

THE EURO CURRENCY CUL-DE-SAC

Seventeen years of broken promises –
and now a dead end.



THE BREXIT PAPERS

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Bob Lyddon

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Printed by The Edinburgh Copy Shop, 52 St Mary's Street, Edinburgh EH1 1SX

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THE BREXIT PAPERS – No.2



Published by
Global Britain, 55 Tufton Street, London SW1P 3QL

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THE UK has decided to leave the EU. Was there really any viable alternative when we had no commitment to join the euro, and were torn between our own policies and the ones of the mainstream EU, whose principle aim was and is to protect the euro?

The UK was always on soft ground being in the EU but permanently outside the euro, when the economic policy of the EU, its legislative agenda, and its monetary policy are inextricably linked with the euro. Our detaching the pound from the ERM was a token gesture when measured against our implementation of so many euro-reinforcing Directives and Regulations.

The euro itself has reached an impasse. At its heart is a crass imbalance of internal EU trade between creditor and debtor nations, and a financial system that recycles the debtors' money back to the creditors to help the latter pay for the next shipment of imports from the former.

That can continue until the debt capacity of the debtors is maxed out, as it has been on the open market but not quite yet within the funding mechanisms that the Eurozone makes available.

Sub-optimal and synthetic

Painful as it may be in the short term for the UK to withdraw from a 'free trade area', it is not a fully functioning free trade area, and it is largely based on a currency that is a synthetic: it exists in many unequal forms, most notably in the government bonds of the Eurozone member states. Although these are all supposed to represent 'central bank money' and be free of credit risk for an investor, there is no longer any pretence that this is the case. Furthermore, the euro's impact and its long-term viability can be

judged from its original objectives, the current predicament of its Member States, and from the many initiatives - hitherto fruitless - undertaken by EU policy-makers to get the euro to deliver on its promises to the EU citizenry.

In the beginning

The euro was launched on 1st January 1999, its predecessor being the EU's basket currency, the ECU. The ECU was composed of weightings of EU Member State national currencies and was converted into the euro at 1:1. The national currencies of the Euro-joiners were also converted into the euro at irrevocably fixed rates of exchange on the same date but were allowed to continue in being for 3½ years as denominations of the euro. They were suppressed completely as of 30th June 2002, the date upon which national currency note and coin ceased to be legal tender.

Many objectives were set for the euro, not least that it was needed to underpin the EU free trade area called the Single Market. A single currency would:

- increase direct, cross-border SME-SME trading, rather than SMEs being confined to trading in their national markets and cross-border trade being the preserve only of the larger, multinational companies;
- cut the costs of trading within the EU and eliminate the uncertainties regarding exchange rate fluctuations;
- create a single capital market in euro, a much larger market than existed in all the predecessor countries put together, because:
 - the euro would become a reserve currency to rival the USD, and many institutions would hold assets in EUR when they never held balances in ITL, PTE, IEP, FIM...
 - there would be greater liquidity in the market because it was bigger
 - it would be a safer market to trade in for this reason, so investors would commit a larger quantum to the merged market in EUR than they did to its predecessors, and make a net re-allocation of assets out of the USA, Japan and elsewhere and into the Eurozone,
- make capital available to EU businesses in much larger quantity and across the entire spectrum of debt and equity instruments: each one would become a large sub-market in its own right, offering specific risk-return characteristics and being liquid (meaning a two-way price would be available in market lot sizes from a number of market-makers during normal business hours);

- enable pan-European banks to emerge with the scale of the large US banks; and,
- aid the attainment of the EU objective of becoming an economic player rivalling the USA, China and Japan when looked upon in aggregate.

Two virtuous circles for end-users of products and services would emerge:

1. Breakdown of national compartments in the EU market in each category of products and services > each category becomes a pan-European market of its own with economies of scale > it is easier for participants to attract investment monies because the returns can be obtained from a much larger addressable market > quantum leap in new investment > innovation > better products and services; and,
2. Pan-European markets > served by pan-European participants > price transparency > price comparison > price reduction.

In parallel with these policy aims, though, the overriding objective of the euro is laid down in the Treaty on the Functioning of the European Union, Article 127 (1): to maintain price stability – “ensuring price stability is the most important contribution that monetary policy can make to achieving a favorable economic environment and a high level of employment”. This prioritisation is partially qualified: “Without prejudice to the objective of price stability”, the Eurosystem shall also “support the general economic policies in the Union with a view to contributing to the achievement of the objectives of the Union”. These include *inter alia* “full employment” and “balanced economic growth”.

In concrete terms the Governing Council of the European Central Bank has defined price stability as “a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%. Price stability is to be maintained over the medium term”.

Indeed this is being achieved, by quite some margin, and the picture of the Eurozone economy as a whole does not compare unfavorably to those of the USA, China and Japan, when one takes a helicopter view of the Eurozone economy from the ECB. The ECB view¹ reads like a catechism about the functioning of an economy, namely that:

- the benefits of price stability are substantial: stable prices on a

sustained basis are a crucial pre-condition for increasing economic welfare and the growth potential of an economy; and,

- the natural role of monetary policy in the economy is to maintain price stability. Monetary policy can affect real activity only in the shorter term, but ultimately it can only influence the price level in the economy.

The ECB's explanation goes on to bracket the objective of price stability as referring to the general level of prices in the economy, so as to avoid both prolonged inflation and deflation. The Articles of Faith continue by stating that price stability contributes to achieving high levels of economic activity and employment by:

- improving the transparency of the price mechanism: people can recognise changes in relative prices (i.e. prices between different goods), without being confused by changes in the overall price level. This allows them to make well-informed consumption and investment decisions and to allocate resources more efficiently;
- reducing inflation risk premia in interest rates (i.e. compensation creditors ask for the risks associated with holding nominal assets). This reduces real interest rates and increases incentives to invest;
- avoiding unproductive activities to hedge against the negative impact of inflation or deflation;
- reducing distortions of inflation or deflation, which can exacerbate the distortionary impact on economic behaviour of tax and social security systems; and,
- preventing an arbitrary redistribution of wealth and income as a result of unexpected inflation or deflation.

Expectations and outcomes mismatch

This all very well but after seventeen years what has happened?

- Prices in euro accelerated upwards to reach a high common denominator, at which level they are stable now;
- The euro itself has become what used to be known as a Low Interest Rate Currency or LIRC, with a low nominal interest rate and a rising value against other currencies;
- The ECU has thus lost that component of its basket that was (i) GBP and DKK (ii) the weak euro currencies - ITL, ESP, PTE, and GRD and (iii) the medium euro currencies – FRF and IEP, and continued only with the

weightings of the strong currencies: DEM and the ones that had been locked closely to the DEM over many years: LUF, BEF, and NLG;

- EU exports have become more expensive;
- There is indeed no inflation risk premium in interest rates: the euro yield curve in the most creditworthy country (Germany) is completely flat, and the nominal interest rate is at or below the rate of inflation;
- Investors in low-risk instruments do not receive the annuity-style income they should be getting in a “normal” financial market: inflation plus a small premium;
- This kicks away the props under any form of prudential personal financial planning;
- Zero or negative interest rates have encouraged excessive borrowing and discouraged private savings;
- Wage levels have stagnated or even been eroded, both in nominal terms and in real terms;
- Taxes are high, because the public sector remains very large as a proportion of the whole economy;
- Private capital formation is very low, which means low savings rates and an absence from capital markets of direct retail investment (as opposed to indirect through funds, or doubly indirect through a fund in which a pension plan is invested);
- The large capital market with liquid sub-markets in instruments right along the spectrum of debt to equity has not emerged;
- Governments take a disproportionate slice of available capital, along with other big borrowers like the European Investment Bank, which are backed by governments;
- Despite the sub-prime fiasco in the USA, there remains a large capital market in mortgage-backed instruments of various flavours;
- In other words the credit risk appetite of investors is disproportionately for instruments that are either taxpayer-backed or real-estate-backed - i.e. very low credit risk – and these instruments do not deliver a “real” rate of return;
- Nevertheless, investment is concentrated in these instruments that represent what Adam Smith would have termed “rent-collecting”, the lowest form of economic activity below labour, which is below the highest form: risk-investing;
- The euro has disincentivised risk investing – investors do not regard the Eurozone as a stable and benevolent long-term investment environment; and,
- The result has been a colossal mis-allocation of resources towards

“rent-collecting”, led by the EU public authorities in the name of creating the preconditions for a free market.

Dangerous imbalance

The free trade area that the euro has supported is now characterised by an entrenched and dangerous structural imbalance, between creditor nations (Germany) and debtor nations (a majority of the others), within which the commercial banks and the Eurosystem (i.e the ECB and the national central banks) conduit the money from debtor to creditor and back, such that the debtor nation is borrowing from the creditor nation in order to buy the creditor nation’s goods and services.

It is a truism of free trade arrangements that under them the weaker partner deindustrialises and the stronger one is the beneficiary. An aspect of that, as far as the EU is concerned, is that the high-value-added jobs have become established and concentrated in certain Member States (often the small ones with artificially favourable domestic tax regimes), whilst the de-industrialising Member States see an increase in low- or medium-skilled jobs. The freedom of choice of establishment in the Single Market combines with the freedom of movement of labour, to reduce the amount of value-added in the de-industrialising Member States, increase the number of low- or medium-skilled jobs, and vastly increase the number of low- or medium-skilled job applicants.

This leads to wage deflation – both nominal and real – for a very large number of European citizens, and complete wage deflation for many - unemployment. Then, since the money available in the local economy is not being created as value-added in the local economy itself but being borrowed back from creditor nations, the local economy’s growth potential is limited to its unutilised debt capacity.

In Greece the capacity ran out. In Italy, Spain, Portugal, Ireland and Cyprus the capacity has been elongated by the European authorities, notably acting through the European Investment Bank.

To find comparisons outside the Eurozone, the results have some similarity to those of NAFTA on US manufacturing – a point of Donald Trump’s appeal to blue collar America.

A Zollverein stepping stone?

The situation also inevitably draws comparisons with the Prussian customs union or “Zollverein” which acted as a stepping stone towards the creation of a unified Germany in 1871.

The identification of German political benefit with customs unions did not begin or end with the “Zollverein”. The historian Hew Strachan in his book “The First World War” demonstrates that German war aims as formulated in early 1917, when a compromise peace with Britain, France and Russia might have been possible, were for a “German peace” with a customs union led by Germany and with the involvement of Austro-Hungary and Romania, thereby solidifying Germany’s hold over its supposed allies and converting them to a *de facto* part of the peacetime German economy, no different from Alsace-Lorraine and a large slice of Belgium which Germany also proposed to retain.

In fact the western end of that “Zollverein” would have encompassed a very similar territory to the immediate predecessor of the EU - the European Coal and Steel Community – established in 1951 with the aim of pooling ownership of the war-making capacity of Germany, France, Belgium, Luxembourg and the Netherlands, namely their coal, iron and steel reserves and facilities.

In the present day, though, the Eurozone version of a “Zollverein” is not necessarily benefiting Germany in the long term, since it is acting as a brake on Germany’s growth as well, with a highly-valued currency restricting its exports outside the new “Zollverein” and with stagnation in its main export markets within it.

Taking eight of the nineteen Eurozone countries as examples, the statistics that most affect people’s lives make grim reading.

The following table shows a broadly stagnant economy with sporadic recession and deflation, wide variances in employment levels and appalling youth unemployment. 10.6% youth unemployment in the Netherlands is shameful, but looks good in comparison with all the others except Germany.

COMPARATIVE UNEMPLOYMENT & GROWTH

	Unemployment	Youth unemployment	GDP Growth	Inflation	'Real' GDP Growth
Germany	4%	7%	0.4%	0.7%	(0.3%)
Netherlands	6%	11%	0.6%	0.1%	0.5%
France	10%	25%	(0.1%)	0.4%	(0.5%)
Finland	7%	21%	0.0%	0.4%	(0.4%)
Spain	20%	43%	0.8%	0.3%	0.5%
Italy	11%	39%	0.0%	0.1%	(0.1%)
Greece	23%	43%	0.2%	(1.0%)	0.3%
Portugal	11%	28%	0.3%	0.6%	(0.3%)

Data for September 2016 Source: Trading Economics

To set against that we have the continuous and determinedly optimistic initiatives of the EU political units, normally introduced by an element of denial such as an objective being set of “further strengthening European Monetary Union” as if EMU were already strong:

- Lisbon Strategy for Growth and Jobs 2000;
- The March 2005 re-launch of the Lisbon Strategy;
- In March 2008, a new policy cycle started and then we had the Europe 2020 Strategy for creating jobs (e.g. 75% of 20 - 64 year olds to be employed) and promoting growth through economic and social reforms, while respecting environmental limitations, and including:
 - the re-launch of the Single Market
 - aligning the EU budget and EIB lending with the Strategy, and
 - a new trade strategy improving global market access for EU companies;
- The Euro Plus Pact agreed by euro area leaders in March 2011, to further strengthen the economic pillar of monetary union by improving competitiveness and enhancing economic policy coordination, thereby leading to a higher degree of convergence; and,
- The Treaty on Stability, Co-ordination and Governance in the EMU of 2012 - the Fiscal Stability Treaty - to agree to reduce the ratio of government debt to GDP to 60% by 2030.

These initiatives have had little impact so far. Italy is discussing “EU fiscal flexibility” regarding its compliance with the Fiscal Stability Treaty and that is at the level of the direct debt of the Republic of Italy: debt at regional

and municipal authority level, and in publicly-owned limited-liability companies, has risen sharply to make good what the Republic was not allowed to add to its own debts – and now the Republic has even failed to hit its very modest target for debt stabilisation (let alone debt reduction).

Unmitigated failure

The euro itself has failed on numerous of its own objectives and the trade-off for each Member State has all the hallmarks of a disaster for those ones with weaker economies: surrendering autonomous control over public debt levels, interest and exchange rates, in order to obtain a hard currency, a de-industrialising economy, increasing debts to the European institutions and, through them, to Germany, and a complete absence of policy levers to pull.

The aggregate figures for the Eurozone economy allow the ECB to view a serene external picture that masks the disaster within. Given the overall picture, the ECB's mandate under the Treaties and the means at its disposal do not require emergency action of it, beyond the ECB's QE, whose stated aim is to do whatever it takes to protect the euro – not “whatever it takes to reduce youth unemployment”. That is the dead-end that the euro has caused its adopters and policy-makers to drive into.

There will be some pain for the UK in detaching ourselves from the policies at the EU level whose sole aim is to bolster the euro. But the euro has not been a success, and its situation is deteriorating. Did we really want to be shackled to a corpse?

Bob Lyddon
27 October 2016

Summary of
The euro currency cul-de-sac

*The euro – 17 years of broken promises
and now a dead end*

- The euro was established in 1999: all 27 other EU Member States are either in it, committed to join it, or pursuing policies in exact alignment with it;
- For this reason all EU policy initiatives, regulations and directives in the economic and monetary spheres – and many in other spheres as well – are dedicated to defending the euro;
- The UK is out-of-step, pursuing divergent economic policies while having EU initiatives, regulations and directives imposed upon it: this position was untenable;

What will we be missing out on?

- The euro's principal aim is price stability: the catechism establishes price stability as the principal aim of monetary policy, with a wave in the direction of full employment and balanced economic growth;
- Prices have indeed stabilised: after rising to the highest common denominator they have stagnated, and Eurozone inflation is currently at least 1% lower than the European Central Bank target of not more than 2%, and in some countries (Slovakia & Greece) inflation is below 0% i.e. a damaging deflation;
- GDP growth is even lower than inflation in a number of Eurozone countries (Germany, Finland, France, Italy & Portugal) – they are in recession in real terms, and there is no hint of “balanced economic growth”;
- What about “full employment”? Unemployment exceeds 10% in many Eurozone countries, and youth unemployment is catastrophic (43% in Greece & Spain);
- The Eurozone Member States have surrendered the policy tools to address these issues to the Eurozone authorities, but they in turn see no need use them: from their viewpoint the Eurozone as a whole is performing quite adequately compared to the USA, Japan and China;
- At the micro level the euro has failed to deliver on almost all its objectives for Eurozone citizens and small businesses;
- Many Eurozone countries are de-industrialising as the UK has;
- The Eurozone has a crass internal trade imbalance, and Germany can continue to export for as long as either the European authorities enable

further credit for the importer countries – which is being arranged through financial mechanisms of which the UK is a guarantor – or private finance deals continue to be available e.g. for new German cars in the UK;

- The European authorities have nothing to offer but more of the same, which has been failing since the euro's launch;
- Painful as it might be for the UK to withdraw from the EU Single Market in the short term (although the EU is by no means a single market anyway), there is no certainty that even current levels of demand for UK goods and services within that market will persist, and we would have to swallow further medicines from the European authorities aimed at the Eurozone and irrelevant to our situation in the UK; and,

There was only one possible answer to that choice and the British people gave it: Nej takk!

About the author...

Bob Lyddon

Bob Lyddon is an experienced management consultant both privately and with PwC. Recent engagements include running an international banking alliance, advising small payment providers how to access UK payment systems, and advising a major player in global payments as to the opportunities and threats arising from the establishment the UK's Payment Systems Regulator.

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