

Voodoo economics and the Euro debate

The euro debate is informed by some pretty poor economics, much of it the residual anti-Keynesian foolishness of the Reagan-Thatcher era. Euro supporters urge adherence to the SGP; euro-sceptics criticise a 'one-size fits all' interest-rate and want to return to the *status quo ante* of floating exchange rates. Some basic economics is a pre-requisite for understanding the underlying issues at stake.



George Irvin argues that euro-sceptics and SGP supporters alike need to revise Economics 101.

Germany and Japan

It has become fashionable to equate the euro with Germany's ills. In reality, the comatose state of its economy has little to do with the euro and much to do with the costs of unification, stagnant consumer demand and the slow growth of service sector employment. Looser monetary policy and a return to a floating exchange rate will not cure this problem as the case of Japan illustrates clearly. Japan, once the powerhouse of Asia, has suffered near-zero growth since 1989 and negative growth for the past three years. Yet Japan has an independent monetary policy and a floating exchange rate. Nominal interest rates in Japan have been close to the zero floor during much of that time, while the yen has swung erratically against the dollar.

Labour Productivity

In truth, the deeper an economy sinks into stagnation, the weaker the effect of monetary policy. As for exchange rate policy in a medium-size economy, when daily capital flows amount to \$1.6 trillion, it is financial markets that set exchange rates, not Governments (the lesson of 'Black Wednesday' in the UK). Euro-sceptics retort that without flexible exchange rates, the weight of adjustment falls on wages. Not true! Singapore has a dollar peg and higher inflation than the US; the reason its fixed exchange rate is viable is because of high labour productivity growth.

Not by wage-market flexibility alone

The key to kick-starting the German economy is not simply greater wage market flexibility, particularly if greater 'flexibility' produces greater inequality. True, job creation in Germany could be much enhanced by increasing competition in the services sector and changing archaic regulations on opening hours. But the key to growth is fiscal policy. Elsewhere I have argued in detail that the SGP is a straightjacket and must be amended. The Eurozone ministers on 15 July were foolish to dismiss Monsieur Chirac's carefully qualified call for reform.

SGP not carved in stone

But let's not confuse the euro with the SGP. The main economic argument for the euro is that it shields the Eurozone from a run on individual currencies while delivering the long-term benefits of economies of scale and the technological progress

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inherent in higher investment. Such a shield is necessary if the social-market is to be preserved, a point crucial to the euro-debate in both Sweden and the UK.

It so happens that during the run-up to EMU, the conservative rules of the Maastricht Treaty and the SGP arguably served to reassure international capital markets that the euro would not be inflationary. Today, the SGP rules are archaic; they should not be treated as carved in stone. What's needed---as recommended in the recent annual report of the Bank for International Settlements--- is a large, well-co-ordinated fiscal push to get the core Eurozone economies moving.

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