IS THE EURO SUSTAINABLE?

Richard Conquest

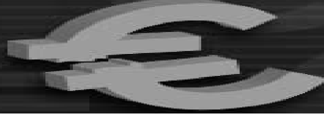
Is the euro Sustainable?

Richard Conquest

© The Bruges Group 2009

Published in March 2009 by
The Bruges Group, 227 Linen Hall, 162-168 Regent Street, London W1B 5TB
www.brugesgroup.com

Bruges Group publications are not intended to represent a corporate view of European and international developments. Contributions are chosen on the basis of their intellectual rigour and their ability to open up new avenues for debate.



About the Author

Richard Conquest is an economist, hedge fund consultant and author whose research focuses on the many aspects of contemporary economic history and events, market developments and crises. Richard has also authored a number of publications on Eastern Europe and Russia which have been used by the Foreign Office for graduate training.

He has had a career working in the financial sectors of many different countries. Richard was Chief Economist at the Japanese financial institution, Daiwa Securities. He has also worked for ABN AMRO in Amsterdam and in the City of London for Skandinaviska Enskilda Banken (SEB).

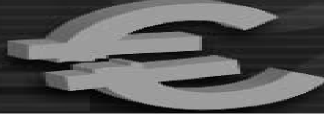


Table of Contents

A POLITICAL ARTIFICE 5

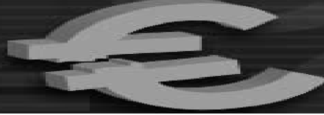
THE TROUBLED ROAD TO THE EURO 6

DIVERGENT, DESTRUCTIVE INFLUENCES 8

THE EXTERNAL BALANCES:
THE ULTIMATE TEST OF COMPETITIVENESS 12

THE UK AND THE ERM:
THE IMPLICATIONS OF PREMATURE MONETARY UNION 15

CONCLUSION 19



A POLITICAL ARTIFICE

The first and possibly the most important fact about the euro is that it is a political construct. It is not the product of a market driven, evolutionary, organic economic process but is rather the product of a Utopian political idea. This means that from the inception, European monetary union has served a political function to which economic and financial realities were always to be subservient. It is hugely significant that this process never served a democratic idea, and when it was tested by the electorate, it was usually rejected.

The vital point is that such an arrangement, a prematurely constructed euro, is absolutely certain to produce serious economic problems of a particularly intractable kind. Intractable for political rather than purely economic reasons as has been the case with fixed exchange rate regimes in the recent past since the abandonment of the Bretton Woods system of fixed exchange rates between 1971 and 1973.

The entirely ‘man made’ problems that confronts the eurozone today have their origins in the fatally flawed notion that one exchange rate and one interest rate are appropriate for economies with very different and disparate histories, structures, performances and sovereign governments. This idea was originally an alarming display of sub-schoolboy economics on the part of the political elite of Europe, and worse still matters have not changed. It is a proposition that flies in the face not only of elementary economic theory but also of past experiments with monetary unions, and indeed, fixed exchange rate regimes.

There are also institutional problems, notably that the institutions of the European Union suffer from a ‘democratic deficit’. The European Central Bank is seen to lack the kind of transparency that characterises both the Federal Reserve Board and the Monetary Policy Committee of the Bank of England.

The move towards political, economic and monetary union has been implicit in European politics even before the signing of the Treaty of Rome in 1959. This has involved various arrangements to try to ‘stabilise’ exchange rates on the totally spurious ground, amongst others, that without this a unified market was impossible. Nobody argues that the North American Free Trade Association cannot work without monetary union. This notion of using a fixed exchange rate regime to ‘stabilise’ exchange rates is itself economically semi-literate: Like any other commodity, the value of money denominated in different currencies between markets will fluctuate depending upon an indeterminate number of economic and political variables.

The idea of fixity is no more or less than a politically motivated state of denial of these economic realities. This perversion of economic policy is absolutely certain to engender serious problems.

THE TROUBLED ROAD TO THE EURO

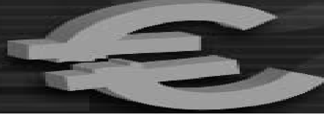
Political attempts at manipulating and controlling the foreign exchange market are, depressingly not new or recent. As a consequence of a general wish to avoid the monetary disorders and competitive devaluations of the 1930s, the Bretton Woods 'system' of fixed exchange rates was devised in 1944. The disintegration of the Bretton Woods regime of fixed exchange rates in 1971 and the abandonment of gold convertibility by the United States was followed by the creation of the European 'currency snake' in 1972.

Given the economic problems and disorders which followed the first OPEC 'oil shock' in 1973, the system became unstable and then un-workable. France, for example, joined and departed twice. The currency snake could not withstand speculative market activities and it was abandoned in 1978 only to be replaced by the Exchange Rate Mechanism of the European Monetary System in 1979.

The Exchange Rate Mechanism was obviously premature and was, again, based upon the idea that currency discipline would engender economic 'convergence' which would then make the single market and single currency viable. But of course, that was never going to happen – it made totally unrealisable demands for change in the political and economic culture of countries such as Italy and Spain (as from 1986) Portugal and Greece. This was very much the triumph of hope over experience.

The result was that during the 1980s a series of crises blew up – driven by the always doubting and suspicious foreign exchange markets – invariably resulting in the revaluation of the Deutschemark and the devaluation of the French Franc and other second tier currencies: of course the word 'devaluation' was never used, it was politically too insensitive so the euphemism 'DM revaluation' was employed instead.

But exercises in semantic obfuscation could not conceal the fact of a loss of competitiveness by countries such as France and Italy and a corresponding gain by Germany. However, the logical conclusions were never reached because that was politically inconvenient and not in keeping with the vision of 'ever-closer union' within the EU.



In the first eight years of the ERM it was found necessary to adjust exchange rates, on a multilateral basis, no less than eleven times and this invariably led to the revaluation of the Deutschemark. This long series of political and financial conflicts within the ERM culminated with the crisis of 1992/1993 which led to UK Sterling effectively being ejected – and this crisis also affected other currencies.

But the simple truth from the 1970s, 80s and 90s to the present day is that too many European Union economies find it virtually impossible to live with a German exchange rate. In the past the major cause of this has been a failure to comprehend the corrosive effects of inflation differentials upon fixed exchange rate regimes: inflation differentials have proved to be the Nemesis of most such arrangements in the post-War period.

Albert Einstein described insanity as '….doing the same thing over and over again and expecting different results'. It is worrying that Einstein is now seen to be so correct in the realm of monetary economics, as conducted by the political elites of 'Europe'.

Even more serious is the fact that even if the structural faults with the euro were admitted, this would still not lead to a rational discussion of future policy options. Rather, like Prime Minister Harold Wilson in the events leading to the devaluation of Sterling in 1967 and like Prime Minister John Major in the events leading to the humiliating policy failure of 1992 (the ejection of Sterling from the ERM and its subsequent substantial devaluation) an enormous economic price has to be paid for political delusion reigning over any attempt at economic rationality.

On both occasions, 1967 and 1992, the political response to the failure of policy was to blame the markets. Prime Minister, Harold Wilson identified the 'gnomes of Zurich' to explain his failure. And in 1992 both Prime Minister John Major and one of the principle architects of the ERM and the euro, Helmut Schmidt, blamed the markets and 'speculators' for the failure of government policy. Naturally, both recommended that the markets be controlled in some way.

The investment of political capital in the euro has been so enormous that we must expect that an even more destructive economic price will be paid before the grandees of 'Europe' acknowledge that the euro is fatally flawed, and it will be even longer before the grandees decide what to do about it.

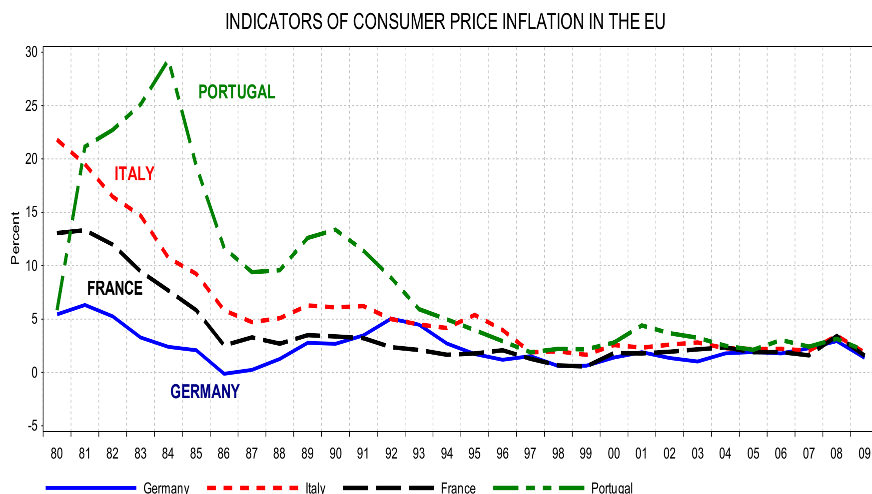
Economic policy in 'Europe' is in a state of political and indeed, economic confusion.

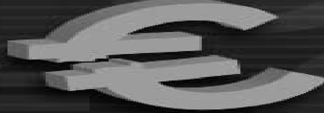
DIVERGENT, DESTRUCTIVE INFLUENCES

What causes fixed exchange rate regimes to fail with such tedious regularity? The UK Pound in 1967, and again in 1992. Or the Mexican Peso in 1994, the Thai Baht in 1997, quickly followed by the Philippines Peso, Indonesian Rupiah and Malaysia Ringgit. Or the Russian Rouble in 1998 and most suggestively, the great ERM fiasco of 1992.

There are two answers. The first is that all these crises were ignited by the political adherence to clearly flawed and unsustainable fixed exchange rate regimes. It is as simple as that. The market is characterised by extreme scepticism and the easy identification of politicians in a state of denial provokes the kind of cumulative surge of speculative pressure that was brought against Sterling in 1992.

In the case of European currencies, with which we are now concerned, the second answer is competiveness, the loss of which leads to unsustainable external deficits and the accumulation of foreign debt. Devaluation, which is clearly what Portugal, Italy, Ireland, Greece and Spain so urgently need is a forbidden option, not to be mentioned in the corridors of power in 'Europe'. And let us not mention France, now wedded to the German political interest to the point of policy impotence. So the stresses and economic pressures will simply build up until they provoke a political reaction.





The first problem that has been mentioned is that of inflation differentials. It is the case that in a very benign global environment these have calmed down in the last ten years or so. However, it is certain that the colossal monetary response to the ‘credit crunch’ carries with it the seeds of future inflation and in that there will be differentials which will further undermine the credibility of the euro.

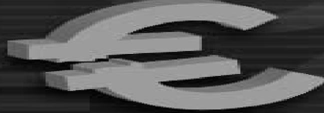
It is probably true to say that in the realms of economic history the enhancement of living standards and national wealth depends upon the growth of factor productivity. If this assertion is accepted then Europe faces a serious problem. The divergence in performance in terms of labour productivity and Unit Labour Costs is so extreme as to beg yet more questions about the wisdom and sustainability of this particular fixed exchange rate regime, the euro.

It is the case that in the past decade or so there has been a marked improvement in the inflation performance of many countries, this serves to increase the importance of other tests of competitiveness, notably the course of wages, productivity and unit labour costs. In these terms there have been very significant differences in performance which must, again, have a very corrosive impact upon overall competitiveness. As will be set out in the following table, the contrast between Italy and Germany in these terms could hardly be more stark, or alarming.

The most frequently offered explanation for the trends that are set out in the table concern Germany’s extraordinarily disciplined labour market allied with high levels of fixed investment in the industrial sector. Italy’s investment ratio to GDP is very close to the European Union average, but has not yielded a commensurate improvement in labour productivity which has on occasions actually declined in recent years. Again, the contrast between the surging strength of Germany’s productivity, frequently against the background of declining Unit Labour Costs, and all too often negative productivity growth of Italy could hardly stand in greater contrast to each other.

Euroland and Beyond: Tests of Competitiveness

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Hourly Earnings										
Advanced	5.4	2.8	4.6	4.5	2.6	2.5	3.8	3.2	3.5	3.2
USA	9.0	2.4	7.3	7.0	2.0	1.9	4.1	3.5	3.8	4.0
Euroland	5.2	4.4	3.4	2.7	2.9	2.8	3.9	3.1	3.2	2.9
Germany	3.6	3.5	2.4	2.5	0.8	2.2	2.8	2.6	2.4	1.9
France	3.4	1.4	4.2	2.4	4.9	3.6	4.3	3.3	3.5	3.2
Italy	1.7	2.5	3.2	2.8	4.0	1.5	3.8	3.1	3.0	3.0
Spain	2.9	4.1	5.0	4.9	4.0	3.5	4.2	3.4	2.8	2.8
Japan	-0.1	0.9	-1.3	1.0	0.3	1.3	0.4	0.3	1.6	-0.4
UK	4.7	4.3	3.5	3.6	3.6	3.7	5.2	3.5	3.2	3.6
New Asia	9.0	6.2	7.9	6.5	6.9	6.2	5.8	5.5	5.9	4.7

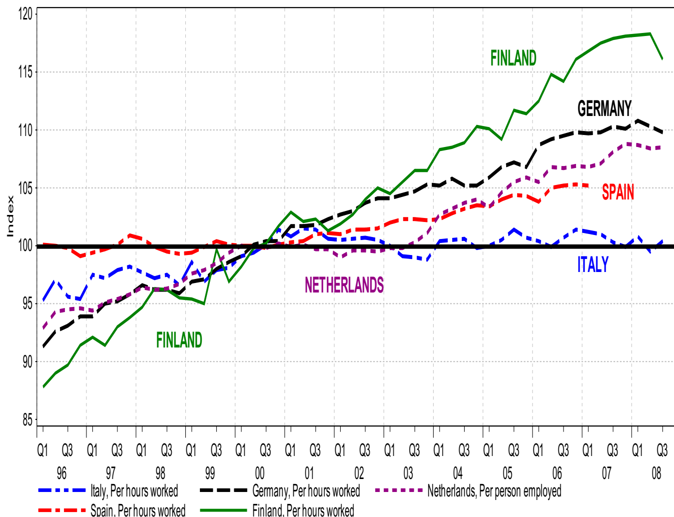


Productivity										
Advanced	5.0	0.8	4.3	4.4	3.3	3.7	2.6	3.3	2.0	2.0
USA	3.9	1.7	6.9	6.2	2.2	4.9	1.1	3.4	2.5	2.7
Euroland	6.8	2.9	1.4	2.3	3.1	3.4	4.1	3.2	1.0	1.9
Germany	5.3	3.0	0.9	3.9	4.1	6.7	7.1	5.9	2.7	2.7
France	6.5	1.1	3.0	4.4	4.1	4.9	4.1	3.0	2.0	2.0
Italy	1.3	-2.1	-0.9	-1.0	1.7	-1.7	1.2	1.2	-1.1	0.8
Spain	1.9	2.1	2.3	2.2	2.3	1.0	1.5	2.3	-2.1	2.1
Japan	6.8	-3.0	3.7	5.2	4.5	1.9	2.9	1.8	2.4	-1.5
UK	6.1	3.4	2.5	5.1	6.6	4.5	4.7	3.0	1.9	3.2
New Asia	13.1	-2.2	8.4	5.0	7.3	4.8	8.8	8.3	4.9	4.1
ULC										
Advanced	0.4	2.0	0.3	0.1	-0.7	-1.2	0.9	-0.1	1.5	1.2
USA	4.9	0.7	0.3	0.8	-0.2	-2.8	3.0	0.1	1.2	1.3
Euroland	-1.4	1.4	2.0	0.3	-0.2	-0.6	-0.2	-	2.2	1.0
Germany	-1.7	0.5	1.5	-1.3	-3.1	-4.2	-4.0	-3.1	-0.4	-0.8
France	-2.9	0.3	1.2	-1.9	0.8	-1.2	0.2	0.3	1.5	1.2
Italy	0.4	3.7	4.1	3.9	2.2	3.2	2.5	1.9	4.1	2.2
Spain	1.0	2.0	2.7	2.7	1.7	2.5	2.7	1.1	4.9	0.7
Japan	-6.4	4.0	-4.8	-4.0	-4.0	-0.6	-2.4	-1.4	-0.8	1.1
UK	-1.3	0.9	1.0	-1.4	-2.8	-0.8	0.4	0.5	1.2	0.5
New Asia	-3.6	7.9	-0.7	0.6	-1.2	0.7	-2.8	-2.4	1.0	0.7

(Source: International Monetary Fund, World Economic Outlook, October 2008)

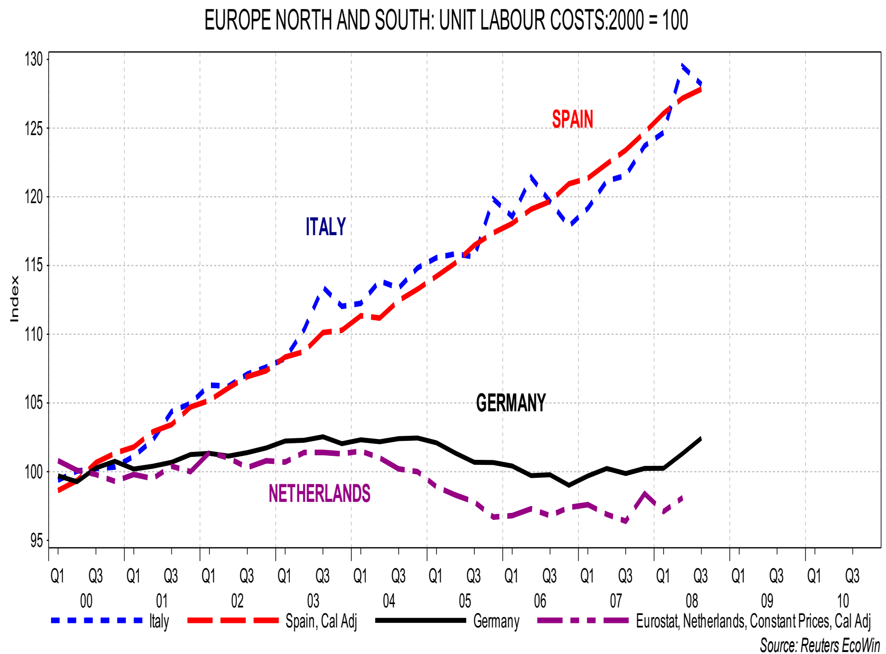
The greatest doubts about the sustainability of the euro as presently constituted has centred very much upon the North-South divide and in particular regarding Portugal, Italy, Ireland, Greece and Spain. The following graph illustrates the nature of the problem.

EUROZONE NORTH AND SOUTH - PRODUCTIVITY TRENDS PER HOURS WORKED



Once again, the loss of competitiveness of so many of the euro's component economies can be expressed, as in the next graph, in the trend of relative Unit Labour Costs. As can be seen the euro has in no way produced the economic 'convergence' of these disparate economies but rather is creating an ever wider divide.

The problem for the EU is not simply domestic, with the emergence of substantial eurozone trade imbalances it is also global and the country that has been particularly afflicted by the loss of competitiveness against emerging economies such as Turkey, India and of course China, is Italy. By tradition a highly entrepreneurial culture with a remarkable ability to respond to changing market conditions in world trade, Italy has been seen to lose all economic momentum to the extent that some commentators speak of the 'de-industrialisation' of that country.



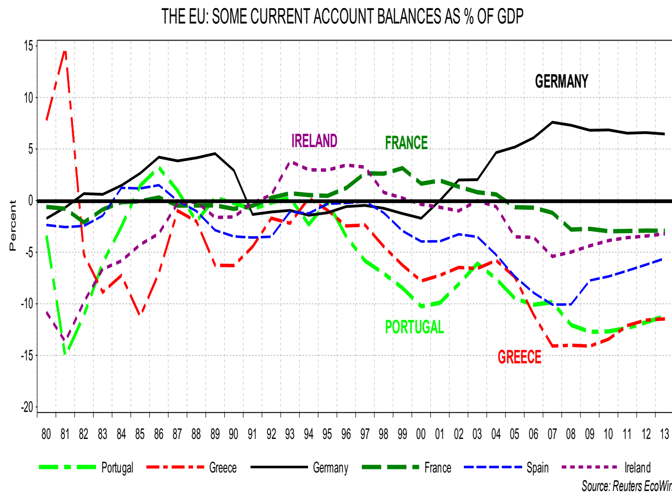
Yet again, the contrast between Italy and Germany (her largest single export market) could hardly be more stark.

And for other economies that do not have such a strong export culture as Italy, Greece and Spain for example, the situation is just as bad, the loss of competitiveness resulting in the emergence of trade and current account deficits that compare very badly with some economies in Eastern Europe which are not as yet economically trapped by euro membership. For these, such as the Baltic States, the option of abandoning their fixed exchange rate regimes and devaluing is still available.

For Portugal, Italy, Ireland, Greece and Spain this option is not available, short of precipitating a major economic and political crisis in Europe. This is by no means to say that such an outcome will not materialise.

THE EXTERNAL BALANCES:
THE ULTIMATE TEST OF COMPETITIVENESS

The eurozone is in a state of contradiction. On the one hand the largest economy, the extremely meritocratic Germany, generates a massive trade surplus and on the other hand, Spain, not exactly the World's second largest economic power, generates the second largest trade deficit in the world economy. And this within the realms of the single currency which we were told would being about economic 'convergence'.



The previous graph shows the manner in which current account trends have been extremely divergent and when it is remembered that the deterioration of the balances of Southern Europe began before the inception of the euro in 1999, then this makes the decision to continue with this perverse policy even more difficult to explain.

And even more perverse and impossible to explain in rational terms is the reasoning behind the declared intention of the nations of Eastern Europe to participate in this eccentric monetary adventure.

When reference is made to the dire condition of so many current account balances in Eastern Europe then it is indeed so consistent with Einstein's definition to say that it would be, unwise, for these economies to fix their exchange rates against their strongest immediate competitors at this juncture. Would joining the euro then bring about current account convergence?

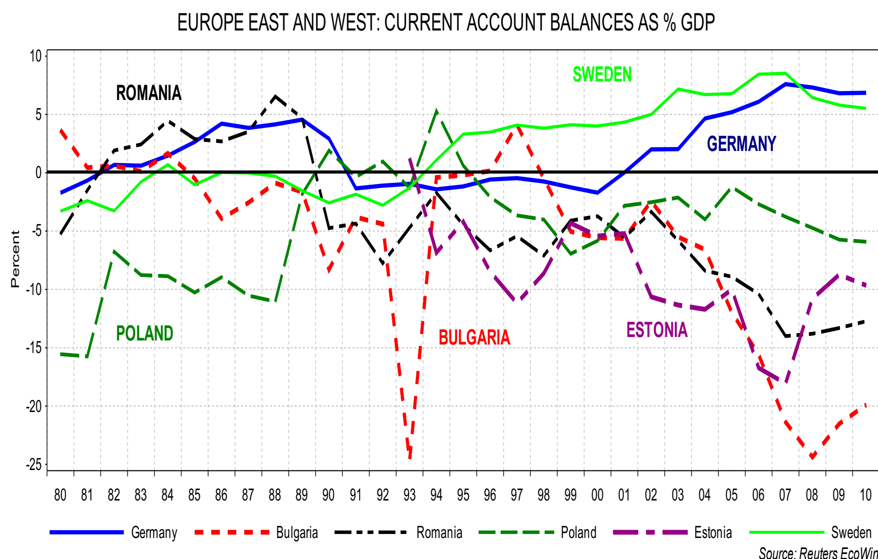
EUROPE EAST AND WEST: CURRENT ACCOUNT BALANCES AS % GDP

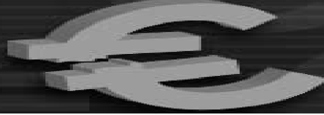
	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
USA	-4.3	-3.8	-4.4	-4.8	-5.3	-5.9	-6.0	-5.3	-4.6	-3.3
Euroland	-0.6	0.1	0.7	0.6	1.2	0.5	0.3	0.2	-0.5	-0.4
Germany	-1.7	-	2.0	2.0	4.7	5.2	6.1	7.6	7.3	6.8
France	1.6	1.9	1.4	0.8	0.6	-0.6	-0.7	-1.2	-2.8	-2.7
Italy	-0.5	-0.1	-0.8	-1.3	-0.9	-1.6	-2.6	-2.5	-2.8	-2.4
Spain	-4.0	-3.9	-3.3	-3.5	-5.3	-7.4	-8.9	-10.1	-10.1	-7.7
Netherlands	1.9	2.4	2.5	5.5	7.5	7.1	8.2	6.8	5.6	5.1
Belgium	4.0	3.4	4.6	4.1	3.5	2.6	2.7	2.1	-	-1.1
Austria	-0.7	-0.8	2.7	1.7	2.1	2.0	2.4	3.2	2.8	2.4
Finland	8.1	8.6	8.8	5.1	6.5	3.6	4.6	4.6	3.4	2.9
Greece	-7.8	-7.2	-6.5	-6.6	-5.8	-7.4	-11.1	-14.1	-14.0	-14.1
Portugal	-10.2	-9.9	-8.1	-6.1	-7.6	-9.5	-10.1	-9.8	-12.0	-12.7
Ireland	-0.4	-0.8	-1.0	-	-0.6	-3.5	-3.8	-5.4	-5.0	-4.4
Luxembourg	13.2	8.8	10.5	8.2	11.9	11.1	10.5	9.9	8.6	8.2
Cyprus	-5.2	-3.3	-3.7	-2.2	-5.0	-5.6	-6.9	-9.7	-9.7	-7.8
Malta	-13.1	-4.1	2.5	-3.1	-5.8	-8.7	-8.2	-5.4	-7.7	-6.4
Slovenia	-2.7	0.2	1.0	-0.8	-2.7	-2.0	-2.8	-4.9	-4.7	-4.7
Slovak Rep	-3.3	-8.3	-8.0	-5.9	-7.8	-8.5	-7.1	-5.4	-5.1	-4.7
UK	-2.6	-2.1	-1.7	-1.8	-2.1	-2.6	-3.4	-3.8	-3.6	-3.4
Bulgaria	-5.6	-5.6	-2.4	-5.5	-6.6	-12.0	-15.6	-21.4	-24.4	-21.5
Czech Rep.	-4.7	-5.3	-5.7	-6.3	-5.3	-1.3	-2.6	-1.8	-2.2	-2.5
Estonia	-5.4	-5.2	-10.6	-11.3	-11.7	-10.0	-16.7	-16.1	-10.8	-8.7
Hungary	-8.4	-6.0	-7.0	-7.9	-8.4	-6.8	-6.1	-5.0	-5.5	-6.1
Latvia	-4.7	-7.5	-6.7	-8.2	-12.8	-12.4	-22.7	-22.9	-15.1	-8.3
Lithuania	-5.9	-4.7	-5.2	-6.9	-7.7	-7.1	-10.7	-14.6	-14.9	-8.7
Poland	-5.8	-2.8	-2.5	-2.1	-4.0	-1.2	-2.7	-3.8	-4.7	-5.7
Romania	-3.7	-5.5	-3.3	6.8	-8.4	-8.9	-10.4	-14.0	-13.8	-13.3

(Source: International Monetary Fund, World Economic Outlook, October 2008)

The point should be made that the US current account deficit, hovering at between 5% and 6% of GDP has been described as being ‘unsustainable’ for at least twenty years. Within the sixteen euroland economies no less than twelve have current account deficits, and of these no less than seven were estimated by the IMF last year to have had deficits of 5% of GDP or more. Furthermore, three economies, Spain, Portugal and Greece were estimated to have deficits above 10% of GDP.

Turning to those economies of Eastern Europe that are seeking membership of this peculiar arrangement, it has to be said that they have no choice in the matter. Membership is mandatory under the terms of their treaties of accession. Slovenia and the Slovak Republic have already joined and of the remaining contenders, all eight have current account deficits. The Slovak Republic joined with a deficit of more than 5% of GDP in 2008. But then the Maastricht Criteria which governs eligibility for membership are hardly concerned with ‘real’ economic issues such as growth, unemployment, external deficits and so on. And of these eight economies, no less than seven have deficits of more than 5% of GDP. Even more incredibly, last year five of the eight had deficits of more than 10% of GDP.





This entire situation makes no sense and no sense can be made of it. For countries with huge current account deficits, which means the accumulation of external debt, to fix their exchange rates against both the euro and by proxy to the currencies of developing Asia, appears, to say the least, to lack a degree of rationality.

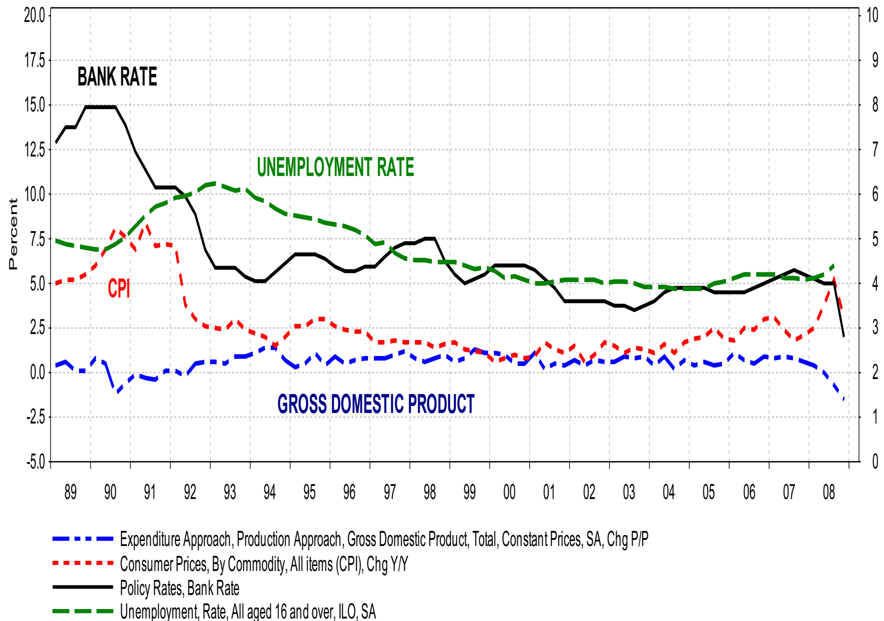
But this is the inevitable consequence of a system of political-economy which places political self-delusion above any consideration of actual economic and financial realities. There is only one certainty in all of this and that is that no good can come from it. Rather, the ruling elite in Brussels is simply creating huge problems – with no necessity whatever – while at the same time the EU is losing world export market share and dynamism to Asia. The political elite has a mindset that was determined in the 1940s.

THE UK AND THE ERM: THE IMPLICATIONS OF PREMATURE MONETARY UNION

The United Kingdom is not, thankfully, a participant in the peculiar monetary experiment known as the euro. However, a Conservative government took the UK into the ERM in October 1990, as a precursor to full monetary integration in the eurozone. This was the very moment when German monetary policy became dominated by the enormous costs and stresses associated with the reunification of East and West Germany – necessitating the Deutsche Bundesbank to adopt a tight monetary policy demanding high interest rates.

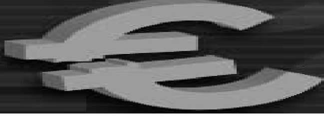
The UK Pound was a subservient currency, forced to accept an interest rate risk premium against the stronger currency to which it was pegged within the ERM. The timing could not have been more unfortunate and economically disastrous. Worse still, the UK entered the ERM at a hugely over-valued exchange rate of DM 2.95/£. This was done against the advice and common sense of the German monetary authorities.

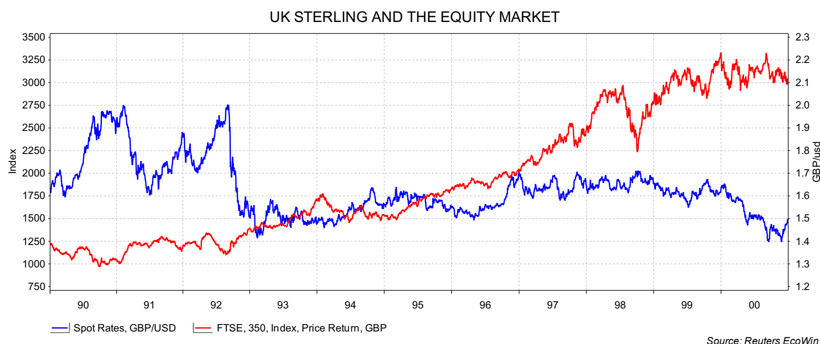
The UK, being hopelessly overvalued at a joining rate of DM 2.95/£ was under constant pressure from the markets to devalue and this was reflected in the risk premium attached to Sterling debt and money markets. The point then is that the government of Prime Minister John Major was determined to remain within the ERM regardless of the ruinous economic and financial price that had to be paid by the country at large, in terms of personal and corporate bankruptcy, home repossessions, unemployment, the balance of payments and the public finances. George Soros understood all this.



Source: Reuters EcoWin

Sterling was ejected from the Exchange Rate Mechanism on 16 September 1992, a date that has inexplicably become known as 'Black Wednesday', a pejorative term, when it should have been a celebratory and congratulatory term. The immediate and long-term consequences of Sterling's ejection were entirely beneficial as even the most blinkered euro-enthusiasts would find difficult to deny that economic growth recovered, unemployment and inflation declined and monetary policy was adjusted to a position appropriate to the realities of the British economy and not to John Major's puerile notion of the UK '…being at the heart of Europe…' whatever such mumbo-jumbo actually means – if anything.





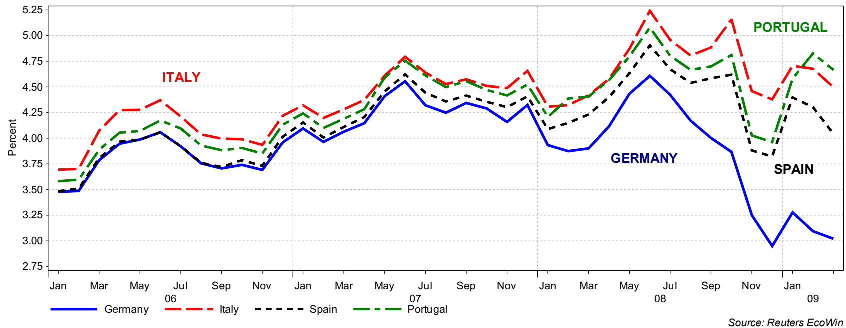
The point that emerges from the previous graph is simple: once liberated from the chains and constraints of a fixed exchange rate regime, the economy will prosper and this in turn will be reflected in the performance of the equity markets. Such was the case with the UK when the Pound was finally liberated from the prison of the ERM on 16 September 1992 – a day of economic liberation from a perverse and unworkable economic policy.

Exactly the same prospect is available and awaits the Italians. Even if devaluation is a cheap palliative and does not solve problems in the long term that does not matter; what is needed now is immediate palliatives – the panaceas can wait.

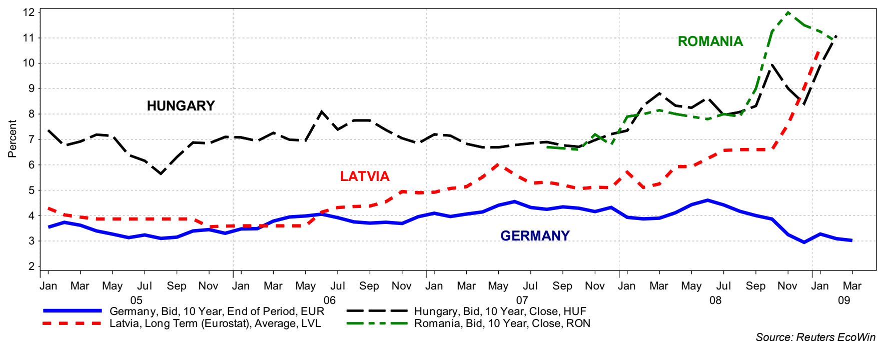
The credibility of the euro arrangement has recently been tested by the onset of the 'credit crunch' and the resulting economic stresses. The most obvious expression of market doubts about the sustainability of the present situation is that of the government bond markets. The spread between the 10 year benchmark German bond yield and that of both existing and aspiring members of the euro could not be more unambiguous.

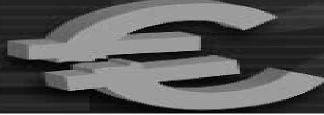
As can be seen in the chart above, the situation for existing member states of the euro is all too often dire, with huge implications for the borrowing costs and credit status of these sovereign debtors. But for the aspiring member states, the situation appears totally untenable – except in the myopic vision of the ruling elite.

The point is that communism has only been gone for less than two decades and it is impossible to believe that the economic mis-management, corruption and incompetence of the socialist era, following as they did the extremely destructive Second World War, can be corrected in the space of less than twenty years.



And to think that these economies can stand and succeed in the same currency unit as the resurgent Germany is indeed eccentric to the point of Einstein's definition of insanity.





CONCLUSION

The conclusion to this argument is brief because one does not really exist that is acceptable in both economic and political terms. This situation is the direct result of flawed economic policy making by two or three generations of the political class. Politicians never admit to their mistakes and this means that economic rationality is put to one side in defence of political reputations, or ‘legacies’.

This means that the government of Europe, Old and New, will continue to be in a state of denial blaming policy failures upon the market, which are at present in a very defensive and disgraced state. The present low reputation of the banking sector makes it all the easier for politicians to blame the ills of the world onto the ‘Anglo-Saxon’ system and ‘speculators’.

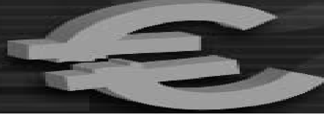
This means that there will be no adequate political response to this situation.

Economically, the continuation of the situation described above will only make matters worse because the countries most immediately concerned have shown themselves to be incapable of undertaking the kind of economic reform that could help to rectify the position. In countries such as Greece, Italy, even France, Spain and Portugal, there are too many vested interests that will protect their own privileges thus preventing any meaningful structural reforms.

And as a consequence of the mismanagement of monetary affairs there is also the financial dimension. Countries such as the Baltic States have been encouraged by low euro interest rates to borrow massively in euro and Swedish Kroner. If they abandon their fixed exchange rate regimes – thus ending their chances of early membership of the euro – then their external debt burden becomes even more onerous. This could even be ruinous.

One practical solution would be for Greece, Italy, Spain and Portugal, Ireland as well possibly, to absent themselves ‘temporarily’ from the euro in order to allow them to resume their national currencies and devalue – just like Sterling’s ejection in 1992. But this would unleash a myriad of tensions within the European Union that could easily be life threatening for that self-perpetuating institution and its highly privileged apparatchiks.

Perhaps the only conclusion can be that presented with a serious economic problem of their own making, the policy makers are seen to be incapable of acting. Thus, the economic imbalances and distortions which have been mentioned above will continue to worsen. The political consequences of such a scenario are difficult to predict but they are likely to be destabilising and messy.



If this reasoning is correct and its conclusions also, that the euro as a hybrid fixed exchange rate regime is unsustainable, then the issue of its failure must be addressed.

The financial consequences of past policy errors are that future borrowing costs will become prohibitively expensive in weaker economies such as Portugal and Greece. Equally, the cost of debt serving means that devaluation will be ruinously expensive. The combination of credit risk evaluation and currency devaluation makes any market driven resolution of the present situation appear disastrous.

It is remarkable that the activities and intentions of the Brussels elite have not invited more overt political opposition. In part this has been due to the corrosive effects of corruption and patronage; but the political future can never be fully anticipated. In the case of the European Union this can only ultimately result in the rejection of government by the venal and corrupt institutions of the EU and a subsequent return to democratic rule by accountable national governments that uphold the rule of law.

THE BRUGES GROUP

The Bruges Group is an independent all–party think tank. Set up in February 1989, its aim was to promote the idea of a less centralised European structure than that emerging in Brussels. Its inspiration was Margaret Thatcher's Bruges speech in September 1988, in which she remarked that "We have not successfully rolled back the frontiers of the state in Britain, only to see them re–imposed at a European level…". The Bruges Group has had a major effect on public opinion and forged links with Members of Parliament as well as with similarly minded groups in other countries. The Bruges Group spearheads the intellectual battle against the notion of "ever–closer Union" in Europe. Through its ground–breaking publications and wide–ranging discussions it will continue its fight against further integration and, above all, against British involvement in a single European state.

WHO WE ARE

Honorary President: The Rt. Hon the Baroness Thatcher of Kesteven, LG OM FRS
Vice-President: The Rt. Hon the Lord Lamont of Lerwick
Co-Chairmen: Dr Brian Hindley & Barry Legg
Director: Robert Oulds MA
Head of Research: Dr Helen Szamuely
Washington D.C. Representative: John O'Sullivan, CBE
Founder Chairman: Lord Harris of High Cross
Former Chairmen: Dr Martin Holmes & Professor Kenneth Minogue

Academic Advisory Council:
Professor Tim Congdon
Professor Kenneth Minogue
Professor Christie Davies
Professor Norman Stone
Dr Richard Howarth
Professor Patrick Minford
Ruth Lea
Andrew Roberts
Martin Howe, QC
John O'Sullivan, CBE

Sponsors and Patrons:
E P Gardner
Dryden Gilling-Smith
Lord Kalms
David Caldow
Andrew Cook
Lord Howard
Brian Kingham
Lord Pearson of Rannoch
Eddie Addison
Ian Butler
Thomas Griffin
Lord Young of Graffham
Michael Fisher
Oliver Marriott
Hon. Sir Rocco Forte
Graham Hale
W J Edwards
Michael Freeman
Richard E.L. Smith

BRUGES GROUP MEETINGS

The Bruges Group holds regular high–profile public meetings, seminars, debates and conferences. These enable influential speakers to contribute to the European debate.Speakers are selected purely by the contribution they can make to enhance the debate.

For further information about the Bruges Group, to attend our meetings, or join and receive our publications, please see the membership form at the end of this paper. Alternatively, you can visit our website www.brugesgroup.com or contact us at info@brugesgroup.com.

Contact us
For more information about the Bruges Group please contact:
Robert Oulds, Director
The Bruges Group, 227 Linen Hall, 162-168 Regent Street, London W1B 5TB
Tel: +44 (0)20 7287 4414
Email: info@brugesgroup.com

www.brugesgroup.com