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Controlled dismantlement of the euro area in order to preserve the European Union and Single European Market

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Controlled Dismantlement of the Euro Area in Order to Preserve the European Union and Single European Market

Stefan Kawalec
Ernest Pytlarczyk

No. 441/2012
Materials published here have a working paper character. They can be subject to further publication. The views and opinions expressed here reflect the author(s) point of view and not necessarily those of CASE Network.

This paper represents a contribution to the debate on the future of the European Monetary Union, and CASE is glad to host it in this series at the request of the authors. The views in the paper do not correspond necessarily to CASE’s position on the matters under review, but in the interest of debate they have merit in being discussed.

Keywords: Eurozone crisis, Internal devaluation, Deflation, Currency devaluation, Euro break-out, Future of Europe

JEL Codes: E5, F15, F32, N1
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Abstract

The Eurozone crisis mobilises an appreciable amount of the attention of politicians and the public, with calls for a decisive defence of the euro, because the single currency’s demise is said to be the beginning of the end of the EU and Single European Market. In our view, preserving the euro may result in something completely different than expected: the disintegration of the EU and the Single European Market rather than their further strengthening. The fundamental problem with the common currency is individual countries’ inability to correct their external exchange rates, which normally constitutes a fast and efficient adjustment instrument, especially in crisis times.

Europe consists of nation states that constitute the major axes of national identity and major sources of government’s legitimisation. Staying within the euro zone may sentence some countries – which, for whatever reason, have lost or may lose competitiveness – to economic, social and civilizational degradation, and with no way out of this situation. This may disturb social and political cohesion in member countries, give birth to populist tendencies that endanger the democratic order, and hamper peaceful cooperation in Europe. The situation may get out of control and trigger a chaotic break-up of the euro zone, threatening the future of the whole EU and Single European Market.

In order to return to the origins of European integration and avoid the chaotic break-up of the euro zone, the euro zone should be dismantled in a controlled manner. If a weak country were to leave the euro zone, it would entail panic and a banking system collapse. Therefore we opt for a different scenario, in which the euro area is slowly dismantled in such a way that the most competitive countries or group of such countries leave the euro zone. Such a step would create a new European currency regime based on national currencies or currencies serving groups of homogenous countries, and save EU institutions along with the Single European Market.
Introduction

Europe gave birth to conflicts that started two disastrous world wars in the first half of the 20th century. But in the second part of that century, the spirit of European integration resulted in the creation of the European Union and Single European Market, both institutions being great political and economic successes. After the break-up of the Soviet bloc, aspirations for EU membership and consequent access to the Single European Market were among the key factors that enabled the successful political and economic transformation of post-Soviet countries. Today, the preservation of the single market and the European Union is necessary for the continuation of economic prosperity in European countries.

The introduction of a common European currency at the turn of the 21st century was another important step of integration that generated exceptionally high hopes. However, after nearly a decade of success, the euro zone has come to a crossroads. The current crisis mobilises an appreciable amount of the attention of politicians and the public, with calls for a decisive defence of the euro, because the single currency’s demise is said to be the beginning of the end of the EU and Single European Market. We acknowledge that view and share some of its premises. However, we fear that preserving the euro may result in something completely different than expected: the disintegration of the EU and the Single European Market rather than their further strengthening. The fundamental problem with the common currency is individual countries’ inability to correct their external exchange rates, which normally constitutes a fast and efficient adjustment instrument, especially in crisis times. The introduction of the euro proved to be a step that contradicted the prevailing philosophy of European integration based on respecting member needs and accepting only those measures which do no harm to any country. Staying within the euro zone may sentence some countries – which, for whatever reason, have lost or may lose competitiveness – to economic, social and civilizational degradation, and with no way out of this situation. This may disturb social and political cohesion in member countries, give birth to populist tendencies that endanger the democratic order, and hamper peaceful cooperation in Europe.

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1 The first Polish version of the article was submitted to “Liberté” and is available at www.liberte.pl from 11th April, 2012. This version was distributed on the 22nd of June 2012.
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The text is divided into ten sections.

The first section elaborates on the fact that the key to the problems of those euro zone economies in crisis lies in the decline in competitiveness, driven by different factors in different countries.

The second section explains two short-term strategies available to boost competitiveness: weakening the currency (either by market depreciation or planned devaluation) and deflation (sometimes also called “internal devaluation”). Weakening the currency is potentially a very effective instrument, but an improvement in competitiveness has to be complemented by proper monetary and fiscal policies in order to be permanent. Deflation policy is by nature far less effective and brings about higher costs associated with the decrease of GDP and the rise of unemployment; hence it is a policy that is hard to maintain in democratic regimes.

The third section describes some case studies of the use of deflation and currency weakening that took place before the 2008 financial crisis. We present explanations for why deflation was an effective adjustment mechanism before World War I but ceased to be one afterward. We discuss an instructive example of the spectacular failure of deflation policy, the defence of an overvalued pound sterling in Great Britain in the mid-twenties of the 20th century. We remind the reader that devaluation was one of the most important steps of Franklin Delano Roosevelt’s presidency in 1933. We also present some controversies connected with devaluation policy in the nineteen thirties and explain that they do not undermine the thesis that devaluation policy can be a successful tool. We also cite some examples from the Asian and the Russian crises in the 1990s. They show that adjustment programs including devaluation can be very quick and effective in restoring competitiveness and current account balance, leading economies out of deep crisis and back to the path of growth. We describe the instructive example of Argentina at the turn of the 21st century, which leads to three conclusions. Firstly, a country enjoying a sound macroeconomic
situation and apparently solid institutions may encounter competitiveness problems for unexpected reasons. Secondly, attempts to restore competitiveness using deflation policy within a fixed exchange rate regime may bring serious social unrest. Thirdly, currency depreciation is a strong adjustment instrument and may help to pull a country out of political and economic chaos and put it back on a growth path. However, we remind the reader that currency depreciation is not a miraculous instrument that can on its own and painlessly solve all problems. Its overuse is harmful, but swift restoration of competitiveness in crisis times without currency depreciation is a difficult or even impossible task.

In section IV, we consider whether deeper fiscal union could deliver measures that would boost the competitiveness of countries in crisis, and which would be an alternative to currency devaluation or deflation. We look at southern Italy and East Germany and discuss ways of restoring competitiveness of underdeveloped regions within the single currency area through a policy of structural aid and budget transfers. We argue that such policies are so ineffective and expensive that they cannot become a significant tool of reviving competitiveness in problem euro zone countries.

Section V presents some natural experiments, which are often used as examples of successful “internal devaluation” or deflation policies, implemented by reducing government expenditures. We discuss Latvia’s experience and show that it cannot be regarded as an argument for recommending “internal devaluation”. Moreover, we compare Latvia and Iceland’s experiences and show that the costs of adjustment in Iceland as the country pulled itself out of deep crisis were significantly smaller because of the devaluation. We cite case studies of successful expansionary fiscal consolidation, i.e., situations in which fiscal tightening immediately became an impulse for the acceleration of economic growth. It turns out that in those cases fiscal tightening was accompanied by substantial currency depreciation or by substantial interest rate cuts and falling inflation. Expansionary effects of fiscal tightening cannot be counted on within euro zone countries, where currency depreciation is impossible and inflation and interest rates are already very low.

In section VI, we make use of the conclusions from sections I-V to discuss the consequences of the single currency in Europe. We stress that Europe is fundamentally different from the USA because it consists of nations speaking different languages, drawing on different traditions, and is organised into national (sovereign) states. Nation states constitute the main axes of citizens’ identity and are the sources of legitimacy of power. Nothing suggests that this situation will change during this century. The European Union and its institutions are auxiliary entities, created in order to improve security and economic prosperity of the
member states. The success of integration was based upon the philosophy of respecting the needs of all members, upon accepting solutions that serve everyone and threaten none. Yet implementing the common currency undermined this philosophy. A euro zone member that loses competitiveness for whatever reason or is forced to liquidate its current account deficit may be practically doomed to economic, social and civilizational demise, with no chance of changing this situation. We think that these problems have totally different and far more serious dimensions when they concern whole countries rather than underdeveloped regions within particular countries. We remind the reader that a Europe in which individuals embedded in national societies have no possibility of improving their economic situation other than to migrate will be naturally exposed to conflicts.

In section VII, we present the option of a controlled dismantlement of the euro area. If a weak country were to leave the euro zone, it would entail panic and a banking system collapse. Therefore we opt for a different scenario, in which the euro area is slowly dismantled in such a way that the most competitive countries or group of such countries leave the euro zone.

In section VIII, we consider which mechanism of currency coordination can be implemented after the dismantlement of the euro zone. We argue that there are acceptable alternatives to a single currency, which are not entirely perfect but would facilitate economic prosperity and the development of peaceful European cooperation. We stress that any attempts to support and implement a mechanism aimed at freeing Europe from problems with currency coordination once and for all may lead to economic and political disaster. Such havoc was once wrought by the currency system based on gold parity in the interwar period. This time, similarly disastrous consequences could be linked to the stubborn defence of the single currency in Europe.

In section IX, we weigh arguments and warnings against dismantling the euro zone. We refer to opinions that dissolving the euro zone would: entail economic calamity in Europe, trigger abrupt appreciation of a German currency and end with recession there, and weaken Europe’s position among other economic giants, such as the USA, China and India. We do not underestimate those arguments but rather stress that they are based on shaky assumptions. The first assumption is that Europe with a single currency is able to overcome the current crisis and successfully grow in the future. Secondly, that the dismantlement of the euro zone has to lead to the collapse of the single market and the disintegration of the EU. It is obvious that under these assumptions dismantling the euro zone would be harmful for everyone and would make no economic sense. However, these assumptions are not legitimate, as we will show. Firstly, defending the single currency exposes Europe to
enormous problems and conflicts, hampers economic growth, and weakens Europe’s international position. All this can result in an uncontrolled collapse of the euro area, with unpredictable consequences. Secondly, our variant of the dismantlement of the euro zone assumes the process will advance in an agreed and controlled way, in order to preserve the Single European Market and the EU. Furthermore, our proposal stipulates that it will be possible to design a currency coordination mechanism that limits the appreciation of the German currency in the interim period, just after exit.

In section X, we sketch the most probable scenarios under the assumption that the persistent defence of the euro continues alongside a continuation of deflation policy, known also as “internal devaluation”: 1) a scenario of inevitable political and social collapse of non-competitive countries; 2) a scenario of uncontrolled euro zone break-up. We note also – as less likely but still possible – a scenario under which the current difficulties are overcome as a result of a coincidence of positive factors: a strong upswing in the global economy, a significant weakening of the euro generating a trade surplus for the euro zone as a whole, or – much better effects than hoped from the restoration of competitiveness in economies in crisis via the “internal devaluation” policy. If the euro zone overcomes the current crisis, it does not mean that problems with lack of competitiveness may not occur again in other countries in the future. In each case, the fate of a country that loses competitiveness within the euro zone for whatever reason would be unenviable.

In our concluding remarks, we put forward the idea that, even in the scenario in which the current crisis is overcome, it would be hard to imagine any expansion of the euro zone in the immediate future. Moreover, the preservation of the euro zone will doom the EU to a division into groups of countries constituting a “three-speed Europe”.

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This article expresses personal views of the authors.
1. Loss of competitiveness as an essence of problems faced by euro area economies in crisis

In 2010 Greece, Portugal, Italy, Spain and Ireland faced serious problems in auctioning their bonds. Yields demanded by investors soared. Since then, euro zone countries and the European Central Bank (ECB) have introduced various measures aimed at alleviating and finally solving the problems of the economies concerned. At the very beginning, the political and economic leaders of the EU claimed that there was only a temporary liquidity problem and afflicted countries would be able to pay off their debts after introducing proper reforms. By now, however, at least in the case of Greece, the official EU position is that there is a solvency problem, i.e., a problem concerning the ability to service debt. Therefore it was accepted that debt reduction was necessary. Solvency fears are also a common feature of the other member countries in crisis.

The key to the problems of the euro zone countries in crisis (except Ireland) lies in the loss of international competitiveness. This phenomenon occurs – without going into details – when wages become too high compared to productivity in tradable goods sector. As a consequence, domestically produced goods start to be crowded out (within a country and abroad) by foreign goods. Subsequently, output and employment in the tradable goods sector fall. As long as this fall is offset by growth of employment and output in non-tradable goods sectors – in particular in construction and services – the erosion of competitiveness does not necessarily lead to a decrease in employment and output in the whole economy, but usually manifests itself in worsening of trade and current account balances. Negative trade and current account balances can be sustainable, unless there are problems with foreign financing.

In 1999-2011 unit labour costs (the value of wages per unit of output) in Greece, Spain, Portugal and France increased relative to Germany by 19-26%. Such a loss of competitiveness against Germany reflected itself in worsening trade and current account balances. In 2010 the aforementioned countries had current account deficits worth 2 to 10% of GDP, and their combined trade deficit amounted to EUR 167bn. At the same time Germany had a trade surplus of EUR 154bn and a current account surplus of 6% of GDP.

It has to be stressed that different countries suffered a loss of competitiveness for different reasons. In Greece, Portugal and Italy, the culprits were budget deficits or very high public
debt levels. Spain and Ireland, which before the financial crisis complied with the Maastricht debt and deficit criteria even better than Germany, fell victim to an enormous expansion of private debt that propelled the construction sector and increases in wages.

Financial markets have lost patience recently and are unwilling to voluntarily finance the current account deficits of Greece, Portugal, Italy and Spain. Therefore, in order to repair their trade balances and liquidate their current account deficits, these countries need to bring wages down by 20-30%. Such a rapid improvement in competitiveness could be accomplished by a currency depreciation that would be almost harmless to output and employment. However, in order to progress with such an operation, a country has to be in control of its own currency. A good example of successful currency depreciation is Poland, a member of the EU but not of the euro zone. At the height of the world financial crisis between Autumn 2008 and Spring 2009, the Polish zloty depreciated by 30%. Thanks largely to this, the trade balance improved by 3% of GDP. It was possibly the most important factor that enabled Poland – as the only EU country – to enjoy economic growth in 2009, when other EU economies were contracting.

The euro zone countries in crisis cannot improve their competitiveness by simply letting their currencies depreciate because they do not have their own currencies. As a consequence, and following the general advice of the European Commission, the ECB and the International Monetary Fund, these countries are trying to restore competitiveness by undergoing fiscal contractions (i.e., by reducing government expenditures and hiking taxes) that are hoped will result in the decrease of nominal wages, social benefits and prices. This type of policy is known as “internal devaluation”, but all we are dealing here with is an ordinary deflation policy executed using fiscal tools.

2. Weakening the currency and deflation – two alternative methods of restoring competitiveness in the short-term

There are two methods to revive competitiveness in the short-term: weakening the currency or deflation, i.e., a decrease of domestic prices and wages. When the exchange rate is determined by the country’s monetary authority, currency weakening may be accomplished by devaluation. When the exchange rate is market-determined, the weakening of the
currency is called depreciation. Deflation, in turn, may appear as a consequence of strong demand suppression triggered by fiscal tightening or restrictive monetary policy. The effects of currency weakening and deflation are the same: a decrease of wages and other incomes in terms of the currencies of the main trading partners; both lead to an improvement in the trade balance.

However, there are also differences between the weakening of the currency and deflation. The former automatically generates a fall in wages denominated in foreign currencies, and therefore provides a quick boost to competitiveness that stimulates domestic output. The latter, on the other hand, has effects measured with a lag. First of all, deflation policy has to generate a fall in output and employment through a decrease in demand. In turn, rising unemployment persuades employees in the private sector to accept lower wages. In order to be effective, deflation policy has to deliver changes in thousands of private entities and in thousands of deals. Decisions to lower prices are not made until firms encounter a barrier to demand manifested in shrinking sales. On the other hand, employees only begin to accept wage cuts when the unemployment rate rises considerably. In a process of deflation, a fall in wages and prices denominated in foreign currency is not as automatic and broad-based as it is in the case of an exchange rate change. Moreover, this fall occurs much more slowly than in the case of currency weakening, since the latter that allows for wage adjustment in the whole economy practically overnight.

When an economy runs a large current account deficit and financing for the deficit dries up, while at the same time there is no swift improvement in competitiveness, the necessary reduction in the current account deficit takes place as a direct result of a decline in employment and output. When the trade deficit needs to be reduced urgently, the smaller and slower restoration of competitiveness via deflation policy entails greater costs in terms of employment and output than adjustment carried out via the weakening of the currency.

Weakening the currency is by nature a more effective instrument for the restoration of competitiveness in the short term than is deflation policy. It is also much less costly in social and economic terms. It has to be stressed, though, that the competitive boost generated via a shift in the exchange rate is not necessarily a permanent one. Currency weakening can be effective in restoring competitiveness permanently and can lead to growth, only if complemented by restrictive monetary and fiscal policies. Without such support, a weaker currency leads to price and wage increases, and newly gained competitive advantages are offset by inflation.
3. Selected case studies of deflation and devaluation policy

During the gold standard\(^2\)/ which emerged in the second half of 19th century and functioned until the outbreak of WWI in 1914, deflation policy was the main instrument of restoring economic competitiveness and external rebalancing. A country that encountered problems with financing its trade deficit via an inflow of international capital suffered an outflow of gold from the reserves of the Bank of Issue (the Central Bank), that was obliged to exchange currency into gold at a fixed parity. In these circumstances, and in order to avert the threat of a reduction in its ability to exchange currency into gold, the central bank increased the discount rate, thereby limiting the supply of credit in the economy and generating deflationary pressures. Deflation, in turn, lowered the demand for imported goods, boosted competitiveness, and improved the trade balance. Polanyi (1944), and subsequently Eichengreen (2008), devoted a lot of attention to explaining why deflation was an effective adjustment mechanism before WWI and ceased to be one in the interwar period. According to Eichengreen (2008), central bank policy before WWI was hostage to maintaining gold reserves at a level that guaranteed currency convertibility into gold at fixed parity. Therefore, the central bank did not hesitate to pursue deflation policy if needed, and no other issue apart from maintaining convertibility was taken into account. The implementation of deflation policy was facilitated by the absence, in those times, of a reliable economic theory that explained the influence of central bank policy on the economy and the unemployment rate. Moreover, unemployment emerged in economic discussions as a clear economic category only at the turn of 20th century\(^3\)/. In those days, the franchise was restricted, and in most countries only the wealthy could vote. The unemployed, therefore, not only had no idea of the linkages between central bank policy and their fate, but were also unable to voice their interests under such a political regime\(^4\)/. Labour unions and work regulations were in their infancy, and therefore wages were relatively flexible and deflation policy was successful in decreasing them\(^5\)/. The situation was quite different in the interwar period. All social strata had the right to vote, labour unions grew stronger, unemployment gained importance as an economic category and as a political problem as well, and the link with central bank policy

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\(^2\)/ System in which the bank of issue guaranteed the convertibility of a given currency into gold at fixed parity.
\(^3\)/ See Eichengreen (1995, p. 6).
became clearer. The activity of labour unions and regulations governing work limited the flexibility of wages. Therefore, in order to achieve a given amount of demand slack in the economy, unemployment had to rise more than in the case of more flexible wages. A conflict started to be commonly perceived between keeping economy externally balanced and sustaining domestic business activity.

A spectacular example of the aforementioned differences in conducting deflation policy was Great Britain’s failure to sustain an overvalued pound sterling in 1925-31. After being suspended after the outbreak of WWI, convertibility of the pound sterling into gold was restored in 1925. The pre-war parity was restored, but by that time prices in Great Britain were higher than before the war. At the time, that move was opposed by John Maynard Keynes, one of the experts consulted by the Chancellor of Exchequer, Winston Churchill. In a pamphlet “The Economic Consequences of Mr. Churchill” Keynes estimated that restoring the gold parity of the pre-war pound sterling overvalued the currency by 10-15%, and that would lower the competitiveness of British exports and would entail a rise in already high unemployment. According to later estimates, the overvaluation was less severe, but still around 5-10%. The decision to restore the overvalued parity is commonly perceived as a major reason for the low economic growth and high unemployment in the second half of the 1920s. At that time, as noted by Ahamed (2009, p. 376), France restored gold convertibility at an undervalued parity and enjoyed much higher economic growth and lower unemployment. For six years the British economy and society suffered enormous costs in the defence of an overvalued currency. In order to protect the trade balance and limit the outflow of gold from the country, the Bank of England had to suppress the supply of credit, while the government had to implement increasing fiscal austerity. While the deflation policy was damaging the economy, the problem of the overvalued currency was not solved. Finally, plagued by a 20% unemployment rate, Great Britain left the gold standard and allowed the pound to depreciate by 30%. This move brought some relief to the economy during the deep global economic crisis. In our opinion, the British experience should give food for thought to contemporary European leaders. First of all, the example presented demonstrates that deflation policy as a tool aimed at restoring competitiveness under a fixed rate regime is hardly effective despite its substantial economic and social costs. At that time, a six-year policy of deflation was unable to correct prices overvalued by 5-10% and failed to restore the country’s competitiveness. Is it really possible that such a policy will be successful nowadays, when price levels in the relevant countries are overvalued by 20-30%? Secondly,

6 / Written in 1925, see: Keynes (1933, pp.244-270)
this example illustrates the magnitude of the economic, social and political costs caused by dogmatic economic thinking of economic and political leaders. It was common at that time to assume that the gold standard was the only system underpinning sound currency, and that the pound’s pre-war gold parity was a prerequisite for sustaining the credibility of the British monetary system. Until the last moment, high British Treasury officials reacted with indignation to suggestions that Great Britain might abandon the current pound sterling gold parity. In the spring of 1931, Montagu Norman, the then Governor of the Bank of England, sought a loan from the Great Depression ridden USA that would prolong the convertibility of the pound sterling at the defended parity. When those efforts failed, Montagu complained that the “U.S. was blind and taking no steps to save the world and the gold standard”. Identifying the fate of the world with the gold standard was a mistake. We already know that the gold standard finally collapsed but the world survived. According to Eichengreen (2008), clinging to the gold standard was the key factor in deepening and spreading the Great Depression internationally that ultimately almost led to a collapse of democratic order in the world. This 80-year old experience should also give food for thought to the contemporary European leaders who are tied to the dogma that the EU and Single European Market’s future is tied to the Euro project. It is worth remembering that one of the most important decisions made during the first year of Franklin Delano Roosevelt’s presidency was – besides putting in order the banking sector – suspending the dollar’s convertibility into gold and devaluing it by 40% in 1933.

The abandonment of the gold standard by Great Britain and the USA marks the beginning of the period in which various countries made use of devaluation as an instrument aimed at boosting competitiveness. Such a policy was said to be controversial because devaluation increased one country’s competitiveness at the expense of its trading partners, often forcing them thereby to devalue as well. According to Eichengreen, such arguments cannot obscure the fact that devaluations in the 1930s were effective and constituted a part of the solution to the Great Depression, but were not its cause. Drawing on those lessons, the IMF’s articles called for “fixed but adjustable parities”.

The experience of Argentina, which introduced a currency board in 1991 legally and permanently binding the peso to the USA dollar, is also instructive. During its first years, this policy was successful in reducing inflation and fuelling economic growth. It seemed that finally, after years of unstable macroeconomic policy and high inflation, Argentina had found

an institutional framework that guaranteed macroeconomic stability conducive to further development. However, at the end of the 1990s, some serious problems with competitiveness emerged that can be linked to a mix of external and internal factors. They caused a recession and an increase of public debt. At first, abandoning the currency board was not an option for political leaders. Rather, they decided to use deflation policy (based on fiscal restraint) to combat declining competitiveness and mounting debt. However, such a policy did not bring about the expected results. After three years of recession, bloody riots forced the president and the government to step down. Argentina defaulted on its debt and abandoned the currency board. The peso was devalued by 70%. The economy and the banking system underwent serious turbulence, but after some months of woe the economy began to grow again and the gap in the trade balance closed. During the next six years, the Argentine economy achieved annual growth rates ranging from 7 to 9%. The Argentinian example can serve as an illustration of three truths, which we should keep in mind. First of all, a country that enjoys a favourable macroeconomic situation, and creates a seemingly sound institutional framework, may for unexpected reasons fall into problems with competitiveness. Secondly, in a fixed exchange rate regime, restoring competitiveness via deflation policy has little effect and can lead to social unrest. Thirdly, it is devaluation that constitutes a strong adjustment instrument. And even if it takes place in circumstances of political and economic depression, it may allow a country to swiftly enter a growth path.

The effectiveness of devaluation policy is confirmed by the Asian countries, South Korea, Thailand and Indonesia in the aftermath of the 1997 crisis, and also by Russia after the crisis of 1998. In all cases devaluation was implemented in an environment of deep economic and banking crisis. It seemed that these economies would be unable to escape their predicament given the banking crisis and massive business bankruptcies. However, after devaluation they were quickly able to embark on a growth path.

Devaluation is not a perfect solution and also entails some serious problems. The source of many of the problems lies in the very fact that devaluation is an effective and not costly – socially and politically – instrument of restoring competitiveness in the short term, while it does not affect directly the physical process of production of goods and services which is decisive for competitiveness in the long term. The availability of devaluation often tempts politicians to accept easy fiscal policy and to avoid tougher, more socially and politically complicated reforms aimed at long-term improvements in competitiveness. Such a temptation results from the conviction that any problem with competitiveness can be always solved via currency weakening. There are numerous examples of countries, especially from South America and southern Europe, which in the second half of 20th century kept on using
currency devaluation as an instrument for improving competitiveness which was being systematically undermined by inflation.

Another problem lies in the fact that devaluation policy is not a harmless instrument when it comes to neighbouring countries. The greater competitiveness of one country comes at the expense of its trading partners, which are often forced to react with the same devaluation policy. Ensuing currency wars introduce unnecessary noise and distortions, without bringing any lasting benefits.

Currency weakening is not a miraculous solution that can substitute for sound macroeconomic policy. It is an instrument that should not be abused in order to not harm the health of the economy and its neighbours. There are emergencies, though, in which getting the economy back on track without a devaluation is very difficult or even impossible. It is therefore no coincidence that all successful adjustment programs in Latin America included a deep devaluation at the start that lowered unit labour costs\(^{11}\).

In cases of emergency, when a dip in competitiveness is structural, devaluation accompanied by the proper fiscal and monetary policies can be beneficial both to an affected country and its trading partners. It is far better for a country to increase its competitiveness and embark on a growth path, experience the creation of trade, and more fully service its debt, than to fall into economic stagnation and become a permanent recipient of international aid.

4. **Is fiscal union a cure for the competitive problems of some euro zone countries?**

Many observers claim that the primary mistake made at the time of introducing the Euro was the creation of monetary union without fiscal union. Such observers then often advise correcting this flaw by creating institutions at the EU or euro zone level which would be allowed to tax and issue debt, and establishing enforcement mechanisms for disciplined fiscal policy at the member country level. The followers of this line of thinking seem to expect that creating fiscal union would eliminate the major problems connected with the functioning of the euro area.

\(^{11}\) See Blejer and Ortiz (2012).
Doubts about the success of such an experiment usually concentrate on the question of whether a fully-fledged fiscal union in the EU is politically feasible. The point is made that the EU budget makes up for only 1% of the Union’s GDP, whereas at the outbreak of recent financial crisis the federal budget constituted 20% of the American GDP, and the central budgets of various EU countries typically ranged from 14 to 43% of their respective GDPs.

Setting aside for a moment the feasibility of creating a fiscal union it is worth asking:

1) Is creating fiscal union in the EU going to prevent future problems with competitiveness in different EU countries?

2) Is fiscal union going to deliver instruments that can overcome problems with competitiveness?

We think that in both cases the answer is negative.

1) Fiscal union may limit the risk of irresponsible budget policy, but will not prevent problems with competitiveness that stem from different reasons. Competitiveness problems caused, among others, by overly expansive credit creation for the private sector, by the inflow of foreign capital (including in the form of EU transfers) financing investment in non-export sectors, by faster improvements in competitiveness in trading partners, and by technological or demographic changes, will certainly emerge in the future in some countries.

2) It is unjustified to expect that larger inflows of funds from the EU (or euro zone’s) central budget would be able to solve problems of insufficient competitiveness in some countries. The doubtful efficiency of structural and fiscal policies in boosting competitiveness in underdeveloped regions within common currency area, is confirmed by the examples of East Germany and southern Italy.

At the time of unification in 1990, East Germany’s wages were converted from eastern German marks into western German marks at 1:1. At a stroke such a parity made the lion’s share of the East German economy uncompetitive compared with the West. Since unification, East Germany has enjoyed fiscal transfers which amounted to cumulative EUR 2000 billion by 2009. This sum is comparable to 80% of Germany’s 2010 GDP and 700% of East Germany’s GDP. Annual transfers totalled on average more than 4% of German GDP.
and more than 25% of East Germany’s GDP\(^{12}\). Convergence occurred only in the first half of 1990s; later on the process stopped. The share of East Germany's GDP in Germany's total GDP has been holding steady since 1996, whereas East Germany's per capita income has been increasing as a result of a shrinking population in the eastern Länder, which decreased from 27% of that of the Western Länder at the beginning of transformation to 21% in 2007. As pointed out by Seitz (2009), young and educated people migrate from East Germany because of unemployment – for several years twice as high as in the West Germany – and the overall lack of prospects.

Southern Italy has been a beneficiary of structural policies – aimed at bridging the competitive gap vis-à-vis the north of the country – over several decades. Current annual transfers amount to 4% of Italian GDP, equivalent to 16% of southern Italy's GDP\(^{13}\). Some closing of the development gap took place in the 1960s. But subsequently the convergence process did not continue and for 40 years southern per capita GDP has oscillated around 55-65% of the northern level\(^{14}\). Private GDP per capita in the south is only 46% of the northern level and the value of per capita exports (excluding petroleum products) is only 18%. The southern unemployment rate is twice as high as that in the north\(^{15}\).

These two examples show that structural policies within common currency area are so ineffective and expensive that they cannot contribute significantly to boosting competitiveness in problem euro zone countries. It is hard to assume that non-competitive euro zone countries could permanently receive annual transfers worth 25% of their GDP – like in the East Germany – or worth 16% of GDP – like in southern Italy.

5. Does Latvia’s experience or cases of expansionary fiscal adjustments give hope for the effectiveness of an “internal devaluation” policy?

In this section we discuss some natural experiments, which are often used as examples of successful “internal devaluation” policies, implemented by reducing government expenditures. We argue however that neither Latvia’s experience nor cases of expansionary

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\(^{12}\) According to Jansen (2004) in years 1991-2002 annual net transfers amounted to 4.6-7.7% of Germany’s GDP and 26% to 45% of East Germany’s GDP.

\(^{13}\) See Franco (2010, p. 5).

\(^{14}\) See Viesti et al.(2011, p. 67).

\(^{15}\) See Franco (2010, p.3).
fiscal adjustments support hopes for the effectiveness of an “internal devaluation” policy in the euro zone.

Latvia, a country with a population of 2.3 mln, is not a euro zone member, but has had – for many years – its currency pegged to the euro at a fixed rate. For several years before the outbreak of the world financial crisis, Latvia enjoyed high economic growth, propelled by a credit boom originating from loans that Scandinavian parent banks granted to their Latvian subsidiaries. As a consequence of high wage growth that exceeded labour productivity growth in the tradable goods sectors, competitiveness eroded rapidly. The current account deficit reached an exorbitant 22% of GDP in 2007. In 2008 the flow of foreign financing suddenly stopped and the real estate market collapsed. Latvia was forced to regain competitiveness quickly and to close the current account gap. The government decided to keep the current exchange rate peg and instead embarked on an “internal devaluation” policy. In 2009-2010 Latvia implemented deep cuts in public sector wages, pensions and other government expenditures, and also increased some fiscal revenues. Fiscal austerity amounted to 15% of GDP. In 2008-2010, GDP dropped by 21%, but afterwards, in 2011, the economy returned to a growth path. Despite implementing such a harsh economic programme, Prime Minister Valdis Dubrovskis enjoyed reelection in general elections in October 2010 and also kept his office in the subsequent snap elections in September 2011, in which the biggest number of votes were cast for opposition party representing Russian minority. Latvia’s case is said to be an example showing that “internal devaluation” can successfully restore competitiveness, and a government implementing such a policy need not to lose support of the voters.

It is useful to compare the Latvian experience with the case of Iceland. Before 2008, Iceland with a population of 320 thousand enjoyed – in a similar manner to Latvia – a rapid growth of bank assets financed by the inflow of foreign capital, and an expansion of the construction sector. Before the crisis, the current account deficit in both countries reached more than 20% of GDP. At the outbreak of the financial crisis, both countries lost access to the capital that financed their growth, underwent deep contraction in construction sector and suffered a financial shock; the scale of the latter in Iceland was far greater than in Latvia. Both countries implemented deep fiscal adjustments and were supported by the EU and the IMF. Both countries recorded GDP growth in 2011 after the breakdown in 2008-2010.

\[16\] See Purfield and Rosenberg (2010).
However, adjustment costs in Iceland were far lower than those in Latvia. The GDP contraction in 2008-2010 was half as severe as that in Latvia. The fall of employment in Iceland amounted to 5%, compared to 17% in Latvia. The reason may lie in the fact that Iceland’s currency depreciated, and this improved the country’s competitiveness. Iceland had a floating currency regime and the currency depreciated by 50% in nominal terms in 2008. A further fall was averted in part by implementing capital controls. According to Darvas (2011), part of the competitive boost was eaten up by depreciation-led inflation, but in the end, in 2011, Iceland’s currency was 30% weaker in real terms than at the outbreak of the financial crisis. In effect, wages denominated in foreign currency fell, which increased the competitiveness of Icelandic goods. The situation was different in Latvia. The government substantially reduced wages in the public sector, which in 2010 were about 20% lower than 2008, but wages in industry fell by only 2%.17/ In light of these data, Latvia is actually a clear case for the ineffectiveness of “internal devaluation” as a method of improving the economy’s competitiveness. Current account adjustment in Latvia was accomplished, not by improved competitiveness, but by a deep fall in employment and GDP.

Case studies of the expansionary effects of fiscal tightening, i.e., situations in which fiscal austerity does not limit growth but stimulates it, suggest that any hopes for such effects to emerge in those euro zone economies in crisis are futile. In cases analysed by Perotti (2011), expansionary effects of fiscal tightening occur when the demand contraction caused by fiscal tightening is accompanied by other suitably strong pro-growth factors, such as the weakening of the currency or the fall of inflation and interest rates. Substantial currency weakening that boosted competitiveness and exports was a stimulus for economic expansion after fiscal tightening in Ireland in 1987-89, Finland in 1992-98 and Sweden in 1993-98. In Ireland, the weakening of the currency occurred directly prior to the fiscal tightening, in Finland and Sweden it came about during the tightening. In Denmark (1983-86), it was a fall in inflation (from high levels) that accompanied fiscal tightening, and reduction in interest rates (also from substantial levels), that stimulated growth. In the case of the euro zone economies in crisis, the aforementioned factors are unlikely to emerge since those countries do not have their own currencies, and the room for a fall in inflation and a reduction in interest rates is limited (the former is at a moderate level at the moment, and the latter are very low).

17/ See Darvas (2011).
6. Europe, the USA, nation states and underdeveloped regions versus a single currency area

In previous sections, we presented and justified the notion that exchange rate adjustment is an effective and almost irreplaceable instrument for the restoration of competitiveness. A region of a larger currency area, or even a country that loses competitiveness without the possibility of adjusting the exchange rate, can be condemned to a long-lasting inability to change its predicament. In the following paragraphs we consider how to link these conclusions to the functioning of the single currency in Europe.

Supporters of the single currency area in Europe often refer to the United States of America. The USA has comparable total area, population and is at a similar level of economic development, but the single currency area there functions without any disruptions. Therefore it is concluded that a single currency can also circulate successfully in Europe provided the scope of fiscal integration is strengthened and any obstacles to capital and labour force mobility are removed. We think, however, that one of the major factors that allows a single currency to function properly in the USA is that the currency area overlaps with the area of the United States itself, which constitutes the major focus of citizens’ identity. It is worth remembering that a crucial step of building the aforementioned identity and transforming the union of independent states into a homogenous country was the ruinous American Civil War of 1861-1865. Today, a common American spirit is supported by a common official language, common traditions, and common recognition of the federal government’s legitimacy. A common language also facilitates labour mobility. The competitiveness problems of some states are to a considerable extent mitigated by emigration to more competitive ones. Such migration not only does not threaten the cohesion of the American people but rather strengthens it.

Unlike the USA, Europe consists of countries with different languages, and characterised by different historical and cultural traditions. National states constitute the major source of citizens’ identity; they also serve as sources of governments’ legitimacy. This is not a temporary situation. Wnuk-Lipiński (2004), writes:

- “... nation states that form the European Union do not lose their identity and nothing suggests that they will lose it in the future in favour of some new European identity”.
“It is not really a realistic assumption that the 21st century will be free of economic and military conflicts on a more than local scale. Each more serious economic crisis rather strengthens than weakens national state.”

“The nation state is and probably will continue to be a major actor on global political stage. At the same time the nation state will begin to serve a role of a mediator between economic and social forces operating on a global scale and those operating on a local scale.”

We think that problems of competitiveness have totally different dimensions when they concern regions within countries than when they apply to whole countries, when they become much more serious. There are regions in many countries that have been non-competitive for prolonged periods. We cited examples of East Germany and southern Italy. In Poland, the Warmińsko-Mazurskie province (voivodship) may be an example of such a non-competitive region where the unemployment rate is the highest in the country, currently exceeding 21%. Young people from that region who think of a professional career leave for metropolises such as Gdansk or Warsaw located in other provinces. At the same time, land in the Warmińsko-Mazurskie province is being bought by prosperous citizens from elsewhere. According to long-term forecasts, the province is set to lose population continuously to other parts of the country. Nobody suggests, though, that in order to improve this province’s competitiveness a separate currency area should be created. The aforementioned outflow of people from the Warmińsko-Mazurskie province does not constitute a threat to the community with which those people identify the most i.e., the nation state.

Do we assume that the non-competitiveness problems of Greece, Spain and Italy should be solved or mitigated this way? Do we believe that Greek non-competitiveness would be solved when Greeks leave to work in Germany and other northern European countries and affluent people from those countries buy land and build summer houses in Greece? It is unlikely for economic and social reasons. Migration of a large number of people of productive age from Greece would leave behind a substantial population of the unemployed and the retired. That would deepen the deficit of social insurance sector. Germans accepts large transfers by supporting the social insurance sector in East Germany, and nobody cares in Poland about the scale of such transfers to Warmińsko-Mazurskie. But it is hard to expect that European countries together would be willing to permanently finance the deficit of the social insurance sector in some other European country. Mirosław Czech writes: “After the
Greek lesson we know that the German taxpayer would be unwilling to finance Polish (Greek, Spanish or Bulgarian) retirees." 18/

The lack of prospects for whole countries, and the situation in which its citizens are forced to spread across Europe, can lead to more serious tensions, especially in countries as large as Spain and Italy. This can also easily happen in the future in other euro zone countries that, for reasons unforeseeable today, may run into competitiveness problems.

It is worth remembering that the European Union results from an integration process that was assumed to be an antidote against the national conflicts that led to two disastrous world wars. The EU and its institutions were created by member countries to increase their wealth and security. Integration up to now was based on respecting the needs of all members and on the philosophy of only accepting solutions that served everyone and threatened nobody. It was this philosophy that allowed the European Union and Single European Market to succeed.

Introducing the common currency paradoxically threatens the previous philosophy of European integration. Member countries were deprived of a very effective and mostly irreplaceable adjustment tool that can be used in emergency situations – namely, the exchange rate. At the same time no other instrument exists that could successfully substitute for the lack of one’s own currency. In effect, member countries that for some reason lose competitiveness or are forced to close the current account gap in a short time, can be condemned to economic, social and civilisational degradation, without the possibility of changing this situation.

Some observers claim that this situation may accelerate the process of creating a cosmopolitan European society and eliminating nationalist phantoms. On the contrary, we think that the current lack of conflicts between nations within the EU does not stem from the fact that national identity was lost somewhere, but from the premise that the framework for cooperation between members states was regarded by them as useful. In a situation where a single society realises that is condemned to social and economic degradation within the

18/ See Czech (2011). The title of the text (Me Nationalist) of this ex-activist of the Polish democratic-liberal parties Unia Demokratyczna (the Democratic Union) and Unia Wolności (the Union for Freedom) constitutes a kind of intellectual provocation. In the same article, the author writes: “As I used to be a democratic liberal (longing for a social market economy), I am still one now. I am nationalist but in a European manner. I do not think that the end of nation state is looming and Europe will be soon governed by cosmopolitan community that lays the foundation for the development of democracy. National and state bonds based on citizens’ identity and on multi-ethnic and multi-religious legacy are not set to fade. They will become a content of integrating Europe.”
current EU/euro zone framework (while at the same time this framework is benefitting others), nationalist and populist sentiments may arise in full force. It is worth noting that economic stagnation, high unemployment, lack of prospects and the sense of injustice at being treated as inferior by the ruling powers has, in the past, nourished the growth of radical movements that undermined democratic order and peace in Europe.

As exchange rate adjustment is an effective and basically irreplaceable adjustment mechanism that in emergencies improves competitiveness of a given currency area, it is rational that the power to use this instrument should be located at a level of the community with which citizens identify most, and to which they are prepared to delegate responsibility for their fate. In the case of the European Union, the optimal community level is the member state. In case of a loss of competitiveness, the inability to avert social and economic degradation through exchange rate adjustment may lead in some member countries to an erosion of social and political cohesion and to the development of populism and radical nationalism that threaten democratic order and peaceful international cooperation. That is why depriving member countries of their currencies may – contrary to intentions – menace the future of the EU instead of fostering further European integration.

7. How to dissolve the euro zone?

Many observers agree that the creation of the euro zone may have been a mistake but – at the same time – they think it was a path of no return.

Dissolving currency union in a stable environment and when member countries are at comparable levels of competitiveness is not hazardous. One example of the dissolution of monetary union is the Czech Republic and Slovakia in 1993, after which Czechoslovakian crown was replaced by Czech and Slovak crowns respectively. The process took place without any significant perturbations.

Things look different when the competitive positions of member countries differ significantly. A country that is already in the euro zone but has problems with competitiveness cannot unilaterally say goodbye and leave the zone, since it would face bank runs. In particular, the announcement that it was leaving would force citizens to grab their savings accounts and withdraw money, and that would entail the collapse of the banking sector. Any attempts to prevent such a scenario by introducing temporary bank holidays or limits on deposit
withdrawals would be very difficult and enormously risky. It has to be taken into consideration that planning such an operation and the introduction of new currency takes time and keeping it secret in a democratic country seems impossible. Moreover, freezing deposits for some weeks or months also does not seem possible. In addition, freezing deposits with the prospect of their devaluation along with currency depreciation creates a high risk of social disorder\textsuperscript{19}. Such disturbances are unlikely in the case when a country like Germany, enjoying a stable competitive position, were to leave the euro zone. Holders of bank deposits in German banks would not be afraid that they would lose through devaluation when the euro was replaced by the German mark. They would rather expect their deposited wealth to move with the new currency, which is likely to strengthen towards the euro. Therefore it is possible to dismantle the euro zone in a controlled manner via the gradual and jointly agreed exit of most competitive countries. The euro may then remain – for some time – the common currency of the least competitive countries\textsuperscript{20}.

The controlled dismantlement of the euro area would improve competitiveness of the countries in crisis through the weakening of their currency. However, and in line with the argument of section II, in order to protect their new competitive position from inflation, and in order to deliver sustainable economic growth, the weakening of the currency has to be accompanied by properly restrictive monetary and fiscal policies, and by fundamental reforms that remove the institutional sources of poor competitiveness.

The boost to competitiveness and the ensuing economic growth would improve the ability of countries to service debt, both private and public. However, that does not mean that all the countries suffering from insolvency now would quickly become solvent again. At least in some of these countries, debt reduction (a haircut) would be necessary. The scale of reduction and the cost to creditors would be smaller, though, than in a situation where these countries stayed in the current euro zone and their economies suffered below-potential growth and high unemployment.

\textsuperscript{19} Freezing bank deposits in Argentina in 2001 provoked riots that forced the president and the government to step down. A default was announced as well.

\textsuperscript{20} Such a solution is endorsed by the German historian, Voth (2011). To the question how Europe would look in five years, he replies: “I can imagine a world where there will [be] a left-over euro: with France, Italy, the Mediterranean countries, perhaps Belgium as well. Apart from that the old Deutschmark zone will return, comprising Germany, Austria and the Netherlands, perhaps Denmark as well, perhaps Finland, which have no problems conducting the same monetary policy as Germany. We had a similar system during the European Exchange Rate Mechanism ERM. That was the optimal system, and then we gave it up for the euro”. 
8. The currency coordination mechanism after the dismantlement of the euro zone

Along with the dismantlement of the euro zone, it will be necessary to create a new mechanism for currency coordination in Europe.

A non-orthodox floating rate regime with monetary policy targeting inflation, and with synchronized fiscal and monetary policy within the EU, seems a natural candidate for the new exchange rate mechanism.

The perception of floating rate regimes has gone through different phases in the literature. In the inter-war literature, mainly on the basis of the French experience from 1920s, a floating exchange rate was believed to be inherently unstable; it was also seen as an amplifier of the initial balance of payments disequilibria. Later research concerning the same French experience has led some economists, including Milton Friedman, to revise this criticism and to conclude than high exchange rate volatility in a flexible rate regime was a reflection of the instability and unpredictability of the fiscal and monetary policies being pursued\(^{21}\). According to this notion there is no reason to doubt that when fiscal and monetary policies are reasonable and consistent, a flexible exchange rate mechanism may function properly.

During the period from the end of WWII to the beginning of the 1970s when the Bretton Woods system functioned in the western world, it was a rule that exchange rates would fixed, but could be adjusted in cases of fundamental balance of payments disequilibrium. As capital flows were liberalised, maintaining fixed exchange rates became progressively harder and the adjustment mechanism did not function properly, because decisions to correct a currency’s exchange rate were often postponed. The collapse of the Bretton Woods system marked the beginning of a period in which different countries experimented with various forms of currency regime. Any return to fixed rates usually ended in failure. More and more countries introduced flexible rate regimes, while trying at the same time to mitigate the natural limits of the mechanism, abandoning the orthodoxy of a fully flexible exchange rate and allowing for different forms of currency intervention. (Flexible exchange rate regimes, in

which the central bank may engage in currency intervention, we refer to as non-orthodox flexible exchange regimes).

An important step towards getting accustomed to the flexible exchange rate was the birth of direct inflation targeting, in which a central bank publicly announces the desired level of inflation and pursues it as a top priority via interest rate policy and other instruments dedicated to monetary policy. The concept, first introduced in New Zealand in the 1980s, quickly became popular among other central banks in developed countries. Inflation targeting mitigates an important inconvenience of a flexible exchange rate regime, namely the lack of a point of reference for private entities’ expectations. Specifying an inflation target creates the necessary point of reference, without the need to subordinate monetary policy to defend a given exchange rate level. Barry Eichengreen ends his monograph on the international currency system by stating that: “A floating exchange rate is not the best of all worlds. But it is at least a feasible one.”

A system of non-orthodox flexible exchange rates in different countries can be supplemented by the coordination of macroeconomic policy in the EU, in particular coordination of fiscal policy (by setting ceilings for the deficit of the general government sector in a given country) and coordination of inflation targets and of the instruments used by central banks to achieve them. In such a framework, a flexible exchange rate would serve as a tool for the rapid correction of balance of payments disequilibria. The coordination of fiscal policy and inflation targets would limit exchange rate volatility stemming from the unpredictability and inconsistency of macroeconomic policy, as well as the possibility of running overly expansive monetary or fiscal policies.

A flexible exchange rate, as a primary tool for exchange rate adjustments in Europe, would not rule out the possibility of pegging the exchange rate of a given country to the currency of a strong trade partner. An example of such a policy was the pegging of the Austrian schilling and the Dutch gulden to the German mark before the introduction of the euro, and the currently fixed exchange rate between the Danish krone and the euro. This solution provides the possibility of emergency abandonment of the fixed exchange rate or the option of a one-off correction of the parity. It is obvious that in order to implement such abandonment of the peg without economic disruptions, the existence of systemic solutions that prevent the direct denomination of local contracts in the currency of a foreign partner is crucial.

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Another possible exchange rate mechanism after the dismantlement of the euro zone may be one based on the European Monetary System (EMS) from 1979. Such a framework would allow currency volatility to be reduced, by introducing currency bands, or by defending a given exchange level (or rather preventing the further weakening of a soft currency) by obliging hard currency partner countries to offer unconditional support in the form of currency intervention (or even for a transfer of currency reserves, something which failed to materialize in the original EMS). Such a system would allow for periodic change – as in the original EMS – of currency bands under certain conditions (e.g., balance of payments disequilibria, or acceleration of inflation). A renegotiation of centrally fixed parities between currencies would also be possible\(^{24}\). Such a renegotiation would – owing to the possibility of systematic correction of central parities – be free from the disadvantages inherent in solutions that are suggested by a one-off revision of parity rates within the current euro zone framework\(^{25}\).

The process of searching for currency coordination methods is not at all over, and there will be new solutions aimed at a better reconciliation of a flexible exchange rate with macroeconomic stability and global coordination objectives, or solutions aimed at boosting the effectiveness of currency bands.

Our remarks in this section are devoted primarily to justifying the notion that there are alternatives to the single currency in Europe. Although they are not perfect, they endanger economic, social and civilizational prosperity in Europe far less than solutions that seem ideal and simple, such as a single European currency or a currency system based on gold. It is worth remembering that successful economic development and the development of European cooperation can be based on a system that is imperfect, such as the Bretton Woods system from 1945-1970, while introducing and sticking to a “perfect exchange rate system” can end in economic and social disaster. Such a disaster was the result of the gold parity standard in the interwar period. Today, it is very likely that similar failure may be brought about by the stubborn defence of the single currency in Europe.

\(^{24}\) In the first years of the EMS’s existence, central parities were modified on average every eight months.  
\(^{25}\) Such a proposal of solving the EU’s problems was put forward by Rybiński (2011). A one-off adjustment of central parities within the euro zone does not exclude a situation in which balance of payments’ imbalances are growing again.
9. Warnings and arguments against euro area decomposition

In this section we deal with popular arguments and warnings against the dismantlement of the euro area.

*Argument of an economic disaster*

Some believe that dissolving the euro zone may lead to economic disaster. Experts from the Swiss bank UBS (Deo, Donovan, and Hatheway (2011)) estimate that losses incurred by leaving the euro zone would total 40-50% of GDP in case of PIIGS\(^{26}\) countries and 20-25% in case of an economy as strong as Germany. These estimates stem from the assumption that a euro zone break-up would also destroy the Single European Market (or would exclude a departing country from its benefits), would entail introducing trade barriers, and would cause a dramatic collapse of trade. However, the conclusion will be different if we assume the dismantlement of the euro area be accompanied by the preservation of the Single European Market. Moreover, the UBS economists do not compare the costs of leaving euro zone with the costs of staying in. For example, in their calculation of a German exit, they take into account the cost of a 50% reduction in the debts of Greece, Portugal and Ireland as if those costs would be incurred only in the case of Germany’s leaving. Yet if the euro zone is preserved, the costs of PIIGS insolvency will still have to be incurred, and may be far higher than those entailed by the scenario in which Germany leaves the euro zone.

The UBS economists also assume that overcoming current euro zone crisis is possible and the defence of the single currency does not threaten the future of the European Union and the Single European Market.

We do not dispute anyone’s right to make the aforementioned assumptions, nor the right to the conviction that the dissolution of the euro zone would be a disaster. However, in our view the UBS estimates do not objectively justify the conclusion that dissolving the euro zone would be destructive. Such a notion just results from the questionable assumptions, regardless of whether the numerical estimates are reasonable. It is obvious that under the

\(^{26}\) Acronym coined from the capital letters of the following countries: Portugal, Ireland, Italy, Greece and Spain.
UBS economists' assumptions, dismantling the euro area would be disastrous for everyone and would not make sense.

In our opinion, the probability of a successful solution of the current crisis without a thorough overhaul of the euro zone is small owing to the lack of effective adjustment instruments, which we mentioned earlier. Moreover, we think that even if the most optimistic scenario comes true and the euro zone survives today, it will be prone to other costly perturbations in the future. The European Union and the Single European Market can function without the single currency, just as they did before the introduction of the euro. We suggest that dismantling the euro zone should take place through an agreed and controlled process, to preserve the European Union and the Single European Market and at the same time to introduce a mechanism of currency coordination that limits appreciation of the new German currency in the interim period. The decomposition of the euro with the preservation of the EU and the Single European Market can improve the relative situation of the PIIGS countries and may enable them to enjoy economic growth. Such a solution for the PIIGS's problems would bring benefits to all euro zone countries compared to the scenario of a dangerous policy of "internal devaluation".

The threat of appreciation of the new German currency and ensuing recession

So far German firms have been the major beneficiaries of the introduction of the euro. In the period between introduction of the euro and the outbreak of the global financial crisis, Germany's trade surplus increased from EUR 65bn (3.2% of GDP in 1998) to EUR 198bn (8.1% of GDP in 2007). At the same time the trade account of the euro zone as a whole was more or less unchanged and stayed balanced. This enormous growth of the German trade surplus by EUR 133bn between 1999 and 2007 stemmed from the increase of the surplus in internal euro zone trade. The increase of the trade surplus in Germany, the Netherlands and Austria (in total by EUR 166bn) was accompanied between 1999 and 2007 by worsening trade balances in Spain, France, Greece, Italy, Belgium and Portugal, in total by EUR 178bn.

A situation in which Germany enjoys a huge trade surplus and the less competitive countries suffer from a trade deficit and stagnate is unsustainable in the long run, unless Germany directly or indirectly decides to finance the deficit countries. Therefore if German leadership succeeds in introducing a sound macroeconomic framework to the euro zone, the narrowing of trade deficits of less competitive countries will be a by-product. The latter would also mean a lower German trade surplus, unless the total trade surplus of the euro zone rises. There are of course different possible scenarios, but we think it is most likely that preserving the
euro zone and the continuation of deflation policy would simultaneously dampen German growth and Germany's trade surplus. Moreover, in the case of a disorderly break-up of the euro zone, it is most likely that trade rebalancing would occur in the aftermath of a deep crisis that would afflict the whole of Europe, including Germany. Taking these risks into account, a controlled dismantlement of the euro zone is rational from the German perspective. It is a dismantlement that entails a transition to a currency mechanism that makes chances of economic growth equal for every country, and also the one that does not generate threats to the survival of the EU and the Single European Market. Acceleration of growth of the non-competitive euro zone countries and the ensuing increase in global trade volume creates a chance to rebalance intra-European trade in an environment of common economic growth in Europe and Germany, even in the case of German currency appreciation. When Germany decides to leave the euro zone, some agreement between central banks would be justified to prevent the new German currency from appreciating excessively in the interim period.

**Worries about weakening Europe vis-à-vis the USA, China and India**

An argument that appeals to many observers is that abandoning the single currency would weaken the EU vis-à-vis such economic powers as the USA, China and India. The euro is nowadays one of the most important world reserve currencies, and it is doubtful that the currency of any of the individual European countries would share the same status. Deo, Donovan, and Hatheway (2011) claim that after the break-up of the euro zone, individual European countries – even the biggest – would barely be noticed on the international arena.

The notion that abandoning the single currency would weaken Europe’s in the international arena only makes sense under the condition that single currency is not weakening Europe at the moment. If the existence of the euro hampers economic growth and generates threats of conflicts endangering the European Union, the Single European Market and peaceful cooperation in Europe, it would not strengthen European international position. Quite the opposite – the existence of the euro is weakening it. A multicurrency EU, but with a good performing Single European Market and with principles of cooperation that generate prospects for sound development of every member state, will be stronger than an EU with single currency, but paralysed by economic stagnation, internal problems and conflicts. A sound multicurrency EU will be stronger than the current one, which is seeking help, not only in the USA, but also in China, and prospectively also in India.
10. What may happen if the euro is continuously and stubbornly defended

In this section we discuss the most probable outcomes in the case that the euro is stubbornly defended and “internal devaluation policy” continues: 1) a scenario of long-lasting political and social demise of non-competitive countries, 2) a scenario of chaotic euro zone break-up.

We also note a less likely but conceivable set of scenarios in which the euro zone crisis is solved via occurrence of internal and external mitigating factors. They are the following: A) a calming and complete resolution of the euro zone crisis as a result of external growth stimuli coming from the upswing in the global economy; B) a calming and complete resolution of the euro zone crisis as a result of significant euro depreciation that generates trade surplus for the whole euro zone; C) a calming and complete resolution of the euro zone crisis as an aftermath of much better results than we expected in restoring the competitiveness of the economies in crisis via “internal devaluation” policy.

Chronic economic and social demise of endangered euro zone countries

The continuation of the “internal devaluation” policy is set to cause the economic death of endangered euro zone economies.

Gomulka (2012) estimates that fiscal tightening in Greece – being the one strict condition of continued external help – will probably trigger a GDP decline of 20% and will raise the unemployment rate to 20-25% for some years

Feldstein (2011) claims that forcing current account rebalancing in Italy, Spain and France by “internal devaluation” would entail a decade or more of high unemployment and falling GDP, which would be a politically dangerous policy that wastes economic resources.

Recession in the economies in crisis will worsen their prospects for debt repayment. It will force a continuation of direct financial support programs or a continuation of indirect ECB

27/Gomulka (2012) claims that such socially costly developments would also have positive effects: restoring competitiveness through the reduction in labour costs, the improvement of trade balance, and they will “instill in the memory of the nation and its political elite concern for financial responsibility.”
involvement in Greece, Portugal, Spain and Italy. Political and social tensions within endangered countries and between countries will be on the rise. Societies enjoying current account surpluses (mostly Germany) will not only feel, but also express, discontent with the incapability of deficit countries (Greece, Portugal, Spain and Italy) to tidy up their economies. This will result in expressed resentment towards granting any more financial help. Deficit countries, on the other hand, will more frequently blame surplus countries for profiting from their problems while – at the same time – being at their root. The next step of crisis escalation may be extending the list of countries in crisis to include Belgium and France.

The risk of political crises and chaotic euro area exits

The political dynamics of the crisis may get out of control in particular countries, as well as at the level of the euro zone and the European Union. Endangered countries may lose the ability to continue the “internal devaluation” policy, as a consequence of new electoral outcomes or government collapses triggered by riots, as was the case in Argentina in 2001. Other countries will have to accept some softening of the conditions for further support or accept consecutive insolvencies in the crisis countries. Those insolvencies will trigger loses in bank balance sheets and make further public support for the banks necessary, leading, in turn, to a deterioration of the financial standing of other countries. Bank losses and problems with their capital base will trigger another round of credit tightening, leading to further deceleration of growth and the spread of recession. There will be more and more pressure for ECB involvement, in an environment of mounting resistance by German public opinion to ruining the euro and any further departure from the good old Bundesbank standards. Such a situation may lead to chaotic exits from the euro zone on the basis of unilateral national decisions.

A country that loses its ability to continue the “internal devaluation” policy would also be cut off from other countries’ support, would announce partial default, and would not be able to raise the financing for necessary government spending. Such a country may be forced to issue its own currency, which may be preceded by issuance of various forms of quasi-money to settle internal liabilities and pay public sector wages.

One of the surplus countries may also decide to issue its own currency. But such a move would be triggered by the exhaustion of patience with actions that damage the euro and with increasing support for the euro zone economies in crisis.
In case of unilateral exits from the euro zone, mutual accusations are likely to intensify and negative sentiment between nations will rise. There will probably be retaliatory acts in the form of trade barriers that will harm the single market. In such a case it is more likely that the ongoing recession will deepen and there will be a surge in the number of domestic and pan European conflicts.

**Possibility of overcoming the crisis and preserving the euro**

The current methods of solving the euro zone debt crisis seem unlikely to improve the competitiveness of crisis countries and repair their balance of payments sufficiently fast to avoid a deepening of the recession and an escalation of the debt crisis. Nevertheless, there is a chance that the euro zone survive in its current form. Such a survival scenario can be the result of various positive factors.

The crisis can be overcome if some external and internal mitigating effects occur, such as: external growth stimuli stemming from a faster global economic upswing than expected, a trade surplus generated (somehow) for the euro zone as a whole, and also better effects of restoring competitiveness of economies in crisis via the "internal devaluation" policy than we expect.

A strong upswing in the global economy would, even with the maintenance of the current internal disequilibria in the euro zone, allow such a high growth rate to be achieved that it neutralises the negative, short-term consequences of the “internal devaluation” policy pursued in weaker countries. It would make it easier for weaker countries to get out of the deflation and debt spiral, increasing thereby the chances for the euro zone as a whole to survive. However, a strong, external growth impulse is nowadays not very likely, given the ongoing balance sheet adjustment in the American private sector and the risk of deceleration of the Chinese economy that has been so far one of the engines of global growth.

An effect similar to those of the growth acceleration scenario would be brought about by the depreciation of the common currency\(^{28}\). In the case when the euro depreciated substantially, a trade surplus for the euro zone as a whole might be achieved. Therefore the less competitive countries in the euro zone might have overall trade surpluses, despite their deficits in intra euro zone trade. Peripheral countries have relatively stronger trade relations with countries outside the euro zone, which would strengthen the positive effects of euro

\(^{28}\) Depreciation as a cure for Euro zone woes was revived by Feldstein (2011).
depreciation for their trade balances. The chances of a significant depreciation have been so far limited by the weak dollar policy pursued by the Fed.

Solving the euro zone crisis would be more likely if the “internal devaluation” policy brought better results in terms of restoring competitiveness than expected. Although such a state of the world definitely cannot be excluded, arguments put forward in the former sections do not give any reasonable basis for such optimism.

Summing up, it cannot be excluded that a combination of the aforementioned factors (or just one factor alone) will help to overcome the current crisis and that the euro zone will survive. However, even if it survives, it does not mean that the ongoing crisis is the last one. Problems with competitiveness may occur in different countries in the future. And one thing is certain: the fate of the country that loses competitiveness while staying in the euro zone will never be one to be envied.

**Closing remarks**

The European Union and the Single European Market are great achievements, and therefore there is a lot to fight for. The introduction of the euro, while marked by good intentions, was a mistake that should be corrected. Existence of the single currency remains at odds with the previous philosophy of European integration that aimed to create conditions for the prosperous development of every member country. Yet, membership in the euro zone deprives member countries of their ability to use the most effective adjustment tool that works in crisis situations – an exchange rate correction. A member country that loses competitiveness for whatever reason is trapped. Euro zone exit may end with bank panic, whereas staying in may be equivalent to long-lasting recession. Awareness of such traps limits the chances for further euro zone expansion, even in the optimistic case in which the current crisis is overcome. As long as the euro zone exists, there will be a division of EU members into three groups: the euro zone members that are reasonably competitive, the Eurozone members in crisis and suffering recession, and the countries outside the euro zone and not hurrying to join. It will be a “three-speed Europe”. Controlled dismantlement will free the countries caught in the trap, will prevent the unforeseen consequences of a chaotic euro zone break-up, will allow the preservation of the EU and the Single European Market, and
will help to focus on new challenges. As for the latter, the big push may be a result of the creation of a customs union with the USA.\footnote{A call to create customs union encompassing the USA and the European Union by 2025 was put forward in Świeboda and Stokes, editors (2012).}

A controlled dismantlement of the euro area could take place as soon as European elites and public opinion get accustomed to the idea that the euro and the European Union are not one and the same thing, and that the European Union and the Single European Market can exist without the euro and still offer advantages for their members. Also, rules for a new European currency regime have to be established. Until such a time, it is advised to at least stick to actions that prevent the current situation from getting out of control.
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