

Greece and the Euro, All Over Again

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Those whom the gods would destroy....

--Euripides

"In the end, an inflexible euro was doing its job, as did gold drains in the 19th century or speculation against currency pegs in the 20th. If one wanted to abide by the gold standard or keep the peg or stay within the Eurozone, sacrifices had to be made."

The inventors of the euro thought that by artificially constructing a single currency and imposing it on the nations of Europe they would strengthen the Union they were intent on building. The effect has been to deepen its divisions. The aim, for the Germans especially, was to build a solid currency of stable value issued by an independent central bank, along the lines of the *Deutsche Mark* and the *Bundesbank*. They meant well, but the Great Recession of 2007 uncovered some defects in the design that led to a general revolt. Defective or not, the euro as originally intended is today rejected by the greater part of the Eurozone. The governments of the southern reaches of the Union are trying to create something quite different. Even Signor Mario Draghi with his Quantitative Easing seems intent on changing the euro fully into a fiat currency with no institutional limits to discretion. The ultimate reason is that voters in many member countries, not just in Greece, feel that the solid euro is too harsh a discipline given their profligate habits.

The original euro

After many tries the euro was adopted in 1997 in Maastricht, a charming walled town in the Low Countries, famed for its antiques fair. A number of conditions were set for members wanting to enter the Eurozone, the principal ones being: a low rate of inflation; sustainably moderate interest rates; a balanced budget with at most a deficit of less than three per cent of GDP, and public debt equivalent to 60 per cent of GDP or less. These conditions were demanded so that the members of the future currency zone would not be too far separate as regards their financial structure and would react in harmony when an unexpected shock struck the zone. This would allow the central bank to apply the same interest rate policy to all members without unwanted effects.

Germany however drew attention to the need for the same rules to apply to members of the monetary union once it was formed, to control possible free riding by countries using the low interest rates to finance large public deficits. A "Stability and Growth Pact" was agreed to along those lines just before the euro was introduced in the year 2000. Unfortunately, in 2003 Germany was still spending large sums to aid the ex-communist part of the country, and France was suffering the hangover from the Keynesian policies of President Mitterrand; both countries indicated that they would overstep the Maastricht limits and the Union decided to soften the rules. In 2011 the harsh lessons of the crisis forced a return to the more severe rules.



In its original form the euro was meant to function as a quasi-gold standard. For a time during the first seven years of the new century, with the European Central Bank charging the same low interest rate to all parts of the region, it looked as if the skies over continental Europe were perpetually blue. This could not last, first because the ECB's generous monetary policy fuelled real estate prices and profits; and second because ever larger public expenditures could not permanently be funded by loans. In some countries the crisis went from financial to fiscal: the 2007 crisis uncovered the financial weakness of unwisely marketed mortgages, so governments had to step in to save banks, as happened in Spain when the real estate bubble burst. In other countries, the crisis went from fiscal to financial, when over-indebted Treasuries were forced to borrow abroad at extortionate rates, if they could find a lender.¹ Markets had been asleep during the halcyon days but finally they cracked their whips. What had become clear is that the ECB could not apply a prudent monetary policy unless it took asset prices into account and not only consumer prices; and that countries could not hope to stay in the euro if year after year they overspent on the welfare state, as was the case in Greece.

In the end, an inflexible euro was doing its job, as did gold drains in the 19th century or speculation against currency pegs in the 20th. If one wanted to abide by the gold standard or keep the peg or stay within the Eurozone, sacrifices had to be made. A fixed exchange rate demands that prices, and especially wages, be flexible. Large budget deficits must be avoided since mountains of debt tempt governments to inflate. When markets realize this means that a monetary or an exchange crisis is developing the heavens fall in. To avoid catastrophe, harsh austerity measures become necessary. Thus the single European currency turned out to be a brake on easy monetary policy and on excessive government expenditure.

Financing foreign deficits

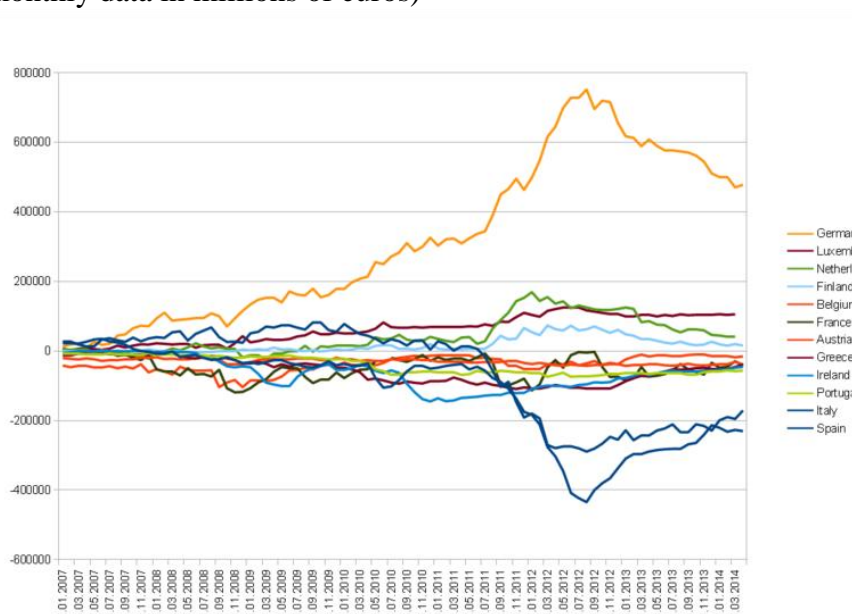
The trouble is that it took too long for the brakes to work. The ease with which balance of payments deficits were financed within the Eurozone led to belated reaction to wrong policies. Also, a dangerous feature of the euro was overlooked. It goes under the obscure name of TARGET2. In the present world there is a whole industry engaged in finding attractive acronyms to shorten the forbidding names of bureaucratic institutions. For example, the body of doctors who, under the British National Health Service, decide whether persons of advanced age will receive expensive treatment is known as NICE, for "National Institute for Health and Care Excellence"—a job that I would not want. As regards the euro, TARGET2 clearly wins the rhetoric stakes for bowdlerization of inglorious administrative appellations.² TARGET2 stands for "Trans-European Automated Real-time Gross settlement Express Transfer system", a second generation of the automated system for clearing payments within and across euro-countries. Let me explain the workings and disastrous effects of the TARGET2 payments system. Imagine a Spanish driver who orders a gleaming motorcycle in

Germany. He owes his bank the euro price of this machine. His bank now is a debtor to the Banco de España, which in turn becomes a debtor to the ECB, which credits the *Bundesbank* the money transferred to commercial bank of the motorbike seller. The essence of this transaction is that the payment for the motorbike is channeled through the ECB and paid in ECB euros, so that in the end the balance of payments deficit caused by the purchase of the machine is financed by the *Bundesbank*. If Germany is a net exporter to the rest of the Union its TARGET2 credit grows and grows. And vice versa for debtor countries.

The reason the ECB wants to be the exclusive channel through which all these debits and credits flow in real time, for a very small commission and no collateral, is that it wants to give the euro a good reputation for being a reliable currency in which everybody in the Eurozone automatically accepts for goods and services, *whatever the credit standing of the member country making the payment*. The result of this, however, is that countries can run huge balance of payments deficits without being called to question. It is thus that Spain was able to run such large payments deficits during the crisis: for example its current account balance showed a shortfall of ten per cent of GDP in 2007-2008.

As can be seen in Figure 1, the main creditor for these and other countries buying more than they sell with the help of TARGET2 was Germany. If one of these debtor countries (for instance Greece) left the euro, the *Bundesbank* would suffer a large loss. Also, as there are no limits to running up debt through this facility and the same flat commission is charged to all users, whether or not they have large deficits, the incentive to excessive spending will be irresistible.

Figure 1. TARGET2 balances in the Eurosystem from January 2007 to April 2014 (monthly data in millions of euros)



[ZOOM](#)

Source: [Wikimedia](#)

It is neither inevitable nor necessary that these transfers be channeled through the "European System of Central Banks". The member countries of the euro could have been left to make their own arrangements for international settlements through private banks, as is now the case for clearance with residents outside the Eurozone. The effective nationalization of foreign transfers within the Zone on the pretext of making the euro popular was a clear mistake and resulted in putting the euro out of kilter.

Greece's protest vote

A single currency, such as the gold standard was or the euro aspired to be, works more smoothly the more flexible the economy is. This is the implication of [Robert Mundell's](#) seminal 1961 article on Optimum Currency Areas (OCAs),³ where the exchange rate cannot be used as a policy instrument. The rate of exchange of a Eurozone country, let us say Greece, is by definition fixed. Hence, the Greek National Bank has no power over monetary policy. The ECB sets the basic interest rate, which may or may not suit Greece if its real economy has not converged with the rest. The interest rate adapted to the average circumstances of the Zone will cause unemployment in Greece if it is too high (or an artificial boom if it is too low). The remedy for such disharmonies is for factors of production quickly to move out of the country (or move in). The trouble with the Eurozone is that, due to the diversity of language and culture, labor is virtually tied to its original location. The other remedy to lack of economic convergence is productive flexibility, in the form of welfare cuts and changes in wages and prices. Absent such flexibility, there will be need for more foreign aid or additional issues public debt and there will an increase in unemployment. This is exactly what has been happening in Greece: the funds supplied to Greece by the rest of the Eurozone in the form of loans or bonds amounts to no less than €253 billion (\$282 billion), a sum equivalent to 275% of its GDP in 2013, even after half the debt owed to foreign banks was forgiven; and the unemployment rate averages 27 per cent.

The harshness of the euro as originally conceived has led to disaffection precisely for the reasons that make it a better currency than pure fiat moneys. Austerity in the form of cuts in public services, reduction of pensions, pressure on those who never paid a tax, labor law reform and the resulting unemployment have been felt in Greece as a bitter and unjust medicine. Syriza, the leftwing populist party, after winning the general election on the 25th of January, is just one seat short of absolute majority in Parliament and has been able to form a coalition Government with the near-fascists of Golden Dawn. The new Prime Minister, Mr. Tsipras, has pledged to restructure the national debt and put an end to austerity.

For more on these topics, see [Balance of Payments](#), by Herbert Stein in the *Concise Encyclopedia of Economics*. See also the EconTalk podcast episode [Cowen on the European Crisis](#), and ["Eurozone: It Seemed a Good Idea at the Time"](#), by Anthony de Jasay, October 3, 2011; ["Nothing New on the Euro Front"](#), by Wolfgang Kasper, December 5, 2011; and ["Europe in Disarray"](#), by Pedro Schwartz, September 1, 2014, Library of Economics and Liberty.

"Restructuring" is one of those weasel words that mean something different from what they sound. Restructuring the debt means not paying your debts in full, and the new government should say it clearly. Greece already restructured its debts when EU

governments forced foreign banks to cut their claims by 50 per cent. Though Mr. Tsipras has suggested his government may be content with extending the life of the bonds while recognizing their nominal value, but is adamant he will reject any more austerity measures. Putting an end to austerity may in fact go against repayment. Austerity means trying to live within one's means, but in the minds of the Greeks is associated with unending despair. Tsipras did say during the campaign that he would keep his promise to Frau Angela Merkel to balance the primary budget but that he rejected any more cuts in public expenditures. This clearly means higher taxes. Since the government will be left-wing, we can expect all the usual baloney about taxing the rich. This will not satisfy the so called "troika" (made up of a representative of the IMF, the European Commission, and the ECB) who can refuse to free the funds needed by Greece to pay next quarter's pensions and civil service salaries. The classic game of chicken.

Delayed backlash

Greek voters have set a pattern which may be repeated in Ireland and is even more likely in Spain. It is striking that the protest vote comes when austerity finally producing positive results. The Greek economy is growing again, if only at a rate of 0.6%. The IMF expects it to grow by 2.9% in 2015. The primary budget (i.e., not counting the service on the debt) is in surplus. But people have suffered too much, especially as regards the loss of jobs, and they have voted against the whole program of cutting the size of the state. This backlash is fuelling the progress of the populists of Sinn Fein in Ireland and Podemos in Spain, two other countries where austerity is getting results—but too late in the view of ordinary voters.

Everybody in Europe needs more growth quickly, not least orthodox governments. The reaction of Signor Draghi of the ECB has been precisely the wrong one. Instead of encouraging European authorities to insist on structural reforms, on flexibility, on productivity, it has launched what in my view is an illegal QE program to buy €1.3 trillion (\$1.56 trillion) worth of bonds from the present month of February to September 2016. It will be like pouring oil on the choppy waters of the Eurozone. For a time this will make for plainer sailing. But it is the euro ship itself that badly needs mending.

Footnotes

[1.](#)

An outstanding analysis of the two forms the 2007 crisis took—financial to fiscal, and fiscal to financial—is masterfully explained by Leszek Balcerowicz in "[Euro Imbalances and Adjustment: a Comparative Analysis](#)", *Cato Journal*, vol. 34, no. 3 (Fall 2014). PDF file.

[2.](#)

By the way, rhetoric is much more important and pervasive than people think, and if you do not agree let me recommend a book by Sam Leith, *You Talkin' to Me? Rhetoric from Aristotle to Obama* (Profile Books, 2012). We defenders of liberty have great need for good rhetoric or the art of persuasion as it is called today. The least we could do is follow the example of Mark Antony's speech rather than Brutus's in Shakespeare's *Julius Caesar*.

[3.](#)

Mundell, Robert A. (1961): "[A Theory of Optimum Currency Areas](#)", *American Economic Review*, vol. 51, no. 4 (September), pages 657-665. PDF file.

