CATO INSTITUTE
ECONOMIC DEVELOPMENT BULLETIN
CENTER FOR GLOBAL LIBERTY & PROSPERITY

No. 14 • May 26, 2010

When Will the Eurozone Collapse?

by Václav Klaus

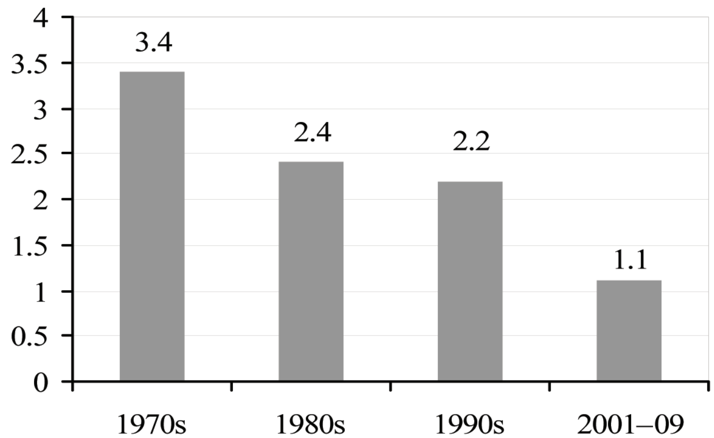
As a long-standing critic of the concept of a single European currency, I have not rejoiced at the current problems in the eurozone that threaten the very survival of the euro. Before discussing the events surrounding the Greek debt crisis further, I must provide at least a working definition of what the word "collapse" means. In the context of the euro, there are at least two interpretations that come to mind. The first one suggests that the eurozone project or the project establishing a common European currency has collapsed already by failing to bring about positive effects that had been expected of it.

The creation of the eurozone was presented as an unambiguous economic benefit to all the countries willing to give up their own currencies that had been in existence for decades or centuries. Extensive, yet tendentious and, therefore, quasi-scientific studies were published prior to the launch of the single currency. Those studies promised that the euro would help accelerate economic growth and reduce inflation and stressed, in particular, the expectation that the member states of the eurozone would be protected against all kinds of unfavorable economic disruptions or exogenous shocks.

The Euro Has Not Led to Higher Growth in the Eurozone

It is absolutely clear that nothing of that sort has happened. After the establishment of the eurozone, the economic growth of its member states slowed down compared to the previous decades, thus increasing the gap between the speed of economic growth in the eurozone countries and that in major economies such as the United States and China, smaller economies in Southeast Asia and parts of the developing world, as well as Central and Eastern European countries that are not members of the eurozone. Since the 1960s, economic growth in the eurozone countries has been slowing down and the existence of the euro has not reversed that trend. According to European Central Bank data, average annual economic growth in the eurozone countries was 3.4 percent in the 1970s, 2.4 percent in the 1980s, 2.2 percent in the 1990s and only 1.1 percent from 2001 to 2009 (the decade of the euro) (see Figure 1).[1] A similar slowdown has not occurred anywhere else in the world.

Figure 1
GDP growth rates in the eurozone, percentage



The Eurozone Economies Have Not Converged

Not even the expected convergence of the inflation rates

Václav Klaus is president of the Czech Republic.

of the eurozone countries has taken place. Two distinct groups of countries have formed within the eurozone—one with a low inflation rate and one (Greece, Spain, Portugal, Ireland and some other countries) with a higher inflation rate. We have also seen an increase in long-term trade imbalances. On the one hand, there are countries with a balance of trade where exports exceed imports and, on the other hand, those countries that import more than they export. It is no coincidence that the latter countries also have higher inflation rates. The establishment of the eurozone has not led to any homogenization of the member states' economies.

The global financial and economic crisis only escalated and exposed all economic problems in the eurozone—it did not cause them. That did not come as a surprise to me. The eurozone, which comprises 16 European countries, is not an "optimum currency area" as the elementary economic theorems tell us it should be. The former member of the Executive Board and chief economist of the European Central Bank Otmar Issing has repeatedly pointed out (most recently in a speech in Prague in December 2009) that the establishment of the eurozone was primarily a political decision.[2] That decision did not take into account the suitability of this whole group of countries for the single currency project. However, if the existing monetary area is not the optimum currency area, it is inevitable that the costs of establishing and maintaining it exceed the benefits.

My choice of the words "establishing" and "maintaining" is not accidental. Most economic commentators (not to speak of the non-economic commentators) were satisfied by the ease and apparent inexpensiveness of the first step (i.e., the establishment of the common monetary area). This has helped to form the mistaken impression that everything was fine with the European single currency project. That was a mistake that at least some of us have been pointing out since the very birth of the euro. Unfortunately, nobody has listened to us.

I have never questioned the fact that the exchange rates of the countries joining the eurozone more or less reflected the economic reality in Europe at the time when the euro was born. However, over the last decade, the economic performance of individual eurozone members diverged and the negative effects of the "straight-jacket" of a single currency over the individual member states have become visible. When "good weather" (in the economic sense) prevailed, no visible problems arose. Once the crisis or "bad weather" arrived, however, the lack of homogeneity among the eurozone members manifested itself very clearly. In that sense, I dare say that—as a project that promised to be of considerable economic benefit to its members—the eurozone has failed.

The Hidden Costs of the Euro

Of greater interest to non-experts and politicians (rather than economists) is the question of the collapse of the eurozone as an institution. To that question, my answer is no, it will not collapse. So much political capital had been invested in the existence of the euro and its role as a "cement" that binds the EU on its way to supra-nationality that in the foreseeable future the eurozone will surely not be abandoned. It will continue, but at an extremely high price that will be paid by the citizens of the eurozone countries (and, indirectly by those Europeans who have kept their own currencies).

The price of maintaining the euro will be low economic growth in the eurozone. Sluggish eurozone growth will result in economic losses in other European countries, like the Czech Republic, and in the rest of the world. The high price of the euro will be most visible in the volume of financial transfers that will have to be sent to eurozone countries suffering from the biggest economic and financial problems. The idea that such transfers would not be easy without the existence of a political union was known to German Chancellor Helmut Kohl back in 1991 when he said that "recent history, and not just that of Germany, teaches us that the idea of sustaining an economic and monetary union over time without political union is a fallacy."[3] He seems to have forgotten it, unfortunately, as time went by.

The amount of money that Greece will receive in the foreseeable future can be divided by the number of the eurozone inhabitants and each person can easily calculate his or her own contribution. However, the "opportunity" cost arising from the loss of a potentially higher growth rate, which is much more difficult for a non-economist to contemplate, will be far more painful. Yet, I do not doubt that for political reasons this high price of the euro will be paid and that the eurozone inhabitants will never find out just how much the euro truly cost them.

To summarize, the European monetary union is not at risk of being abolished. The price of maintaining it will, however, continue to grow.

The Czech Republic has not made a mistake by avoiding membership in the eurozone so far. And we are not the only country taking that view. On April 13, 2010, the *Financial Times* published an article by the late Governor of the Polish Central Bank Slawomir Skrzypek—a man whom I had the honor of knowing very well. Skrzypek wrote that article shortly before his tragic death in the airplane crash that carried a number of Polish dignitaries near Smolensk, Russia. In that article, Skrzypek wrote, "As a non-member of the euro, Poland has been able to profit from flexibility of the zloty exchange rate in a way that has helped growth and lowered the current account deficit without importing inflation." He added that "the decade-long story of peripheral euro members drastically losing competitiveness has been a salutary lesson."[4] There is no need to add anything more.

Notes

The original Czech version of this article was published in *Ekonom*, a Czech weekly magazine, on April 22, 2010.

1. The European Central Bank, "Statistics Pocket Book," March 2010, http://www.ecb.int/pub/pdf/stapobo/spb201003en.pdf.
2. Otmar Issing, *The Birth of the Euro* (Cambridge, U.K.: Cambridge University Press, 2008).
3. Quoted in Otmar Issing, "The Euro: Does a Currency Need a State?" *International Finance* 11, no. 3 (2008): 303.
4. Slawomir Skrzypek, "Poland Should Not Rush to Sign Up to The Euro," *Financial Times*, April 13, 2010.