The Euro Leads Europe into Economic Problems

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When politicians in the European Union persuaded the public about the benefits of the single currency, they argued that the euro would increase economic growth, cut unemployment and bring monetary stability to all countries. Today it is obvious that the launch of the euro failed to prevent a continuous decrease in the growth of European economy, and that the introduction of the single currency is proving to have a different impact in each member state of the euro-area. The fast-growing Ireland now has higher inflation than prior to the euro, and the stagnating Germany is on the verge of deflation. Such divergent effects are caused by the economic diversity of the European monetary union, in full accordance with the theory of optimal currency areas. Excessive inflation or unemployment is a standard side effect of any monetary integration of heterogeneous economies.

A country that gives up its own currency for the euro loses the monetary exchange rate as a natural tool balancing the flows of money between the domestic economy and other countries, so that the amount of money in the economy becomes an uncontrollable quantity. Any increase in exports or investment inflow translates into an increase in the amount of money in the economy, whereas a decrease in exports or outflow of capital within a currency area leads to a lower volume of currency. When the amount of money is growing, prices tend to reflect the trend flexibly by moving upwards, which has been the case of the Irish inflation. When the monetary stock decreases, the lower aggregate demand is often reflected by a decrease in production due to the downward inelasticity of certain prices, that has been the case in the German recession.

When the German export lobby pushed for the launch of the euro a few years ago, it hoped that the membership of weaker economies of the southern Europe would contribute to the depreciation of the single currency, with a weaker euro boosting German exports. But today the German economy is paying the price of the euro introduction. If the stagnating German economy could use the mark today, the mark would depreciate and help to bring Germany back to the growth track. The relatively fast economic growth of Spain, Greece or Ireland hinders the depreciation of the euro, which would be so beneficial for the German economy. Moreover, the German deflation combined with uniform interest rates means that the real interest rate in Germany is higher than in the rest of the euro-area, which further inhibits Germany from escaping the recession. The European Stability Pact says that a country with a deficit above 3 per cent of the GDP should pay huge fines to Brussels. If Germany paid such penalties, it would have not only negative fiscal but also monetary consequences: further outflow of money from the country would only add to the deflation crisis. In this sense, the European Commission President Romano Prodi was right in saying that the Pact is stupid. But even without the fines, Germany gives away a vast amount of money annually for the subsidies to poorer EU members, since Germany has long been a net contributor to the EU budget. Now that Germany no longer has its own currency, the German monetary stock can decrease each year in any case.

Today the European Central Bank’s inflation goal is 2 per cent. However, this is only an average, and the inflation varies significantly from country to country. The low inflation goal means that some regions – and today it is Germany – are very much prone to deflation followed by some economic contraction and unemployment growth. In general, we can say that the more the economic development varies in different regions of a currency area, the higher the average inflation rate must be in order to prevent the single currency from causing deflation or recession in some of the regions. As a result, we often hear about the need to ease the inflation goal of the European Central Bank. If this happens, under pressure from Germany, the hallowed independence of the European Central Bank will die sooner than anybody would have expected.

The unfavourable consequences of the euro should be a warning to those who favour further enlargement of the Euroland. The Czech Republic, for instance, is a growing economy experiencing an inflow of capital. This inflow leads annually to an appreciation of the koruna by about ten per cent. If Czechs started to use the euro instead of the koruna today, it would mean not only an end of currency appreciation but also a return of the annual 10 per cent inflation that used to be the result of a capital inflow combined with a fixed exchange rate up to 1997. The launch of the euro in the Czech Republic would not only lead to a faster price growth but also to the inflation being determined and regulated from the European Central Bank in Frankfort. And the Czech Republic would have little influence on its policy.

Romano Prodi may be right when he says that the Stability Pact is stupid, given its rigidity. But to be consistent, he ought to extend his judgment on the euro project as a whole.
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