

THE MYTHS AND LIES OF THE "EURO-CRISIS"

Currently the euro does not appear to have many friends. Almost every day (self-acclaimed) experts are telling us that our currency is doomed to collapse. At the same time, the narrative of the crisis in the euro area is shrouded in errors and myths. Myths are simplified descriptions, which while giving the appearance of accuracy are in fact far from reality. We, a group of Austrian and German social democrats based in Brussels, intend to demystify the crisis by means of this little pamphlet. Our goal is to overcome popular misconceptions simply by presenting facts. **Facts allow for ideologies to be unmasked**, provide the basis for a **correct diagnosis** and are helping to design **effective and sustainable policy solutions**.

Given the origin of the authors, this brochure adopts an Austrian-German perspective. Despite their differences, Austria and Germany often find themselves in the same policy camp, together with the Netherlands and Finland. However, we do not accord to the logic of a fundamental clash of interests between **'core and periphery countries'**. On the contrary, we firmly believe that the current problems in the euro area can only be solved in a sustainable manner if northern and southern Europe develops a common understanding of the crisis. More importantly, we need to overcome partisan politics and inside-the-box thinking. In this respect, we let facts prevail and focus on ten particular myths:

1. Leaving the euro is the best solution
2. The euro is in crisis
3. Public debt is to blame for everything
4. There is no alternative to austerity
5. We are living beyond our means
6. Crisis countries are reform laggards
7. The printing press is causing inflation
8. Financial aid is only delaying bankruptcy
9. They only want our money
10. The worst is behind us

Subsequently, we propose a **comprehensive solution**.

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SPD

MYTH 1

"Leaving the euro is the best solution"

The fundamental critique of the euro and the monetary union can be summarised as follows: While different economic developments in each country could be easily compensated for by **adjusting the exchange rates** of national currencies, the necessary **adjustment in euro-area countries would have to be based on tax increases and wage cuts**. Since this would overburden many Member States, other euro-area members would be forced to step in and provide financial assistance. Therefore, according to the myth, the re-introduction of the drachma and the lira would be the best and cheapest solution for everyone involved.

Of course the technical aspects of the re-introduction of national currencies remain largely unclear. What should be clear, however, is that **the new currencies would depreciate in value very rapidly**. Attempting to prevent the likely loss of (parts of) their savings, investors would withdraw their funds from vulnerable Member States immediately and transfer it to more stable countries. This capital flight would trigger **'the mother of all currency crises'** and plunge the already ailing countries into even greater misery. Germans and Austrians might believe that they would not be affected by the disintegration of the euro area, but their currency (which would still be the euro) would increase in value ... and yes, it would **worsen the prospects of their own export sector massively**. As a result, unemployment in the new (old) hard currency countries would be likely to rise even further.

It is conveniently overlooked that not only the European economy in general, but also the **European financial markets in particular have become considerably more integrated over the last decade**. For example, Spanish companies or Greek households obtained loans in euros from German and Austrian banks. This debt would remain denominated in euro, even after a Spanish or Greek exit from the monetary union. After the introduction and subsequent devaluation of their new currencies the debt burden would increase dramatically when measured in the currency of the debtor countries. Thus, loans would be unlikely to be repaid because of the excessive debt burden. But if companies/households or whole EU countries go bust, banks in Vienna or Frankfurt would also face significant write-downs and possibly bankruptcy.

In addition to these direct costs resulting from the re-nationalisation of currencies it is often forgotten that **currency crises were occurring in Europe repeatedly** before the introduction of the euro. During these events much private wealth such as old-age provisions and other savings was destroyed. Thus, a euro exit is not the 'best' and 'easiest' solution, neither for the current crisis-stricken countries nor for more stable countries like Germany or Austria.

MYTH 2

"The euro is in crisis"

There is much talk about a 'euro crisis'. But our currency is in no crisis. Contrary to the general belief **the euro is stable** – both externally, i.e. the euro exchange-rate is relatively high in spite of normal fluctuations – as well as internally, i.e. the average rate of inflation is lower than before the introduction of the euro. Thus, we are not dealing with a crisis of the euro but with a **sovereign refinancing crisis of individual euro-area countries** and – due to the lack of political will to take effective action – a crisis of the entire monetary union.

The **triggers of the crisis** can be traced back to **the bursting of the housing bubble in the United States** which culminated in the collapse of the global investment bank Lehman Brothers in September 2008. It soon turned out that many European (especially German and Irish) banks owned non-performing U.S. real estate loans in the form of so-called **'toxic assets'**. As a result of the implied dramatic loss of confidence among banks the interbank market seized up and monetary flows stalled, while world trade and global industrial production collapsed. When it became clear that the recession could take dimensions similar to those of the Great Depression in the 1930s, governments and central banks began to support the economy through unprecedented economic stimulus measures. In particular, banks received financial assistance to an extent that was unthinkable before.

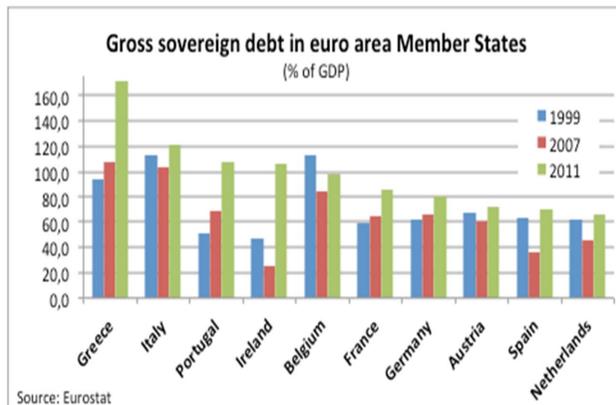
When the worst seemed to be over, the weaknesses of the (public) rescuers became apparent: **Empty coffers, high debt and a faltering economy**. The desolate situation of public finances across advanced countries sapped investor confidence, while the actions of speculators and credit rating agencies exacerbated the already severe situation. High-debt countries with an own central bank (e.g. the U.S. or Japan) got away with a black eye, as they were able to ease the debt burden at the price of higher inflation. Countries within the monetary union faced the much more serious **risk of a sovereign default** – unless the ECB or the community of euro area countries would step in and bail them out.



MYTH 3

"Public debt is to blame for everything"

With the exception of Greece and perhaps Portugal, neither the lack of fiscal discipline nor excessive sovereign debt triggered the crisis. Prior to the crisis countries such as Ireland and Spain did not violate the Stability and Growth Pact (in contrast to Germany and France). The main cause of the crisis in these countries was rather **the excessive indebtedness of private households and companies** due to a credit-fueled property-price bubble. When this housing bubble burst as a result of the global financial meltdown, governments had to raise large funds to cushion the economic and social consequences. At the same time, extensive financial measures were taken to prevent banks from bankruptcy and the financial system from collapse. Both policies have driven government debt significantly upward. **High government debt is therefore in most cases only a symptom** of a deeper problem, and it comes therefore without surprise that the current crisis management approach that has focused almost exclusively on these crisis symptoms has not proved successful.



An **unholy alliance between governments and banks** has exacerbated the crisis since banks are the main buyers of government bonds. On the one hand, banks that hold government bonds are likely to face massive write-downs or even bankruptcy if government bonds are threatened by a (partial) default because the issuing country is heavily indebted. On the other hand, banking crises have a direct impact on public finances, since the state is often forced to take on risks from the banking sector. **Banks have become too big and too important** for the banking system which means that governments cannot afford to let these credit institutions fail without risking a collapse of the whole financial system (too-big-to-fail problem). In fact, the balance sheets of many banks and thus the risks involved have become so large that the country itself is threatened by bankruptcy. Therefore, we need a **genuine banking union** that breaks the **vicious circle between banks and governments** effectively.

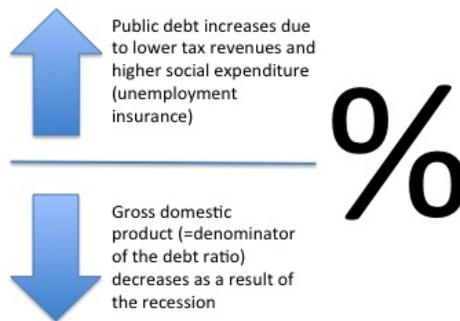
MYTH 4

"There is no alternative to austerity"

Even though the German federal government would like to make us believe the contrary, the stark reality is that **nation states cannot just simply 'save their way out of the crisis'**. At first glance it sounds logical that countries – in the same way as over-indebted households or companies – reduce spending and/or increase revenue to 'balance the books.' However, this logic is misleading from a country perspective, since the expenditure of one part of the economy represents the income of the other. This is especially true in times when key international trading partners are also reducing their expenditure and thus demand for European goods, and when the domestic economy hardly grows. Thus, if households tighten their belts, companies cut short on investment and governments reduce public expenditure, **national income shrinks** as long as we do not shift our adjustment burden to the world.

Due to drastic austerity measures, economic output (gross domestic product - GDP) in the problem countries has fallen so massively that the debt ratio, i.e. the ratio of government debt to GDP has increased even further. Although some governments cut their budgets fiercely, often by slashing social expenditure, the end result achieves exactly the opposite effect. Even though the consolidation of public finances is more than necessary in some countries, this **self-defeating austerity** has widely been criticised, not least by the International Monetary Fund (IMF).

Self-defeating austerity: the debt ratio explodes



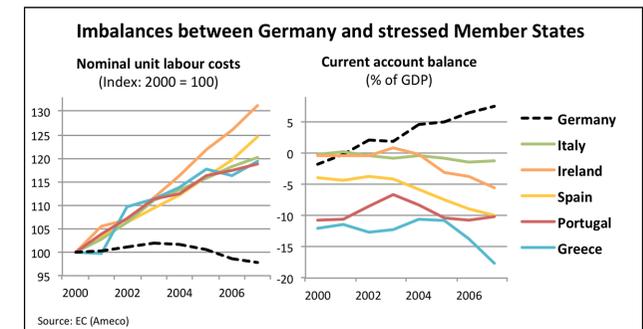
It goes without saying that Europe needs solid public finances, especially for providing essential public services. But when reducing total debt levels we should give **priority to the balance-sheet repair of households and businesses** and thereby lay the foundation for a self-sustained recovery. Once the EU economy has returned to growth, the consolidation of public finances would clearly be more effective and less painful.

MYTH 5

"We are living beyond our means"

In Germany, the public debate centres around the common claim that the crisis countries had been living beyond their means for a number of years. While it is accurate to assess that the previous **credit-financed boom** led many people in Ireland or Spain to believe that their economy was on a healthy and ever-increasing upward trend, accusations that crisis countries had celebrated a lavish party are inaccurate and ill-founded. While experiencing only moderate real-wage growth before the crisis, lower and middle income groups now pay a high price for the hybrid of banks and other investors. But also governments and international organisations thought that economies could not grow fast enough, even if there was the risk that everything collapses like a house of cards.

As a matter of fact, based on the scope for wage increases **Germans and Austrians live less than within their means**, i.e. the sum of productivity growth and the inflation target of the ECB (close to 2%), was anything but exhausted in Germany and Austria. But lower wages imply depressed consumption and lower domestic demand. Because of higher domestic demand (German and Austrian) investors were rushing to Southern Europe and Ireland. The dynamic economic growth promised higher yields, but in the end capital from northern Europe mainly fuelled a property bubble. The resulting buoyant import demand in those countries also explains to some extent recent export success in both Germany and Austria.

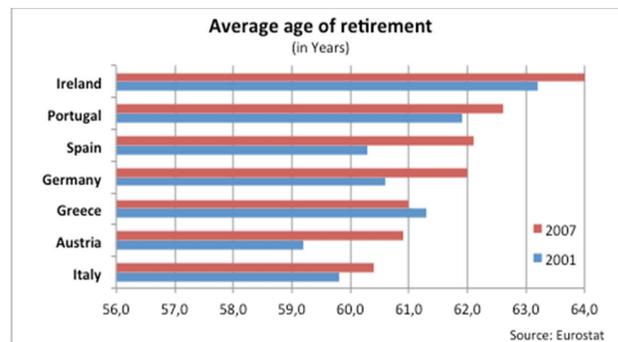


Until the onset of the global financial crisis in 2008, real wages increased only very weakly in Germany compared with the rest of the euro area. But this development cannot be blamed on the euro. Instead, **wage restraint was an explicit policy objective** of the government and social partners (keywords: Alliance for Jobs and Hartz IV). But already in the 1990s, net real wages had hardly increased in Germany and they even decreased in the years 2004-08! Never before in German history has a strong economic expansion been associated with such a persistent reduction in net real wages over so many years.

MYTH 6

"Crisis countries are reform laggards"

The scathing criticism of lacking reform zeal in the current crisis countries is missing the point. Especially the ailing countries have no other choice than deeply revamping their economic, financial and social systems. But even prior to the crisis some vulnerable countries have embarked on painful but necessary reforms as suggested by a rising retirement age. By contrast, the popular view in Germany and Austria that insufficient reforms were the main crisis trigger is linked to the idea that the latter countries had done their homework on time and thus are less affected by the crisis. It is noteworthy that even though labour market reforms such as Agenda 2010 or Hartz I-IV were aiming at a **higher flexibility of the labour market**, the German labour market is still far less flexible than the Irish one. But still, Ireland was hit much harder by the crisis than Germany. In Spain, young workers lost basically any protection against job redundancy due to the widespread use of temporary contracts, yet youth unemployment has exceeded the 50%-mark. In other areas such as the reform of 'liberal professions' (e.g. lawyers, chemists, etc.) the situation in Germany and Austria is hardly better than in Italy or Portugal. More competition in these areas would certainly be advisable in its own right, but of course it would not prevent a future financial crisis or alleviate its repercussions.

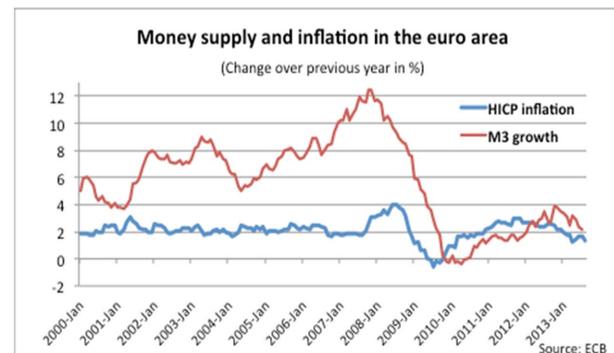


In order to limit the likelihood of future economic and financial crises in Europe, it is necessary to **reform financial market regulation** (keywords: Basle III and capital adequacy requirements) and to push a **comprehensive European banking supervision**. However, first and foremost, the economic and social repercussions of the crisis and the negative feedback loops rampaging in affected countries must be contained. This might require a **certain degree of risk sharing among Member States** when it comes to the creation of EU-wide bank resolution and deposit insurance schemes. But just here, countries like Germany and Austria slam on the brakes and waste precious time by pursuing a purely national agenda and by catering to particular interests of individual banking organisations.

MYTH 7

"The printing press is causing inflation"

A central bank that is printing money and thus increasing the money supply is likely to spark inflation, if the economy operates at full capacity. In that case, people have more money in their pockets and they want to spend at least some of it on consumer and other goods. But since the production of goods and services has already approached its capacity limit there are not more goods to buy in the short-term. Thus, higher demand could only translate into higher prices. However, this simplified textbook case of full capacity utilization is hardly relevant in the European context. On the contrary, in many Member States **economic resources lie idle**, especially labour. In Spain and Greece, the unemployment rate has already climbed to around 27%, a situation in which inflation fears are completely ill-founded. Unless trust in the banking sector is restored and lending to households and businesses resumes, the **expansion of the money supply is unlikely to feed into effective demand**. Since households and companies find it hard to obtain loans for purchasing goods and services, they are unable to increase their expenditure and to cause a surge in prices.



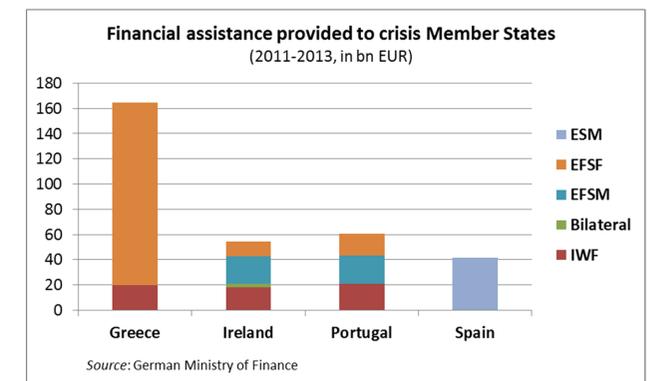
Indeed, one should also bear in mind that the ECB aligns its monetary policy to the euro area as a whole and not just to a couple of individual (German-speaking) countries. In the past decade, the common monetary policy of the ECB resulted in very low inflation rates in Germany and Austria, while countries such as Ireland and Spain recorded significantly stronger rises in prices. On average, however, **the inflation rate was close to 2%** (equivalent to the ECB target). If countries like Portugal and Italy want to regain price competitiveness by allowing wages and prices to grow only very weakly in the future (e.g. by 1%), inflation in other countries of the euro area must be higher than 2%, so the average remains around 2%. In fact, inflation rates of 3% in Germany and Austria for a few years would not constitute an economic disaster. For example, the average inflation rate in the economically prosperous years of the 1980s and 1990s was noticeably higher than 2%.

MYTH 8

"Financial aid is only delaying bankruptcy"

Financial aid is often misunderstood as a gift from the 'rich' EU countries to the ailing Member States. Bankruptcy may thus only be delayed but not prevented. However, **financial assistance is not a gift** but comes in the form of loans that have to be repaid. Moreover, these loans also benefit the lenders. For example, loans from the rescue package allowed Irish and Spanish banks to service their outstanding debt obligations vis-à-vis other European banks that lent recklessly to the problem countries before the crisis. **Without those rescue loans banks and other investors in Germany or Austria would have lost a lot of money** and taxpayers in those countries would have been forced to bail out their own banks. It should also be kept in mind that creditor countries such as Germany make money out of the crisis as long as there is no default. On the one hand, the yield on German government bonds is historically low which has pushed down borrowing costs for Germany to unprecedented lows. On the other hand, the interest crisis countries have to pay on rescue loans is relatively high. This interest-rate spread is a form of profit that accrues to the lending countries.

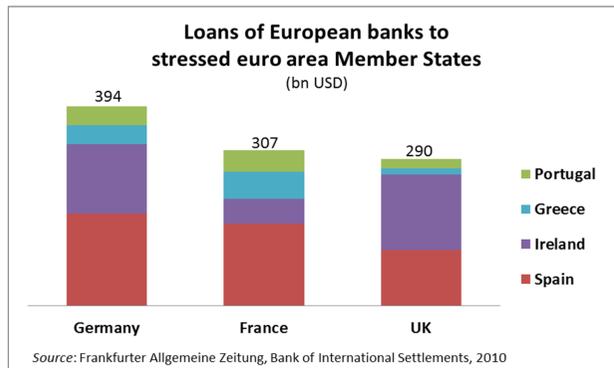
Whether the crisis countries will be able to fully repay their debt largely depends on the interest they have to pay on their loans. **The lower the interest rate, the more likely will be its full repayment** and the higher the rate, the greater the likelihood of a government default. The level of interest rates reflects the assessment of the market participants whether all debts can be redeemed, i.e. the more credible a repayment promise, the lower the interest rates. Conversely, a loss of credibility will act as a self-fulfilling prophecy, if exploding interest rates force an illiquid government into bankruptcy. In contrast, financial assistance and the associated economic reforms strengthen the credibility of crisis countries on financial markets and thus facilitate the repayment of their debt. For example, Ireland has already been able to issue bonds at affordable costs after two years of financial assistance.



MYTH 9

"They only want our money"

Populists like to prop up the image of Germany or Austria as the 'pay-masters of Europe' who have to foot the bill for others. Apart from the fact that 'the others' often are German and Austrian banks, which speculated in southern Europe and Ireland and incurred large losses, it is often overlooked that our net contributions tend to flow back into our countries with a significant interest mark-up. Thus, our economies are net beneficiaries but the crisis also brings about also other tangible benefits to the 'core countries' of the euro area. More specifically, **the yield of Austrian and German government bonds is at a historical low**, while interest rates in crisis countries have exploded. The reason behind this phenomenon is that investors seek a 'safe haven' for their funds and are prepared to forego higher returns. At crisis peaks they are even willing to pay more for this assurance and interest rates can turn negative. According to several independent estimates, Germany has saved between 70 and 100 billion euros in terms of lower interest payments (over the entire maturity of its bonds) due to the crisis.



We are often told that community bonds (euro bonds) would increase the cost of debt financing in countries with high creditworthiness (AAA-rated countries) and would provide no incentive to crisis countries for budget discipline. Theoretically, it is not proven from the outset that jointly-guaranteed bonds would actually be more expensive for some countries. For example, given the larger supply of (euro) bonds, the liquidity premium is likely to be lower, i.e. the part of the interest rate that investors demand because they are concerned about the ability to sell their bonds anywhere and at any time. Euro bonds would also remove the basis for speculation. Of course countries would have to meet strict requirements in fiscal discipline in order to get access to shared sovereign funding. Actually, euro bonds already exist in the form of issuances of the euro rescue fund (EFSF, ESM) and the requirements of the Troika concerning fiscal discipline can certainly not be characterised as too lax.

MYTH 10

"The worst is behind us"

Whenever the crisis abated and markets revived, hopes were rising that the worst was over. Immediately, commentators started to proclaim that German chancellor Merkel's and finance minister Schäuble's strategy of small steps had proved successful. The truth is that it is mainly thanks to the ECB that the crisis has not yet ended in a collapse of the euro area. **But the actions of the ECB have only bought time.** Unfortunately, this period of relatively benign market conditions is not used effectively as political decision makers have resorted to complacency and put off necessary projects to overcome the crisis like a genuine banking union. As long as a viable political solution is lacking, the danger is by no means averted. At the same time, the economic and social costs of reinforced austerity are ticking time bombs that threaten the internal and social cohesion of Europe to the extreme.

Political reluctance and wrong recipes have already cost us dearly. Since 2010, the economy of the entire euro area grew by three percentage points less than its U.S. counterpart. This is equivalent to a loss of 270 billion euro! And while the U.S. economy creates jobs, another three and a half million people became unemployed in Europe.



Although the crisis countries make progress in gaining competitiveness and adapting their economic structure, they are **stuck on a treadmill** in three ways: First, austerity is compressing domestic demand which leaves already tumbling banks reeling and causes public debt to rise due to lower tax revenues and higher social spending. Second, the improved trade balance of the euro area tends to strengthen the euro which implies a loss in competitiveness. And third, deflation in crisis countries (through falling wages) reduces nominal output even further which causes the debt-to-GDP ratio to increase despite harsh consolidation measures.

A COMPREHENSIVE SOLUTION

Monetary union 2.0 with social dimension

Muddling through and tampering with crisis symptoms does not represent a viable option. A convincing alternative beyond self-defeating austerity has to be comprehensive and efficient. More specifically, we need strong and reliable safety nets with the objective to protect savers and small-scale investors effectively. The banking union, so far only adopted on insufficient terms, must be developed further into a true **Bank Monitoring Union** with the aim to restore citizens' confidence in their personal financial transactions and the financial system as a whole – up to the assurance that those who caused the crisis have to pay for it.

Savings can only be built from output. Instead of a 'fiscal union' which only carries forward inflexible and undifferentiated austerity, we need a **Fair Taxation Union**. This must include budgetary rules and minimum taxation standards, the closing of tax loopholes as well as a burden shifting from small and middle-income earners to high-income recipients and wealth owners. First and foremost, we have to change tack towards growth and employment and open the way for a euro area budget and limited debt mutualisation. Alongside employment-enhancing structural reforms a public investment plan could be the driving force of a socially and environmentally sustainable transformation of the European economy. This investment initiative could be financed through a so-called 'future fund' with a neutral impact on government debt.

In addition, we need both an **Economic** and a **Social Union**. European social partners must be involved in the entire economic and social governance of the euro area and the EU. Structural reforms aiming at a more flexible economy must reconcile economic performance with social security (flexicurity). By coordination of negotiated wages or statutory minimum wages a productivity-oriented wage policy is set to secure the competitiveness of all countries.

The aim of the **Political Union** is not only to legitimize the economic reforms of the monetary union, but also to overcome the democratic deficit in the EU. As a first step, the European Parliament should establish a separate euro-area committee. Finally, we are committed to the vision that the political will of the European citizens has to be formulated directly and transparently in the European Parliament in association with national parliaments and to be implemented by an effective and efficient European executive.

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