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"The Future of the Euro"

OXONIA Distinguished Speaker Event

By Rt. Hon. John Redwood (All Souls College)

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The Rt. Hon. John Redwood developed an argument he first made over a decade ago in "Our Currency, Our Country" (1997), which stated that the entry criteria and stability pact put in place by the founders of the European Union (EU) would not be sufficient, and that more and more powers would have to become centralised. Without this, he foresaw that some countries would free ride on the common interest rate and borrow too much at relatively low interest rates.

When John Redwood presented a seminar at All Souls College in February earlier this year the calamitous outcome of the situation he had predicted had become a reality. Certain member states had borrowed so much because of the induced hike in interest rates they could no longer afford their debt. The highly indebted (so-called) peripheral eurozone economies began facing painful adjustment processes in aim to restore their competitiveness and the stronger member states created expensive loan packages to bailout profligate members. The markets have not regained confidence and in the nine months that have passed the crisis has escalated. The dramatic change, as Sir John Vickers, chair of the seminar, pointed out, is evident from comparing the cost of debt for certain European governments now and earlier this year in February: the cost of borrowing for the Italian government has risen from 4.8% to 7%, and from 12% to 30% for the Greek government.

John Redwood began this seminar by explaining the difference between the common model of a single currency and the European model. Usually, a single currency is backed by a single country and government, and decisions are made by a sovereign. In the UK, for example, the conventional model applies. The elected central government works with the central bank to control monetary policy and inflation targets. The government sets out aims for the economy and is effectively the "sovereign" (although technically it is the Queen), and the central bank has power to buy bonds, lend to banks and set rates. It is the government's job to keep broad consent for the institutions, and if trust breaks down the electorate can exert power to change the government, institution, or policy.

In contrast, in the European model there is no agreed sovereign, individual governments set targets for growth specific to their countries (although there is a common inflation target), and the central bank has limited powers which it must decide to use subject to conflicting pressures from member states. These unconventional characteristics can account for both the crisis and why it so difficult to resolve. The eurozone has a constrained set of tools with which it can overcome the crisis (e.g. it has no legal powers to print its way out of debt and the less competitive countries in the south cannot devalue to promote growth) and since there is no agreed sovereign to make decisions actions must be decided on an EU or euroland level between national ministers. It is proving difficult to keep on top of the fast pace of events as, in addition to the time needed for states to reach an agreement, meetings are sporadic.

As a result, despite numerous negotiations, several key problems remain. Firstly, there needs to be control over the debts and deficits of member states, which John Redwood believes is at the core of the unhinging of the euro. It is not only that some countries borrowed at too low an interest rate, but that from the very beginning every country (excluding just Luxembourg) exceeded the limits set by the founders on how much states could borrow. Reductions are particularly challenging for countries like Italy with a large stock of national debt.

Secondly, the solvency of the banks needs to be ensured. John Redwood scorned the fact that Europeans had been "kidding themselves" when they described the financial crisis of 2008 as an anglo saxon problem. In fact, banks across the West were all equally weak. The boom in lending to the Spanish property market, for example, was no more prudent than subprime mortgages in the US. Unfortunately, this became apparent later on and so when the euro crisis hit it compounded the solvency problem of Europe's already weak banks.

Thirdly, a route to economic growth needs to be found. If growth returned, then inflation and rising government revenue could reduce debts. John Redwood was pessimistic because he does not think Europe is competitive enough globally to achieve growth through exports and he does not think that it has the means to do it internally. Furthermore, public spending cuts which are necessary to increase confidence and reduce the chance of default will not help to promote growth. Some states will cut wages and other costs to compete in the absence of the ability to devalue but he said that, whilst Germany considers this a lesson to spendthrift states, he doubts that the people of those countries, like Greece, will accept it. He revealed that austerity was leading to things he would "not want to mention in polite public" and that he expected to see more rioting and strikes, as well as a rise of far right and left parties.

John Redwood is unconvinced that the solutions advocated in Europe will work. He declared that requiring banks to hold more capital will lead to less lending by weaker banks, and that increasing tax and regulation to raise government revenue is proving counterproductive. In Greece, for example, entrepreneurs only accept cash in order to avoid taxes and the rich are going one step further by taking their money out of the country completely (apparently there are queues to buy flats in London).

The European Financial Stability Facility is a large new fund designed to provide subsidised loans to distressed banks and states but, in John Redwood's opinion, it is hardly the confidence building measure it is supposed to be. He explained that the fund is a Luxembourg based company that has AAA rating only because the countries backing it are currently AAA, and how the trillion euros the fund is supposed to have come from borrowing 440 billion euros that will then be geared by guaranteeing member state debt tranches (e.g. if Italy can only pay 80 cents on its debt, the fund will pay the remaining 20 cents). It is fortunate, John Redwood quipped, that the fund has only managed to borrow 16 billion euros so far. A previous measure that also did not boost confidence was the debt default that led to private banks, who already had weak capital cushions, being cajoled into accepting just half of the money back that they lent to Greece.

John Redwood believes that the euro crisis would be surmountable if there were a sovereign to lead and enforce a resolution; "a single currency works best if they have a single country to love them". Asked what he would do if he were sovereign of the EU, he replied that he would i) immediately order capacity to print and buy bonds ii) enforce urgent reform to single country budgets across EU, and iii) directly bolster banks.

Without a sovereign, a role that John Redwood does not believe the eurozone is ready to create, the 'easiest' solution according to him is the swift exit of weaker member states which will allow them to devalue. He thinks that other possible ways of breaking up the eurozone are worth considering too. He is circumspect of estimates that a break up would lead to catastrophic loss in output if it was properly organised and planned, and claimed that 87 countries have left a single currency since 1945 in an orderly way. Economics aside, John Redwood rejected the suggestion that a break up could have terrible political ramifications, namely that they could give rise to the conditions that once led to war.

John Redwood believes that the consensus among the political and business elite to hold onto the EU stems from an ideology. He is concerned that democratic values are slipping and that the "EU project" is being implemented by stealth as the politicians do not believe that, given the the opportunity to choose, people would vote in favour of it. He suggested that Berlusconi's departure illustrated the serious power in the hands of those pressing for the strengthening of the EU.

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