THE CONTRADICTIONS OF THE EUROZONE

Prabhat Patnaik

- An arrangement among a group of countries which involves their having a common currency, or a system of fixed exchange rates between their respective currencies, with government expenditure within each of them being tethered to government revenue, long predates the Eurozone. In fact the Gold Standard represented such an arrangement.
- The argument of this paper is that the reasons why such arrangements worked in the past no longer hold today. Since the Eurozone has nothing to overcome this basic lacuna, it is fundamentally flawed.

- Let us take the basic identity:

$$Y= C(Y)+ I + G(Y) + (X-M)$$

  Since both consumption and government expenditure depend upon Y, and so does I (via the level of capacity utilization for instance), Y in such an arrangement depends upon net exports. Keynes had recognized this to be the case under the God Standard and attributed wars, wrongly in my view, to the economic motive of increasing the level of activity under this arrangement.

- It is not just the level of activity in any period that, ceteris paribus, depends upon the current account surplus. Since the level of investment, relative to the capital stock, depends upon the level of capacity utilization, the size of the current surplus as a proportion of Y, also determines the growth rate of the economy. This can be shown through a simple model.

- In the national income identity
- $Y= C+I+G+(X-M)$, taking consumption as a given proportion c of income, G a proportion d of income (because of "fiscal responsibility" legislation), and (X-M), for convenience (for the time being), a proportion e of income, we have
- $Y = I / (1-c-d-e)$ (1)
- Ignoring depreciation for simplicity (it can be verified that this does no damage to the argument), and taking a simple investment function of the following form,
- $I(t+1) /K(t+1) = I(t)/K(t). [1+b.(u(t)-u^*)] + \varepsilon$ (2)
- and defining u(t) as
- $u(t) = Y(t)/ K(t). \beta$ (3)
- where β denotes the technologically given (and hence the maximal) output-capital ratio, u* denotes the desired level of capacity utilization, and ε stands for the exogenous stimulus for investment, which can be taken in the current context to refer to the (exogenously given) growth of world trade, we can proceed as follows.

- This system gives two possible positive trends, one stable and one unstable (which is the counterpart of Harrod's "warranted growth rate"). The stable trend is given by

- $g = \{b.u^*-[(b.u^*)^2 - 4.\varepsilon.b/\beta(1-c-d-e)]^{1/2} \} / [2b/\beta(1-c-d-e)]$ (4)

- It can be easily verified that g in (4) is higher for a higher e, which means that, assuming this system to hold for each of the countries in a common currency area, *the country with the higher current account surplus will experience faster growth*. This is because a higher current surplus entails a higher level of capacity utilization, and hence a higher rate of accumulation of capital and growth rate.

- The only other way that growth can occur in such an economy is through a change in the functions themselves. And this can occur through credit-sustained “bubbles”.
- But “bubbles” cannot be made to order. As Keynes had remarked, the end of a boom that has been sustained by euphoria (which is what underlies a “bubble”) can come about *either* through a collapse of the state of credit *or* through a collapse of euphoria, but the initiation of the boom requires *both.*

- Thus when we have a group of economies having a common currency or fixed exchange rates; and pursuing “sound finance”/”fiscal responsibility”, the growth rate, whether in the group as a whole, or in individual economies, would, leaving aside credit-sustained “bubbles”, depend upon the magnitude of the “exogenous stimulus”, which expresses itself through the current account surplus.
- The current account surplus in turn depends upon two factors: the rate of growth of the world economy; and the degree of “competitiveness” of the economy in question which is a function of its relative money wage rate per efficiency unit of labour.
-

- We have so far taken, for any given rate of growth of the world economy (and hence world trade), the current surplus of particular country to be a certain ratio of its Y, the ratio itself varying across countries. The higher the ratio the higher is the growth rate.
- But if a country grows faster than the world market as a whole then the ratio of its current account surplus to its income cannot keep remaining constant.
- It should be remembered however that just as g depends upon e, likewise, for Kaldorian reasons, e too depends upon g. And taking this mutual dependence, *it will still be the case that there will be a divergence in the growth rates across countries within a currency area. The cause for this divergence will be differences in the wage rate per efficiency unit of labour.*
- In periods of rapid growth of the world economy, and with it of world trade, this divergence will not cause much concern; but when the growth of the world economy slows down, or when we come to a crisis, this divergence will assume serious proportions.
- *An essential condition for the sustainability of such a currency arrangement is that there must be some way of taking care of this divergence.*

- The typical solution offered to the problem of divergent growth rates within the group of countries entering into such a currency arrangement is a wage-price deflation in the deficit economies. But it does not work for the following reasons.
- In a large diversified economy producing a whole range of goods a small amount of deflation may be quite adequate to improve the current balance. But in countries which are small and specialized in a narrow range of goods, such deflation would be ineffective.
- And what is more, the very fact of deflation, by putting domestic firms under financial strain because of their inherited debt commitments, would even prevent them from undertaking any serious diversification into such other activities that could have caused an improvement in their current balance. Hence this entire mechanism of wage-price deflation as a means of improving the current balance through *the effort of domestic firms* is, as already mentioned earlier, of exceedingly dubious efficacy.

- But then a wage cut in an economy can always attract foreign direct investment for undertaking production for the export market, in which case an improvement in the current balance can be effected in this manner. But here again, this mechanism can work only if there are no outside economies that offer even lower wages and unit labour costs, an assumption that obviously breaks down for the deficit economies of the Eurozone because of the existence of vastly more attractive East, South, and South East Asian economies where plants can be located for production for the world market. Even for firms in economies within the currency area that enjoy substantial current balances, it is more attractive locate plants outside the zone than in low current balance, or current deficit, countries within the zone.
- Hence the proposition that a wage deflation can improve current balance does not always hold. And when it does not, the tendency for divergent growth rates and for an increase in inequalities within the currency area even in periods when there is rapid growth in the world economy (and of unsustainable current account deficits for certain countries within the zone when there is a crisis), will tend to undermine the entire arrangement.

- Even in the Gold Standard which was a currency arrangement of the Eurozone sort but constituted a *global* order, the text book picture of wage-price deflation was never the equilibrating mechanism.
- This is what Joan Robinson has to say about the pitfalls of wage-price deflation: “First, ..the mechanism is not symmetrical, but has an inherent bias towards deflation, which is the more severe the smaller is the amount of gold possessed by deficit countries. Secondly, a loss of gold does not lead automatically and directly, as in the text-books, to the fall of prices which is required to stimulate exports from a deficit country and foster its home production at the expense of imports…To check the outflow of gold the authorities in a deficit country must restrict credit and encourage a fall in activity and incomes. ..The total loss of income is a large multiple of the reduction of imports which it is designed to bring about… But meanwhile the surplus country is also suffering from unemployment through its loss of export markets. There is pressure there also to lower wages; and much else, including the gold standard itself, may give way under the strain long before equilibrium has been restored.”

- Not only is the mechanism of wage-price deflation as a means of curing deficits both theoretically flawed and empirically unreal (though this does not prevent its being tried out with a vengeance), but it is politically infeasible as well. In fact the effort to impose a deflation through a wage-cut after Britain's return to the Gold Standard in 1925 at the pre-war parity, which was no longer sustainable because of the fact that the economic advantage that Britain had derived from the empire before the first world war had been greatly eroded by the post-war period, had produced the General Strike of 1926.
- In short, currency arrangements of which the Eurozone is a particular example cannot possibly rely on wage-price deflation to rectify balance of payments disequlibria.

- Before we discuss how exactly the Gold Standard worked, let us look at the matter a little more closely. And for this let us concentrate on the single-period for simplicity.
- *There are two problems, not one, which a deficit country faces: a problem of financing the deficit, and a problem of aggregate demand on account of the deficit. Even if the deficit is somehow financed, aggregate demand still remains low, though it is not further reduced on account of having to close the deficit, so that investment remains low, productivity remains low, competitiveness remains low, and the deficit is not closed. And if the deficit is not financed, then aggregate demand reduces further, accentuating the crisis.*

- It is not enough therefore that the deficit be financed through capital inflows, a point that Joan Robinson had emphasized in the article quoted. Investment must also increase in the deficit economy. A currency arrangement of the Eurozone sort must have some *institutional means* of encouraging investment in the deficit economies.
- Raul Prebisch, in the context of a Latin American Common Market, had underscored the necessity for some institutional arrangement for promoting investment in the laggard economies. This holds even more strongly in the context of currency areas.
- But there is no such institutional arrangement in the Eurozone.

- Even when it comes to financing deficits through capital inflows, leaving matters to private capital flows cannot work. When capital in the form of finance flows in, even if it sustains the current deficit, it does nothing to correct it since it dos not stimulate investment, and certainly not in the traded goods sector. And then after some time, when the country becomes a risky one for private capital to flow in, the current deficit can no longer be sustained, in which case the level of activity shrinks further, causing unemployment and hardships without *in any way rectifying the basic problem of the deficit.*
- The entire arrangement, it follows, does not have any mechanism whereby the level of activity in a deficit country can be sustained, let alone be improved. In a situation of crisis, this becomes particularly acute, *but it exists all the time.* It is endemic to the structure of the arrangement itself.

- One way that the entire problem could be resolved is if the leading country in the area, Germany in the case of the Eurozone, which has a current surplus vis-à-vis the outside world, actually stimulates aggregate demand within the zone by running a fiscal deficit, corresponding to which it runs a current account deficit with those countries that are experiencing a current deficit vis-a-vis the rest of the world. Germany for instance, instead of piling up claims on the U.S., could improve the conditions of its own population through transfers from the budget, financed by a fiscal deficit, which would create demand for say Greek or Spanish goods (apart from German ones).
- This would kill three birds with one stone: it would improve the condition of the German population; it would increase employment all around within the Eurozone, and it would also get rid of imbalances within the zone.
- But this Pareto-optimal solution will never get implemented because that is not the way that capitalism normally works, as Kalecki had pointed out as long ago as in 1943. And in contemporary times when fiscal deficits are frowned upon, this is even more difficult to expect. Piling up claims upon the U.S. is deemed preferable to improving the condition of domestic workers; and that is the way things will be.
- It is not surprising in this context that Keynes' idea of making the surplus countries adjust under the Bretton Woods system could never get implemented.

- The secret of the success of the Gold Standard was that it rested upon colonialism. The member countries belonged to two distinct groups: the colonies and the others. Britain, the leading country, ran a current account deficit vis-à-vis continental Europe and the United States. It not only financed this deficit but even made massive capital exports to these very regions and to other temperate regions of white settlement, by using the current account surpluses of the colonies vis-a-vis these regions, for which however *the colonies never got any credit*.
- This was because Britain exported its manufactured goods, textiles, which were not wanted anywhere else, to these markets, where they displaced the products of local artisans causing “de-industrialization” and unemployment. In addition, Britain simply appropriated a “tribute” which was without any quid pro quo from these colonies under a variety of heads.
- The long Victorian and Edwardian boom (or what John Hicks called the Long Boom) rested upon this arrangement, whose collapse in the inter-war period was a major reason for the Great Depression.
- Such an arrangement is no longer possible today. The arrangements that exist instead are therefore without the props which made the Gold Standard sustainable and are therefore fundamentally flawed.

- The end of the Eurozone crisis therefore is far from being imminent. A possibility for its abatement would arise if the world economy itself revives. But there are no obvious stimuli that can effect such an end: the US is unlikely to run a larger fiscal deficit to pull the world economy out of the crisis because it is an economy with a current account, which, unlike Britain in the pre-war period, cannot fall back upon any colonial “tribute”. Besides, the opposition to fiscal deficits in the U.S. is strong.
- A coordinated fiscal stimulus by a number of countries acting together, such as what Keynes had suggested during the 1930s Depression, is as unlikely today as it then was.
- What remains therefore as the only possible way out of the crisis is the development of a new “bubble”. The Eurozone economies like the rest of the world economy are in effect waiting for such a new “bubble” to happen.
- But that wait is turning out to be like “Waiting for Godot”.