The Other Side December 22, 2011

The euro: Exit or devalue internally?

I have for long felt that, culturally, ideologically and geopolitically, the U.K. is perhaps more comfortable as the 51st state of the U.S.A., rather than a card carrying member of the European Union. One manifestation of this is the policy towards the financial sector: the U.K. is far more comfortable with the adventures of finance capital, about which Germany, France and other European countries remain highly skeptical, if not suspicious. No wonder the U.K. was the lone dissenter at the recent Summit Meeting of the European Union countries, insisting on the EU agreeing to make all changes in financial regulations subject to unanimous approval. The U.K. condition was obviously aimed at protecting the interests of the City of London as a global financial centre: one proposal which the U.K. does not like at all is the imposition of a financial transactions tax (FTT) which most of the euro zone members seem to favour.

The Summit's principal agenda was amending the EU Treaty so as to give greater powers to the EU to monitor fiscal deficits of member countries, with suitable constitutional safeguards, and automatic sanctions if the limits are breached. After the U.K. veto, the remaining members of the EU are likely to go ahead with the fiscal constraints in the form of a separate inter-governmental agreement, instead of amending the Treaty. (There are some doubts whether all the members who have agreed to sign the inter-governmental agreement, would be able to get through the process of parliamentary/constitutional approvals, by March 2012, the proposed target date for signing the agreement.) One wonders whether the U.K. forgot that, today, the one country with an effective veto power over EU policies is Germany, not U.K. -- or even France. It is ironic that the victors in the two World Wars in the 20th century are today less powerful than the defeated Germany. Indeed, in the debate over fiscal deficits, bank capital and other technical issues it is often forgotten that the original rationale for the integration of European economies was political rather than economic: at the end of the Second World War, the belief amongst farseeing European statesmen was that the way to stop the previous 150 years of European rivalries and costly wars, was greater economic inter-dependence.

While the proposed inter-governmental agreement on fiscal deficits may well strengthen the euro zone over the medium term, it does nothing to help solve the immediate problems in Greece, Italy and Spain. This was evident in the market reaction: the euro fell from $ around 1.35 pre-Summit to $ 1.31 at the time of writing. Yields on Italian and Spanish government bonds have also increased since the Summit.

The basic macro economic problem in the European Union is that, while the euro zone as a whole has a rough balance between its savings and investments (or its current account), there are major variations within it. The countries in difficulties, principally from the southern part of the zone, have large deficits on the current account even as Germany records a large surplus. In other words, the same euro is overvalued for the southern countries and undervalued for Germany, leading to savings investment imbalances. (To be sure, problems in Ireland and Spain had a different origin.) Huge fiscal deficits in the troubled countries have obviously contributed to greater consumption (and therefore lower savings), and persistent dependence on capital inflows to balance the books. To my mind, this is the basic cause of the sovereign debt crisis in the euro zone, which is also impacting the banking system given its exposure to the debt of the southern countries.

In principle, there are two ways for countries facing unduly large sovereign debts to bring them down to a more acceptable ratio in relation to the GDP. One is fast growth and inflation which would, hopefully, increase the denominator of the debt to GDP ratio faster than the numerator. This would also need to be accompanied by an external devaluation of the currency. However, given that monetary policy in the euro zone is made by a supranational central bank, individual countries have no way to engineer inflation or an external devaluation.

The other way is what I would refer to as an “internal devaluation” achieved by a sharp fall in the domestic consumption levels. The conditionality imposed on Greece, for example, forces it to cut down public sector salaries and pensions by up to 30% helping reduce domestic consumption and making domestic costs more competitive – i.e. an internal devaluation. There is a major question mark weather years of austerity and lower living standards can be made acceptable to the mass of the people as necessary sacrifices, in any democratic country, Many countries are experiencing strikes and street protests against the austerity programs. Would, at some stage, countries like Greece start seriously reviewing whether the cost of staying in the euro zone is becoming unacceptable, that the costs of leaving the single currency may be more palatable?

Overall, the successive Summits leave many question marks about the future of the single currency.

A.V.Rajwade