Vaclav Klaus and the Euro

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I am very pleased to be a contributor to this volume in honor of Vaclav Klaus on his seventieth birthday. I have known Vaclav Klaus for more than 20 years. In those years I admired his leadership of Czechoslovakia and later of the Czech Republic as well as the sound economic principles that he has supported in practice and in his writings.

The euro has been one of the subjects that he and I have discussed over the years. We have both been rightly accused of being eurosceptics. Since he is not only a political leader but also a trained economist, he saw the problems that a single currency would bring even before the euro was formally launched. He and I agreed then that the euro would create serious problems for the countries that accepted the single currency in place of their own national currencies. And as leader of his own country, Vaclav Klaus acted to keep it out of the eurozone.

The fundamental problem of the euro is that it forces a single monetary policy, a single level of interest rates, and a single exchange rate on all countries in the eurozone. The only reason for differences in the interest rates paid by different borrowers in the eurozone is differences in the market's perception of the risks of the different borrowers -- including both private borrowers and government borrowers.

But a single risk-adjusted interest rate for the entire eurozone will generally mean an interest rate that is too high for the countries that are relatively weak and too low for countries in which demand is so strong that inflation is a current or potential problem.

We are seeing that problem now (in March 2011.) Rising prices of imported food and energy have caused inflation to be above the two percent target rate of the European Central Bank. ECB president Jean Claude Trichet is rightly concerned that unions will respond to this by seeking higher wages to protect their members' living standards. Since such wage increases could set off a wage-price spiral that leads to increasing inflation rates, President Trichet recently indicated that the ECB may soon raise interest rates.

Such a rise in interest rates would happen at a time when several of the eurozone countries are very weak and could be pushed into recession by higher interest rates. The problem is exacerbated by the large fiscal deficits faced in several of the eurozone countries. The governments of those countries are responding with programs of fiscal consolidation, raising tax rates and reducing government spending. Although some officials of those governments and of the central bank have expressed the hope that the resulting improvements in confidence about the long-term fiscal outlook would boost short term demand by households and businesses, the evidence is already clear that the fiscal consolidation will reduce overall aggregate demand in the near term. While it would be desirable to offset that weakness in some of these countries with easier monetary policies, the opposite will happen because of the ECB's concern about inflation in the eurozone as a whole.

A second problem caused by the euro is that countries in the eurozone cannot adjust their exchange rate to offset shifts in aggregate demand or to maintain international competitiveness. When exchange rates were flexible, market forces would generally cause the currency of a country that is experiencing economic weakness to decline. That would make the products of that country more competitive globally, leading to increased net exports and a boost to aggregate demand. Conversely, international market forces would generally cause the currency to rise in a country with excess demand, causing a reduction in aggregate demand. Neither of these natural reactions can occur when the currency is fixed as it is in the eurozone.

The other international problem of the fixed exchange rate is that it prevents the gradual adjustment of the exchange rate that could maintain the international competitiveness of a country with a low rate of growth of productivity. Although the competitiveness of a country with slow productivity growth might in principle be maintained when exchange rates are fixed by a lower rate of wage growth than that of other countries, the low inflation rate in Germany and other eurozone countries means that countries with substantially lower long-term productivity growth than Germany would have to experience negative wage changes year after year. I find it hard to believe that Greece or Portugal will be able to impose continually falling wages to offset the lower productivity growth in their economies.

The convergence of productivity growth rates and of competitiveness more generally within the eurozone that some projected at the start of the euro is also not happening. The result will be chronic rising trade and current account deficits in those countries like Greece and Portugal in which productivity lags Germany and in which potential export products do not experience the strong demand and rising prices enjoyed by the products of German firms.

So the economic case against the euro is strong and has been seen as such from the start. European advocates of the euro would often reject these arguments by noting that the United States is able to operate with a single currency in a geographically and economically diverse economy "similar to Europe." But economic fundamentals are actually very different in the United States and in Europe.

One important difference is that the American labor force is very mobile, with workers and their families moving from states and regions with decreasing demand to other parts of the country where jobs are more plentiful. European workers do not do so even though they have the legal right because of barriers of language, culture, religion, union membership and national pension systems.

A second difference between the US and European labor markets that makes the US able to operate with a single currency is that wages are more flexible in the United States. When labor demand declines in an American region, the local real wages (and, more broadly, real employment costs) fall more in the US than in Europe. This leads to increased demand for labor, helping to offset the initial decline in labor demand.

A third important difference is the fiscal structure of the US economy. The central government in Washington collects about two-thirds of all taxes and finances a large share of transfer payments as well as other spending. In contrast, in Europe these activities are done by individual national governments. This is important because it means that a decline of economic activity and income in a particular state leads to a decline in the taxes paid to Washington by households and businesses in that state. In effect, this acts as an automatic stabilizer at the state level, reducing the decline in incomes. The rise in unemployment benefits and welfare payments from Washington has a similar effect. Nothing like that happens in Europe where fiscal actions are all done within the country.

These economic facts were fully recognized by economists like Vaclav Klaus and myself before the euro was formally launched. These warnings were disregarded by other political leaders who wanted the euro as a way of creating a larger political entity in Europe. Those political elites who supported the euro believed it would give the eurozone a prominent role in international affairs. Many of those supporters also hoped -- and continue to hope -- that the eurozone will evolve into a federal state with greater political power as well.

The political leaders in individual countries had their own reasons for wanting to see the creation of the eurozone. Germany saw itself as the leading country of the eurozone, with the largest GDP, a central geographic location, the home of the new European Central Bank, and the strongest economic reputation. French leaders believed that they would be at least the political equal of the Germans and, because of their stronger background in foreign relations, might actually come to dominate the policies of the eurozone. Spain disregarded the warnings because it was eager to join the eurozone to demonstrate that it was fully accepted as a member of the European community even though it had only recently ended the Franco regime. Italy was eager to get in because it had been central to European discussions from the start of the Treaty of Rome and would have seen the failure to join at the start as a demoralizing insult. So each country had a reason to join and to disregard the pending economic adversities that joining would bring.

While similar political arguments could have been made to rationalize a Czech Republic decision to join the European Economic and Monetary Union, Vaclav Klaus successfully provided the intellectual leadership to oppose that decision.

Several of the countries that did join when the euro was established saw their interest rates fall sharply because membership in the euro removed their traditional risk of inflation. That inflation risk could have been avoided by sound independent monetary policies without joining the euro, as many countries outside the eurozone in Europe and elsewhere around the world showed.

The lower interest rates tempted households and governments in the previously high interest rate countries to expand their borrowing. For households this generally meant increased mortgage borrowing to finance a major boom in house purchases. The increased demand for housing led to an excess production of houses and to an overpriced housing stock. We are now seeing the adverse effects of that in Spain, Ireland, and elsewhere. House prices are collapsing and banks are saddled with large amounts of bad mortgage debt.

The low interest rates also induced governments to expand their borrowing to finance large new programs of government spending. If those countries had separate exchange rates, the explosion of government debt in any country would have caused a deterioration of the value of that country's currency. But that could not happen since all of the countries shared the euro. To the extent that an increase in debt in Spain or Italy raised the total volume of euro debt that the market needed to absorb, it affected only the relative value of the euro. So there was no market feedback through the exchange rate to penalize a country that ran an excessive budget deficit, countries continued to run large deficits and accumulate large debts.

Similarly, until recently the financial markets incorrectly treated all euro sovereign debts as equivalent, causing the interest rate on Greek or Spanish debt to be very close to the interest rate on German debt. Again there was no feedback on fiscal profligacy through the interest rate on the individual sovereign debts.

Eventually, of course, the markets recognized the enormous debts that had been accumulated by a number of the individual countries and forced their interest rates to be much higher than the German government bond rates. Europe is now trying to dig out of these excess sovereign debts. I believe that there will be substantial restructuring (a polite word for defaults) of the government debt of several of the high debt countries.

The painful adjustment policies now taking place in a number of eurozone countries is a direct result of their adoption of the euro .

Fortunately, the Czech republic and several other European countries have been spared these painful effects of eurozone membership. It seems that these lessons have been well learned by the Czech people who can thank Vaclav Klaus for insisting that joining the eurozone would be a mistake.

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