DOI: 10.1007/s10272-011-0381-8

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The Euro – a Story of Misunderstanding

From the very beginning of the European Monetary Union the crucial institutions, the European Commission and the European Central Bank, led by mainstream economic thinking, were not up to their task of controlling the core of the system effectively. A huge gap in competitiveness among the member states has arisen due to German wage-dumping policy on the one hand and, on the other, wage growth in Southern Europe which is above the growth of productivity plus the inflation target of 2%. A European-wide coordination of wage policy is the only promising way to close this gap. However, as wages and competitiveness are not high on the agenda of the politicians responsible and their advisers, time to save the euro is running out.

The European Economic and Monetary Union (EMU) is facing increased international and internal scrutiny. More and more observers are questioning the viability of a monetary system with absolutely fixed nominal exchange rates but dramatically divergent real exchange rates and real interest rates. Even worse, despite the accelerating pace of divergence and the everyday threat of panic in the money markets of vulnerable member states, European politics at the highest level fails to understand the cause of the crisis and to address it with a consistent plan. A recent statement by Chancellor Merkel about the impossibility of having different holiday entitlements in the member states of a monetary union[1] proves this with unprecedented clarity.

This is particularly tragic, as the monetary union was an excellent economic idea. Its foreseeable failure will prevent many useful attempts in the future to replace the vagaries of the financial markets in determining exchange rates with an orderly adjustment of the value of currencies to the fundamentals. But the best idea is useless if its protagonists and those politicians putting it into practice fail to understand it. In this respect, the history of the euro is a story of misunderstanding. From the outset neither the European Commission (EC) nor the European Central Bank (ECB) was up to the task of controlling the core of the system effectively. This is potentially the result of the failure of mainstream economic thinking. The crucial institutions were misled from the very beginning. They began to realise their failure only in the face of the crisis – but time is now running out for successful changes to save the euro.

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The Roots of the Misunderstanding

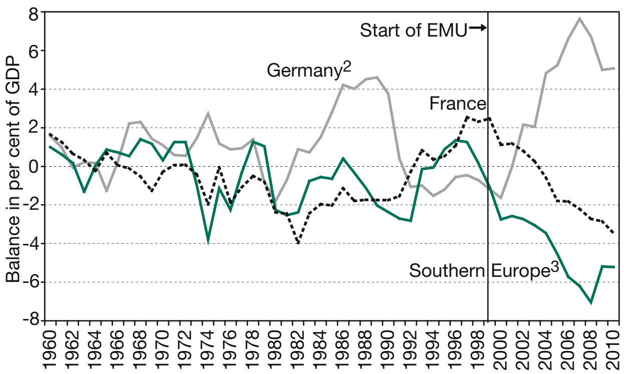
The core of a monetary union is the agreement of all member states on a target inflation rate and nothing else. A monetary union is not a union of harmonised public budget targets or of harmonised holiday entitlements. But unfortunately, many of those who were in favour of the monetary union had, and still have, an unbalanced view of the constitutional elements of a currency union. The focus of the EC and the member states on government deficits and public debt was driven by the overwhelming neoliberal agenda to minimise government and replace it with the private sector wherever possible. Instead of being alerted by the dramatically divergent development of prices, wages and unit labour costs, they fine-tuned the rules for budgetary discipline time and again.

But even today the deluge of comments on the EMU crisis overlooks the crucial inflation divergences and the induced external imbalances inside the monetary union. Greece's budget problems and those of other southern members of the EMU are a problem, but they are closely related to external deficits. On the other hand, Germany's sound budget position is to a large degree the result of the huge external stimulus it got in the last decade. Spain even provides an example of a country under scrutiny despite a strong budget position because its external deficit before the crisis was huge.

Wage and price divergence is at the core of the trouble. A monetary union is primarily an agreement on inflation, because each member state explicitly forgoes its right to have a national monetary policy and its own inflation target rate. All other targets may be of use in one way or

1 See Spiegel Online 18 May 2011, http://www.spiegel.de/politik/deutschland/0,1518,763247,00.html.

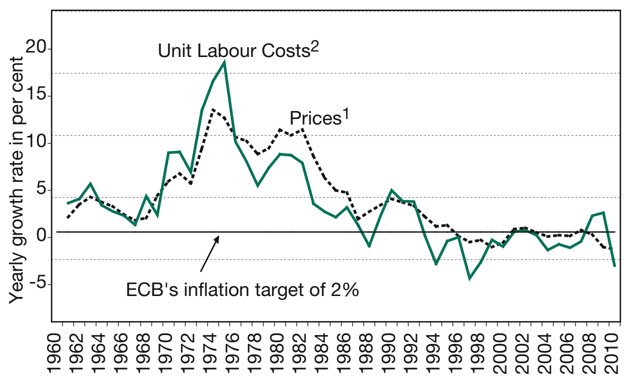
Figure 1
Historically Large Trade Imbalances[1]



[1] Current account balance in per cent of GDP; negative values: deficit, positive values: surplus. [2] 1960-1990 West Germany. [3] Greece, Portugal, Spain and Italy.

Source: AMECO database (updated May 2011); own calculations.

Figure 2
EMU Countries: Unit Labour Costs Drive Prices



[1] GDP deflator. [2] Compensation of employees (total economy) in ECU or euro per employee divided by real GDP per employed person; concept of fulltime equivalents where available.

Source: AMECO database (updated May 2011); own calculations.

another to reach the inflation target as a by-product of sorts, but if the union is not able to agree on the need to keep inflation and its main determinants in all countries on the target path forever, all other attempts to harmonise the one or the other variable will be in vain. In a world of absolutely fixed exchange rates or in a single currency area, a lasting deviation of prices and unit labour costs in one country from its main trading partners creates unsustainable external deficits and threatens the economic survival of the currency arrangement, including a currency union.

The key for the future of EMU, if there is any, is to be found in external adjustment in all countries and not in lopsided government belt-tightening around the Mediterranean Sea. It is the external imbalances that will force the dissolution of EMU if strong corrective action is not taken soon. The imbalances are historically large (Figure 1) and force adjustment on both sides. If the surplus country refuses to become a deficit country, default of the debtor is unavoidable, because a long and painful recession that would produce a surplus *only* through the fall of imports will be politically unfeasible. This is the same logic underlying the stark warning Mr. Keynes issued in 1919 concerning the dangerous economic effects of the reparations Germany was forced to pay for the war. If Europe has still not understood that lesson, the political implications for many European countries could be equally alarming.[2]

2 See John Maynard Keynes: The Economic Consequences of the Peace, Harcourt Brace, New York 1920; and Heiner Flassbeck: Preise, Zins und Wechselkurs – Zur Theorie der offenen Volkswirtschaft bei flexiblen Wechselkursen, Wirtschaftswissenschaftliche und wirtschaftsrechtliche Untersuchungen des Walter Eucken Instituts, No. 23, Tübingen 1988, J.C.B. Mohr (Paul Siebeck).

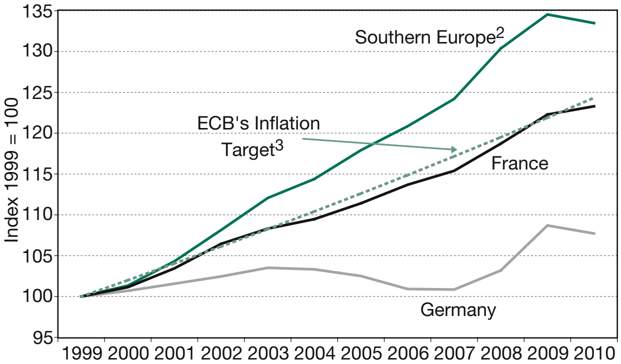
The consequences of this diagnosis are straightforward but difficult to swallow for the standard-bearers of the mainstream economic approach in the EC and ECB. A monetary union in agreement about an inflation target of close to two per cent has to coordinate wage developments in the member states. This is the case because the most important determinant of inflation is unit labour cost growth (Figure 2). Wages and unit labour costs reliably determine prices. As long as trade unions accept their responsibility for the inflation target, monetary policy is free to stimulate the economy to reach other targets like a high level of employment and can abandon its exclusive control of inflation.

This leads to the roots of the misunderstanding. For the EC as well as the ECB, as strong believers in free markets, monetarism and in particular flexible labour markets, the approach to guarantee a low but positive inflation rate based on monetary policy for the union as a whole instead of wage coordination was overwhelmingly attractive. But in reality the relationship of money to inflation is weak, and even if it were relevant it would only play at the level of the union as a whole. However, persistent divergences of inflation rates inside the monetary union are fatal because the differences in the cost and price level among the member countries accumulate over time and produce real exchange rate appreciation and depreciation, or, in other words, unsustainable over- and undervaluation for currencies that no longer exist.

For a monetary union to function properly, nominal wages at the national level have to rise in line with *national* productivity in all member countries plus the commonly

Figure 3

Unit Labour Cost[1] Divergence Opens a Huge Competitiveness Gap Within EMU



[1] Index of Unit Labour Cost of total economy 1999 = 100. [2] Greece, Portugal, Spain and Italy. [3] Yearly increase of 2%.

Source: AMECO database (updated May 2011); own calculations.

agreed inflation target. This implies that real wages at the national level have to grow in line with the growth of national productivity. With so many national politicians and European officials as strong believers in wage flexibility, a fatal conflict was unavoidable. Consequently, the crucial construction error of EMU was the limitation of the criterion of inflation convergence to one point in time (1997 for the founding members) and from there on only to overall EMU instead of a strictly binding target for each country for every year of its membership.

The German Experiment

Since the start of the Union in 1999 Germany, its biggest country and the European stronghold of external stability for several decades, has tested a new way to fight its unemployment. It decoupled implicitly from the common inflation target by putting political pressure on its unions to restrict the growth of nominal and real wages. As a result, nominal and real wage growth remained far below the pace expected by partner countries and the markets.

Germany's vigorous attempt to tackle its persistently high unemployment rate was clearly grounded in the neoclassical conviction that lower wages would result in a more labour-intensive mode of production. After working-time reduction schemes had failed to deliver the expected result, union leaders signed a tripartite agreement in 1996 to abandon the formula hitherto used to determine wage growth – based on equal participation of workers in productivity growth (compared to capital) – and instead agreed to "reserve productivity growth for employment".[3]

The agreement resulted in a fundamental break with the German tradition of targeting a low and stable inflation rate. Historically, Germany had been characterised by moderate wage increases based on agreements that would allow the labour side to raise real hourly wages (nominal hourly wages adjusted for inflation) in line with hourly productivity (real GDP divided by the number of hours worked). An alternative which expressed exactly the same relationship in different terms was to allow an increase of unit labour costs (nominal hourly wages divided by real GDP per hour worked) in line with an inflation target of roughly two per cent.

The new German labour market approach coincided with the beginning of the currency union and brought about a huge divergence in the movements of unit labour costs among the members of the new currency union. Since the start of EMU, German unit labour costs, the most important determinant of prices and competitiveness, have hardly risen (see Figure 3).[4]

In most of the countries in Southern Europe, on the other hand, nominal wage growth exceeded national productivity growth and the commonly agreed inflation target of two per cent by a low but rather stable margin. France was the only country to exactly meet the agreed path for nominal wage growth, as it was perfectly in line with the national productivity performance and the inflation target of two per cent.

The dynamics of such a "small" annual divergence yield dramatically huge gaps over time. At the end of the first decade, the cost and price gap between Germany and Southern Europe amounted to some 25 per cent and between Germany and France to 15 per cent. In other words, Germany's real exchange rate had depreciated

3 See Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Staatsfinanzen konsolidieren – Steuersystem reformieren, Jahresgutachten 2003/04, Ziffer 635 ff.; and Heiner Flassbeck, Friederike Spiecker: Die deutsche Lohnpolitik sprengt die Europäische Währungsunion, WSI-Mitteilungen 12/2005.

4 One line of German defence was the argument that high unemployment had forced the German wage dumping. However, unemployment is a feature in most EMU member states, and the German wage restraint did not eliminate it because the domestic demand gap has offset the external demand boom. Between 2000 and 2010, the overall German growth performance was a meagre 0.6 per cent annually, which was only half of France's. Gross fixed capital formation fell to 0.2 per cent compared to an increase of 1.4 per cent in France. Moreover, countries seeking to repress wages for domestic or other reasons should not join currency unions and agree to pursue a two per cent inflation target. These two approaches are mutually incompatible.

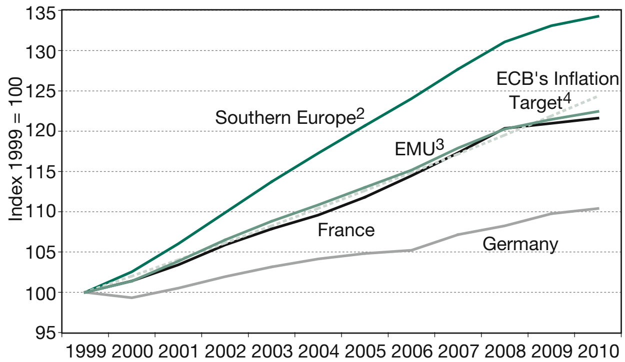
quite significantly, despite the absence of national currencies.

The diverging growth of unit labour costs was reflected in similar price divergences. Whereas the union as a whole achieved its inflation target of two per cent nearly perfectly, the national differences were remarkable (Figure 4). Again, France was by far the best performer, aligning its inflation rate perfectly to the European target. Germany undershot and Southern Europe overshot the target by a wide margin.

The result of the accumulated gaps is an absolute advantage in international trade for Germany and an absolute disadvantage for the other countries. A comparable product which was sold at the same price in the common European and in the global market in 1999 could be sold by Germany in 2010 for 25 per cent less on average – compared to the other countries in EMU – without touching the profit margin.

Figure 4

Inflation[1] Divergence: EMU Reaches the ECB's Target Only on Average



[1] GDP deflator 1999 = 100. [2] Greece, Portugal, Spain and Italy. [3] 12 EMU countries. [4] Yearly increase of 2%.

Source: AMECO database (updated May 2011); own calculations.

Measured against this scale, the conclusion about wrongdoers and misbehaviour is obvious: a two per cent inflation target is only compatible with a two per cent increase in unit labour costs. An increase of 2.7 per cent, as in Greece, indicates that a country has indeed lived beyond its means, but it has violated the rule to a much lesser degree than Germany, which has been living well below its means at 0.4 per cent. Paradoxically, Germany had explicitly agreed to the target of close to two per cent because this was its own target prior to EMU. Given this target and the overriding importance of unit labour costs for inflation, Germany headed towards a clear violation of the common target once its government started to put enormous pressure on wage negotiations to improve the country's competitiveness both in and outside EMU.

The huge gap in unit labour costs and prices had an enormous and accumulative impact on trade flows.[5] With Germany undercutting the other countries by an increasing margin, its exports flourished and its imports slowed. Southern Europe and France ran into widening trade and current account deficits. While trade at the beginning of the currency union and in many years prior was rather balanced, the start of EMU marks a sustained period of rising imbalances (see Figure 1). Even after the shock of the financial crisis and its devastating effects on global trade that are clearly visible in the German balance, the trend remains unchanged. Germany's 2010 current account has risen again and is heading for a new record in 2011.

On the other hand, the deep recession and the austerity programmes in the deficit countries tend to reduce the visible deficits. However, without a fundamental amelioration of competitiveness a quick recovery is much less probable, as the deficit countries lack any stimuli; even if there was an eventual revival of domestic demand, it would quickly bring deficits in the current account back to the fore if no gains in competitiveness had taken place.

Absolute and accumulating advantages of one country or a group of countries over a similar country or a country group are unsustainable. A huge gap in competitiveness has to be closed, because otherwise the country or region will face a situation where it cannot credibly convince its lenders that it will ultimately be able to pay back its debt. As the final repayment of any debt has to be a payment in kind, it definitively requires a current account surplus in the debtor country and a deficit on the creditor's side. With or without flexible exchange rates, an indebted country can only service its debt and repay it if the surplus country allows the deficit country to become a surplus country sooner or later by means of changes

5 The gains in trade clearly prove that Germany's advantage since 2000 is not the compensation for a loss of competitiveness during the German reunification, a position long defended by the ECB. See for example the speech by Jean-Claude Trichet, President of the ECB, at the Institute of International and European Affairs in Dublin, 26 February 2009: "… some countries might have entered the euro area at a moment where this overall cost competitiveness was clearly hampered for a number of reasons. Germany offers a clear example of such an economy due to the strong increases of unit labour costs associated with the reunification. A lower level of increases in unit labour cost than the average of the euro area was advisable for such economies."

in competitiveness through price adjustment triggered by wages and/or exchange rates.

In EMU and similar arrangements with fixed currencies, the situation is much more complicated. This is because wages in overvalued countries have to fall relative to the competing undervalued countries, which normally means a reduction of overall wages with major negative repercussions on domestic demand and the inflation resulting in the union as a whole. For example, if the Southern European countries try to regain their competitiveness *vis-à-vis* Germany inside the monetary union, their unit labour costs will have to undercut the inflation target of the union for quite some time or to a large extent as long as Germany's unit labour costs do not rise more than the inflation target. The effect for EMU as a whole would clearly be deflationary and pose a threat to recovery, in particular if such policies were implemented in an environment of overall fragile demand.

As countries, unlike companies, do not go bankrupt or disappear, they have to find ways to cope with a situation where nearly all their companies have absolute disadvantages compared to their competitors in other countries. The simplest way to deal with an overvaluation or overly high unit labour costs (in international currency) is the reduction of wages. If it is possible to reduce nominal wages exclusively in those parts of the economy that are exposed to international competition, many negative side effects can be avoided. A depreciation of the currency does exactly that. It reduces nominal wages expressed in international currency but not across the board in all sectors of the economy. In this way, real wages fall but imports become more expensive and tend to be replaced by domestically produced products while exports become cheaper for international clients and tend to prosper. But the possibility of depreciation is eliminated for a country that is a member of a currency union.

Competition of Nations?

One of the most intriguing discussions over the last several decades has dealt with the competition of nations in the field of trade. The age of globalisation, more than any previous age, has been interpreted as compelling nations to compete in a manner similar to companies. The wealth of nations was considered to be dependent on their ability to adjust effectively to the challenges created by open markets for goods and capital. Nations with high standards in their capital endowment would be pressured by trading partners with low labour standards. In particular the emergence of a huge pool of idle labour in developing countries like China and India would fundamentally change the capital/labour ratio for the globe as a whole in favour of capital and force the equilibration of low and high wages to somewhere in the middle.

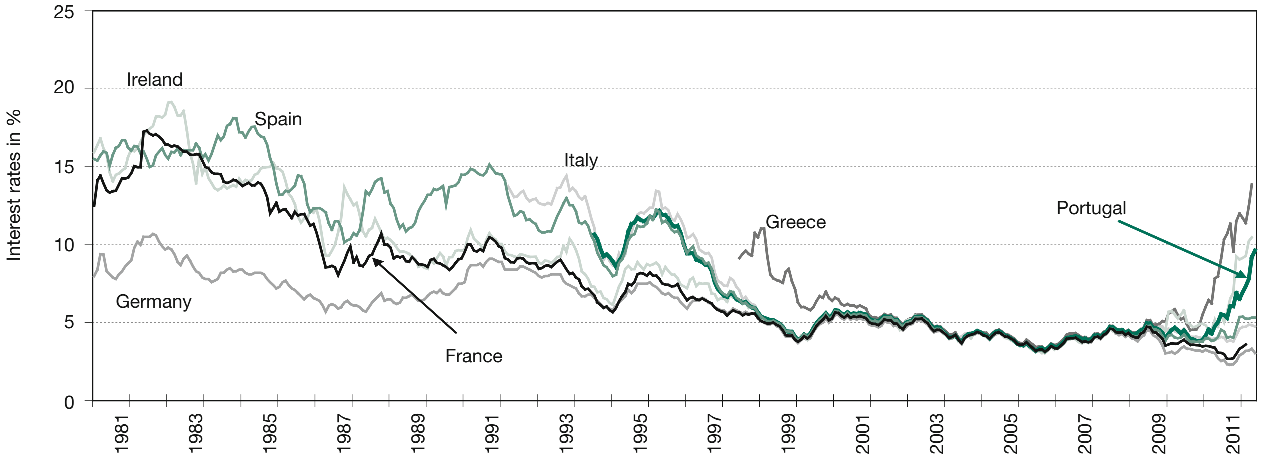
Reality seems to have confirmed this view, as wages in many high wage countries of the North came under pressure and labour was unsuccessful in appropriating the same share of productivity growth as capital, which it had successfully done for many decades. Wage shares are falling and the promise of market economy advocates that the full participation of all people in the progress of society at large would be possible is fading. However, the fact that wage shares are on the decline does not imply that the forces driving this move are those referred to in the neoclassical model of the labour market. Nevertheless, the political perception in many countries in the North that wage shares are falling because of pressure from emerging markets is based on this model.

A closer look reveals the limits and weaknesses of this approach. The model used is taken by analogy from the competition of companies. However, the model describing the competition of companies does not apply to countries – neither to those with independent currencies nor to those in a currency union. In a dynamic setting, market economy companies compete through the differentiation of productivity. The supply side conditions for all companies are normally given – market forces tend to equalise prices of intermediate goods like the price of labour and the price of capital. Consequently, success or failure is determined by the specific value that is added at the company level to the generally traded goods and services. Companies as price takers have to honour the price of labour determined in the market for the different qualities of labour that are offered as well as the price of capital.

Companies able to generate higher productivity through innovation and new products produced at lower unit labour costs than their competitors, which allows them to offer their goods at lower prices or make higher profits at given prices. The former means they will gain market share, and the latter may yield strategic long-term advantages through higher investment ratios. As long as the prices of labour and other intermediary products are given, competitors adjust by implementing the same or similar technology or by quitting the race through bankruptcy.

At the level of countries this mechanism does not apply, because wages are normally set at the country level. Be it through the mobility of labour at the national level or through wage negotiations in a national context, countries – unlike companies – are wage setters, not wage takers. If wages are centrally negotiated at the level of the nation state or if labour is mobile, the so-called law of one price, i.e. equal pay for equal work, has to be applied.

Figure 5
Long-term Interest Rates[1] in EMU Spread Again



[1] Per cent per annum; long-term (10 year) government bond yields, monthly data.

Source: OECD, http://stats.oecd.org/Index.aspx?DataSetCode=MEI_FIN, updated July 2011.

Consequently, stronger productivity growth at this level does not increase the competitiveness of all companies against the rest of the world, as advantages in productivity are normally reflected in higher nominal (and real) wages and unchanged unit labour cost growth.

But even if this mechanism, for whatever reason, did not work, a country with rather high productivity but extremely low wages and very low unit labour costs would not automatically increase its competitiveness or the competitiveness of all its enterprises. The prices in such a country would not necessarily be lower than in the rest of the world as expressed in international currency. In a world of national currencies and national monetary policy, a country supplying its goods at much lower prices would gain market shares and accumulate huge trade and current account surpluses. Economic and therefore political pressure to adjust wages and prices in international currency would mount, and sooner or later the country would be forced to indirectly adjust its wages, as measured in international currency, through a revaluation of its currency.

Nations can open their borders for trade and capital flows if it is assured that their companies have a fair chance in the global division of labour and that they are not in danger of permanently losing out against the rest of the world. This is the simple proposition underlying all international trade arrangements in the WTO and elsewhere. If, at the level of the overall economy, the nominal remuneration of the internationally immobile factor in one nation state, labour, exceeds the effectiveness of its use (labour productivity) consistently by a wider margin than in the competing countries, the country is getting into trouble because most of its companies are in trouble. They must either ask for higher prices and accept the permanent loss of market share or accept lower profits to avoid the loss of market share.

A situation like this, called an overvaluation due to an appreciation of the “real exchange rate”, is unsustainable, and once the accumulated overvaluation reaches some twenty per cent or so, the crisis is unavoidable. The deficit on the current account is just the most visible indicator of this pathological constellation, not its core. In Europe, Italy and Britain were facing such a problem as members of the European Monetary System in 1992; one opted in, one opted out, but both devalued. In systems of adjustable exchange rates, the solution is rather simple: the currency of the country in trouble has to devalue, bringing the nominal wages and nominal unit labour costs measured in international currency back to a competitive level. Indeed, devaluation leads to a relative fall in real wages, but that is not an important aspect of the analysis.

In a currency union, the member countries explicitly or implicitly agree not to go the inflationary route (in which nominal wages exceed national productivity by more than an explicit inflation target) or to all go together. With an inflation target of close to two per cent (in EMU as established by an ECB decision), the implicit contract is that nominal wages will not rise more than national productivity growth plus two per cent. This means that each country can and should enjoy its productivity increase, be it one per cent as in Germany or two per cent as in Greece, in terms of real wage growth, shorter working hours or both. At the same time, each country is encouraged to do whatever is needed to improve its productivity performance. However, in such a union, deviations from the common anchor, the inflation target, by claiming overly high nominal wages is as dangerous as claiming wage growth far below national productivity plus two per cent. The former creates inflationary dangers for the union as a whole, while the latter creates deflationary dangers. If one member deviates upward or downward, it creates an externally unsustainable situation. The capital markets reflect this via the deviation of long-term interest rates among the EMU member states (Figure 5). Germans should know better than anyone else about the dilemma caused by wage divergences in a currency union. It was the deviation of East German wages as measured in international currency after the German Monetary Union of 1990 that destroyed East German industry and forced a transfer union.

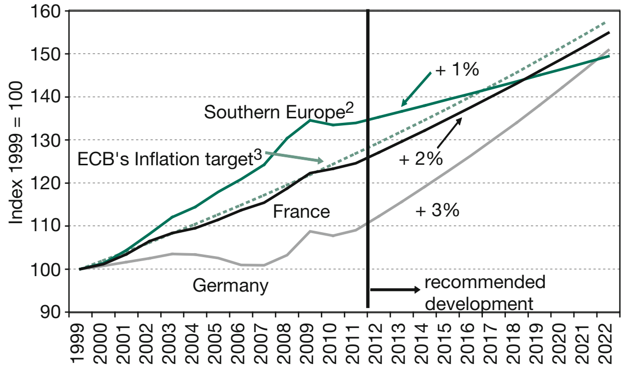
The Way Out

European politicians are wrong if they believe that there will be national solutions. If Germany continues with belt tightening, and there is every indication that it will, the countries with absolute disadvantages would need to cut nominal wages. The result would be protracted deflation and depression for EMU as a whole. If Germany does not agree to concerted action with explicit decisions on non-deflationary wage adjustment paths for many years, indeed for decades, there is no easy way out.

To save EMU by closing the competitiveness gap and at the same time avoid a deflationary trap for EMU as a whole, there is only one way out. Wages in Germany have to rise for a considerable amount of time by more than is warranted by the traditional wage rule (national productivity growth plus the common inflation target) and the Southern European countries must pursue the opposite strategy. Figure 6 shows an example of such an adjustment over the next ten years. Germany's nominal wages would increase by more than 4 per cent, while Italy's, Greece's, Portugal's and Spain's would increase by much less. It is worth noting that even in this scenario, the surplus-deficit relations within EMU will not change quickly. Germany's absolute advantages and its market share gains do not disappear before 2022, and thus a turnaround in deficit and surplus positions cannot be expected soon. However, the announcement of the willingness of the member countries to pursue such an adjustment would communicate the willingness and the ability to tackle the problem in the long run. This would dramatically increase the credibility of the temporary assistance schemes, because for the first time, the markets and the public could understand how the root cause of the euro crisis could be addressed.

Figure 6

Solving the Euro-Crisis: Convergence of Unit Labour Costs[1]



[1] Index of unit labour costs of total economy 1999 = 100; proposal 2012-2020: Germany +3%, i.e. nominal wage growth ca. +4.5%; France +2%, i.e. nominal wage growth ca. +3%, Southern Europe + 1%, i.e. nominal wage growth between +1% and +3.5%. [2] Greece, Portugal, Spain and Italy. [3] Yearly increase of 2%.

Source: AMECO database, values for 2010 and 2011 estimates and forecast by the EU Commission, updated May 2011; own calculations.

A New Role for the ECB

If in general the results of wage negotiations are responsible for reaching the inflation target and if in particular European wage coordination for the next decade is the main instrument to find a way out of the euro crisis, the role of the ECB in EMU has to be fundamentally redefined. Two points are crucial: firstly, a slightly higher rate of inflation during the process of unit labour cost adjustment is unavoidable. Secondly, a monetary union, more than any other currency arrangement, needs instruments to prevent gaps in competitiveness among its member states and unsustainable trade imbalances. Any attempt by members of the monetary union to establish and maintain absolute advantages in competitiveness against other members will eventually fail and threaten the survival of the union.

For many advocates of the euro – Germany's export industries among them – acceptance of this second point would obviously mean reducing the significance of the euro to a dispensable, expensive and even useless project. But this attitude misses the most important argument for the euro. The euro is not an important economic achievement for Europe because it has provided stable exchange rates to foster trade and to dampen speculation. That had been achieved long before the 1999 introduction of the euro via the European Monetary System or European

Exchange Rate Mechanism. Changes in exchange rates were the exception but not the rule in this mechanism. So why did Europe take the risk and give up this valve by introducing a single currency with its "irrevocable conversion rates"?

Unfortunately, the fundamental benefit of a large currency area is little known. It was mentioned occasionally in descriptions of the Bretton Woods era and was called the "policy-domain problem": the problem that the monetary policy stance was largely determined by the specific conditions prevailing in the lead country's economy. In the European Monetary System prior to 1999, monetary policy in fact determined the business cycle of the whole domain of economic influence but focussed only on German monetary conditions. The interest rates of the central banks within the European Monetary System basically followed the monetary policy of the anchor country Germany. In EMU, however, the scope of the ECB is based on the economic development of the euro area as a whole when making its policy decisions. This broader perspective should yield a much more effective monetary policy.

Obviously, this advantage must be understood if it is to be used. Actually, the ECB's basic mandate leaves little room for policies beyond the narrow inflation target. Indeed, this is in conformity with Article 105 of the Maastricht Treaty of 1992, which states: "The primary objective of the ESCB shall be to maintain price stability." Consequently, the ECB's focus is exclusively on monetary policy as a means of controlling inflation, which is based on the firm belief that "(u)ltimately, inflation is a monetary phenomenon".[6] This is the wrong approach. For EMU to function properly, the European Central Bank has to adopt a Fed-like approach, where monetary policy has the additional goal of stimulating growth and employment. Without this, the benefits of a monetary union cannot be reaped.

It is sad to see that many governments still firmly believe that the euro was introduced for purely political reasons. If the political argument is the main pillar on which the EMU is built, the prospects for saving it are grim. Even an economist like Paul Krugman, who certainly shares many of our views, apparently did not grasp the central advantage of a common currency: "The case for a transnational currency is, as we've already seen, obvious: it makes doing business easier."[7] For Krugman, this is the main advantage to be contrasted with the disadvantages the larger currency area may have. By contrast, he points to advantages enjoyed by national currencies because their value can be changed easily: "Liberal American economists, myself included, tend to favor freely floating national currencies that leave more scope for activist economic policies – in particular, cutting interest rates and increasing the money supply to fight recessions."

Is this plausible? Of course, the use of interest rates is a normal feature of recession fighting in larger economic areas like the euro zone as well as in smaller ones if the central bank has adopted a reasonable policy approach. And if economies should develop at sharply different speeds within the euro zone, for whatever reason, trade between these regions should allow for ample adjustment and spill-over, especially because it is not hindered by exchange rate adjustments.

Paul Krugman, however, does not devote a single line to mentioning that outside of fixed exchange rate areas like monetary unions, nominal interest rate differentials have become the single most important gateway for currency speculation, driving currencies over extended periods of time against fundamentals and reducing the room for employment-responsive monetary policy. Additionally, in a well functioning monetary union (which first and foremost requires keeping differences in inflation small), the scope of action for monetary policy is simply bigger. The ECB could not only be more successful in fighting off recessions; it could also do a much better job of stimulating growth in general compared to the case in Europe before 1999.

Unfortunately, in a situation in which European leaders have not understood the fundamental advantages of the euro, arguments in favour of the euro are not easy to sell. As long as the politically responsible people do not grasp the sound reasons behind the euro and the possible solution, the crisis will endure. Some people advocate a transfer union as a way to save the euro and overcome the crisis. But any lasting solution has to bring back sustainable levels of competitiveness for all euro member countries. This can definitively be reached without a collapse and without the move to a transfer union at a level comparable to intra-German transfers. As shown above, this is possible without deflation if the deficit countries are allowed to catch up while the ECB temporarily accepts a small violation of the overall two per cent inflation target and a bigger deviation by the surplus countries. Compared to the political problems of a full swing to a transfer union, this appears to be a much easier and much more convincing solution. But the euro's chances for survival shrink by the day as the responsible people and institutions refuse to learn the lessons in economic logic that the euro crisis conveys.

6 ECB's website at http://www.ecb.europa.eu/mopo/intro/role/html/index.en.html.

7 Paul Krugman: Can Europe Be Saved?, http://www.nytimes.com/2011/01/16/magazine/16Europe-t.html?_r=1&pagewanted=all.