NAI Global

The Euro is Still Doomed

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While reducing trade barriers was essential to the economic growth of Europe, a common currency was — and remains — completely superfluous for achieving this worthy goal. For example, the U.S. and Canada share a trade zone, but not a common currency. Similarly, Switzerland, Norway, and the UK are all part of the European trade zone but function very effectively outside of the euro. The euro handcuffs both the borrowing PIGIS (Portugal, Italy, Greece, Ireland, Spain) and their lenders. The only responsible thing for Greece (and fellow PIGIS) to do is walk — not run — away from the euro. Yet, politicians are avoiding abandoning the euro at almost any cost.

The Maastricht Treaty recognized that fixed terms of trade had a chance of surviving only in the highly unlikely case that the relative competitiveness of member sovereign nations did not notably change. Absent major market reforms (which the bureaucrats never dreamed would occur), would be possible if all member nations lived up to the broad fiscal constraints imposed by the Maastricht Treaty. But these fiscal constraints were almost immediately "ignored", as sovereign Euroland member nations yielded to local political pressures to spend more and tax less. And, it was not long until even Germany violated the Treaty's fiscal constraints, with no penalties imposed on them (or any nation violating these critical treaty conditions). And the moment these violations occurred without consequences, the euro began the death spiral which is playing out today.

The various fiscal guidelines of the Maastricht Treaty were cobbled together in an attempt to restrain changes in the terms of trade among member nations. These rules were marginalized, first via lies and accounting gimmicks, then blatantly flaunted by smaller members, and finally ignored by all members except Estonia, Sweden, and Luxembourg. Not surprisingly, absent consequences, the violations became larger and more frequent. And all the while the terms of trade across members changed, but fixed exchange rates were unable to reflect this altered reality.

The problem is too fundamental and too large to "outgrow", and political bailouts only forestall the inevitable, redistribute resources, and further distort resource allocations.

The longer these distortions continue, the greater is the economic loss, and the greater will be the required adjustment. The losers are those who believed the euro's fantasy of fixed exchange rates without sovereignty. Allowing the fantasy to continue only makes the problem bigger, rather than making it go away. The problem is too fundamental and too large to "outgrow", and political bailouts only forestall the inevitable, redistribute resources, and further distort resource allocations.

People say, "But if the euro breaks, it will be painful." What they miss is that its existence is even more painful. Of course, ending a 16-year (and running) fantasy-turned-nightmare will be painful. But making it a 20- or 25-year fantasy will only make it a larger problem, and assure more years of deepening anguish. If you believe in markets at all, you want the euro to fail, and fail soon!

In addition to the complete ineffectiveness of the Maastricht Treaty's fiscal constraints, when in the early 2000s Germany and Scandinavian countries introduced major market reforms that massively improved their competitiveness relative to other Euroland members, the euro's fixed exchange rate regime was rendered hopeless. In the eyes of Europe's almost uniformly left-leaning bureaucrats, the real villain is Germany for adopting the serious market reforms that improved its competitiveness. Damn those Germans for giving into market pressures to be competitive! In a flexible exchange rate system, fundamental German market reforms would have resulted in a 20-40% increase in the value of the Deutsche Mark versus other currencies. But as Euroland exchange rates remained fixed at their original terms of trade, Germany's currency could not appreciate. Instead Germany benefitted both from fundamental market reforms and an artificially low exchange rate. This excessively cheap German exchange rate handicapped nations with currencies that could not depreciate. To put a simple face on matters, it made Volkswagens too cheap for Greeks, and made Greek vacations too expensive for Germans. This caused money to flow from Greece to Germany (and in general from the south to the north), with no need for this money to flow back. Thus, unlike the case of U.S. dollars flowing to China (i.e., we buy shoes, etc. made in China) as a trade deficit, necessarily returning to the U.S. (i.e., China buys U.S. bonds) as a capital surplus, once euros arrive in Germany they do not flow back to Greece, as the euro can be invested anywhere in Euroland.

The day of reckoning associated with the undervalued German currency was forestalled by Basil II's risk weighting system, which nonsensically encouraged German bankers to voluntarily send euros back to Greece (and the south in general) as they bought zero-risk-weighted Greek bonds (under Basil II) for an extra 50 bps over German bonds, as Basil II essentially viewed these bonds as being as safe as German bonds. However, the Financial Crisis made it abundantly clear that while Basil II may treat certain types of debt as riskless, in the end, the guarantee of repayment is only as good as the guarantor. And in the case of southern members of Euroland, as was the case for many U.S. home loan borrowers, the guarantor was not very good at all.

We have lived less than 2 blocks from Independence Hall in Philadelphia for over 25 years. Whenever we wander past this monument which symbolizes a nation created from disparate parts, we ponder how our nation's forefathers were able to stitch the U.S. together from 13 colonies, for as revealed by the EU experience, it is no small task to create a common government framework from independent parts without the use of military force. Yet any realistic assessment of the U.S. experience of 13 colonies unifying and sublimating to become a single, powerful nation drives home the hopelessness of the European effort.

Let's start with some simple, but dramatic differences. First, the 13 colonies were quite small, agrarian, and homogeneous societies. They all spoke English and had common cultural roots in England. These colonies also had very brief histories at that time, had relatively homogeneous governmental and legal structures, and none were sovereign nations. And critically, they all faced a common powerful enemy which served to unite them. Further, there was no history of wars (and the associated distrust and stereotypes born of conflict) between the colonies. Nor was there any difference in their

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standards of living and social welfare systems (which were all virtually zero), and travel between the colonies had long been achievable without passports and visas as they were all under English rule. And while religious differences existed in the colonies, a belief in the Church of England predominated in all 13 colonies.

Things within the EU could hardly be more different. Member states are not only sovereign nations, but have been so for many decades and even centuries. The member nations are large and do not share a common language, culture, religion, legal system, or governmental framework. They have massively different standards of living, and their economies have vastly different industrial social welfare structures.

The differences are stark. One key insight into why the economic growth in parts of Europe has lagged is seen in the fact that in France, Italy and Greece, only 8% (or less) of people aged 65-69 are employed, versus 18% in Germany, 20% in the UK, and 29% in the U.S. Further, only 22% of those aged 60-64 are employed in France and Greece, and just 32% of such Italians are employed, versus more in Germany, the United Kingdom, and the U.S. These low work rates reflect policies and cultures that view work as a "bad" thing. In short, you cannot have robust economic growth if so many productive economic resources are left fallow.

Another difference is that there is no common enemy unifying the members. In fact, "the historic enemy" for each nation is generally another EU member, and very real wars raged among member nations for centuries. In this regard, it is noteworthy that neither Canada, nor Mexico – against whom the U.S. waged brief wars – ever became part of the U.S. In short, member nations are wildly different and share little in the way of common values. In light of these differences it was foolhardy to attempt a United States of Europe, with its common currency, economic and social structures, and regulatory policy. This is particularly true, without a George Washington or Ben Franklin as a leader. Initial treaties which reduced silly trade barriers were wise, as was easing travel burdens. But truly unified behavior was never achievable. The goal should have been more like NAFTA than creating a European U.S. And as the goals of the EU shifted from "reducing needless burdens" to "unified Europe", the experiment quickly crumbled under the weight of reality. And this disintegration (literally) risks undoing the many productive barrier reductions which occurred. The EU experiment simply went a few bridges too far.

Today the EU and its most disastrous creation – the euro – teeter on the brink of inevitable extinction, propped up only by the political will to spend other peoples' money pursuing an impossible dream. After all, Don Quixote would still be tilting at invisible windmills if he had the resources of the EU and ECB at his disposal. The euro has introduced economic barriers rather than reduced them. Transfers between members are exceedingly difficult due the sovereign status of member nations, while the free movement of people across borders directly affronts both national security and sovereignty. Thus, Europe is weak and not growing, while immigrant pressures from both inside and outside of the EU are tearing the EU apart.

The lack of shared values among members has been laid bare by the recent Middle East refugee crisis as well as the never ending Greek tragedy. In the third quarter of 2015, Hungary had granted asylum to just 278 of over 140,000 refugees, while Germany has accepted about 40% of applicants. This lack of common values makes unified action impossible, and any attempt to force such unity on unwilling nations does far more harm than good in the long run.