitiveness would be lost if trade unions in the export industries would try to compensate real-income losses through higher nominal wage increases. That would certainly be difficult, but there are examples – not just in Germany – that illustrate that wage restraint can be achieved in consensus with the trade unions. If this were to succeed, GIPS countries could escape their dependence on capital inflows and European rescue programs, and achieve economic recovery through their own efforts.

If, on the other hand, Greece and other deficit countries continue to defend their membership in the monetary union, the reduction in export prices

necessary to restore international competitiveness would be achievable only by a real-terms devaluation that would necessitate a rapid reduction in unit labor costs – and therefore a drastic cut in nominal wages. This could not be achieved anywhere – not even in Germany – in consensus with the trade unions. Instead, government-enforced wage cuts would be required, which could perhaps be implemented in the public sector. In the private sector, on the other hand – which would be crucial for competitiveness – the state would not have (in Germany at least) the constitutional powers or (anywhere) the practical ability to effectively dictate wages. Even a European "economic government" could not alter these conditions. In the long term, of course, and under the pressure of high rates of unemployment, market forces could bring about a reduction in unit labor costs. Until then, however, current accounts would remain in deficit. GIPS countries thus will continue to depend on capital inflows and, given the distrust of capital markets, they will continue to depend on rescue credits or eurobonds in order to at least reduce the interest cost of rising debt burdens.

Meanwhile, the uniform monetary policy pursued by the ECB will still be part of the problem. Even the present low ECB interest rates are too high for the crisis in GIPS economies, and real interest rates in those countries have reached extreme levels. As its chief economist, Jürgen Stark explained in a lecture on June 20th of this year, the ECB perceives its task to lie solely in "guaranteeing price stability in the euro-zone. The ECB may not and will not deviate from this task because, for example, real growth or inflation rates in some eurozone member states are substantially lower than in other member states." Having triggered an increase in macroeconomic imbalances, uniform monetary policy in a non-uniform eurozone now also stands in the way of resolving the crisis within the monetary union.

In conclusion, the attempt to save the euro in its present form, whether through loans, eurobonds or direct financial transfers to the deficit countries, will do nothing to change the fundamental structural

problems of the monetary union. This assistance will make it easier for GIPS governments to finance their deficits, but the rigorous austerity conditions will

## Uniform monetary policy stands in the way of resolving the crisis

deepen and prolong the economic crisis and force governments into measures that lack democratic legitimacy. Should they be implemented, they will be perceived as the impositions of European bodies and donor countries. There, however, political frustration is rising as financial commitments seem to grow inexorably without achieving their promised effect.

The attempt to rescue the euro is therefore more likely to undermine the democratic legitimacy of politics and politicians in the member states and drive the European nations apart than to hasten progress toward a democratically legitimate political union. If the euro is to be used as a tool to preserve European integration, the eurozone should be reduced to a closely integrated core of countries committed to long-term stability, allowing the remaining EU members to return to the more flexible European Monetary System. Otherwise, the euro crisis could actually blow the European Union apart. ▲



### THE AUTHOR

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### NOTE

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