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Is it a looming euro crisis?

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The euro's weakness: background and solutions

Over the past eighteen months, the euro has lost about 20% of its value against the dollar, culminating in parity with the US currency. In recent years, the euro has also lost much weight against the Swiss franc, the Chinese yuan and especially the Russian rouble.

Why is this happening, and what is behind the euro's fall? Will the common currency continue to slump, and what impact could this decline have on us?

The controlling function of interest rates

To answer these questions, let's look at differences in interest rates – known as spreads – for different borrowers within individual countries or currency areas. Generally speaking, interest rates depend on borrowers' quality or creditworthiness. The higher the borrower's creditworthiness, the lower the bank's default probability. Hence the lower risk premium charged by the bank is reflected in a lower interest rate the borrower must pay.

Therefore, the difference in interest rates for different borrowers controls capital flows. Faced with high borrowing costs, bad debtors with low credit ratings receive few loans. In other words, high interest rates are supposed to discourage debtors from borrowing too much. Interest rates perform an essential function in managing the economy.

If interest-rate spreads and risk premiums do not reflect economic realities over more extended periods, mainly if risk premiums are not linked to the creditworthiness of borrowers, capital flows will be misdirected, allowing bad debtors to borrow a lot of money on the cheap. As economic history shows, economic shocks occur quite regularly, which can take the form of credit or even financial crises. Recent examples include Japan's real estate crisis in the 1990s, the 1997 Southeast Asian crisis, Spain's real estate crisis in 2008 and multiple project finance defaults in 2008, which exacerbated the 2007-2009 financial meltdown.

Thus, interest-rate spreads play a critical role in any economy. Steep risk premiums are supposed to discourage bad borrowers from taking more and more loans. When governments intervene to manage interest rates artificially, capital misallocations ensue: the wrong borrowers receive the wrong loans, triggering an inevitable market correction further down the road. The longer unrealistic interest rates disorient capital flows, the more drastic adjustments are required later.

Market mechanisms and the euro

When the euro was introduced as Europe's common currency in 1998 and 2002, policymakers started to intervene systematically in the market, which politically impacted the interest rates, and the capital flows were misdirected within the EU.

However, the laws of the market cannot be overruled by political will indefinitely – sooner or later, the market takes its revenge. To be specific, if lenders realize one day that they can no longer get their money back in total, a financial crisis can break out.

In all likelihood, the eurozone is heading for a severe financial crisis mainly because the pattern of interest rates and capital flows across the EU has been out of touch with reality for the past two decades.

In my opinion, the euro has been flawed from a purely economic standpoint from the very beginning. In a way, this creation could be compared to building a bridge based on false calculations. One day such a bridge would probably collapse.

The Italian case

Let's take Italy as an example. When the euro was adopted in 1998, Italy's level of public debt was already in violation of the Maastricht criteria. Officially, it was

supposed to be at or below 60% of GDP, but Italy's debt was as much as 114% of its GDP at the time. Technically, Italy should not have been admitted to the eurozone at all.

Nonetheless, European policymakers turned a blind eye to this fundamental rule from the start, choosing to ignore basic economic criteria. After nearly twenty years of using the euro, Italy saw its national debt soar to 150% of GDP by the end of 2021. In other words, the country's debt has increased by about 35 percentage points.

If the wrong interest-rate signals (i.e., the euro) had not been around, Italy would never have been able to borrow so much at such low interest rates. Since the early days of the common currency, the controlling function of high interest rates has been largely undermined.

For example, interest rates on Italy's ten-year government bonds were almost always lower than those on US ten-year government bonds from 2014 to early 2022. This was both an economic absurdity of the first order and grotesque market distortion. The US has a much higher AA+ credit rating than Italy with its BBB status.

The fact that Italy, as a borrower with a weaker credit rating, has been paying lower interest rates than the US for years is a politically motivated market distortion, an imbalance that the market is likely to punish brutally.

In addition, Italy has roughly the same credit rating as Romania. Still, for the past seven years, interest rates on Romania's ten-year government bonds have been several percentage points higher than those in Italy. This comparison also shows that interest rates have long been set arbitrarily across the eurozone.

If unrealistic prices prevail in the market for too long, they give rise to misaligned incentive structures, which can only worsen the situation.

This state of affairs can be compared to a country that does not have significant energy reserves and keeps energy prices artificially low. As time goes by, such a country gradually gets used to consuming much energy.

If energy prices rise for lack of government subsidies to match real-world market levels, an energy crisis will occur, triggering a painful economic cleanup process. The same scenario unfolds, albeit on a larger scale, when world market rates eventually begin to rise after years of artificial capping.

EU chief Ursula von der Leyen accused Russia of being an "unreliable supplier" and manipulating the European energy market by announcing new measures to combat high energy prices. Photo: Kira Taylor

What's next? The ECB's dilemma

The euro will likely come under more pressure in the coming months or years.
As matters stand now, the ECB is in the throes of a dilemma.

On the one hand, it must implement interest-rate hikes to curb soaring inflation which currently averages 9.1% in the eurozone. The ECB has recently begun to take steps in this direction.

In addition, the ECB's current interest rate of 1.25% is still well below the US Federal Reserve's rate of 2.5%, even though inflation in the United States stands at 8.5%.
The ECB will probably have to lift rates to match the US benchmark to curb runaway inflation. Meanwhile, it is estimated that the Fed will also have to deal with inflation in the US economy by raising interest rates to more than 4% by the end of 2023.

On the other hand, if the ECB also raises interest rates to 4% or more, the Italian government will face significant financial problems: considering that the country's debts are 150% of its GDP, an increase in interest rates by 4 percentage points would translate into an extra financial burden estimated at 6% of GDP. That is a huge amount of money by any standard of measure. How this debt will be financed remains to be seen.

It is worth remembering, however, by the end of 2022, Italy is expected to increase its energy imports by about EUR 60 billion, or 3 percentage points of GDP. It is unclear how the Italian economy will react and how the Italians will cover the runaway energy costs. Italy's real GDP per capita, adjusted for purchasing power, has already dipped below its 2000 level. In other words, the country has not seen real economic growth for almost a generation.

Other EU countries have also accumulated too much public debt to absorb sharp interest rate increases. For example, at the end of 2021, Greece's debt rose to 193% of GDP. Similar metrics for Portugal, Spain and France were 127%, 118% and 113%, respectively. These countries may face significant financial difficulties if they go ahead with substantially higher interest rates.

In short, if the ECB decides to bring down inflation by raising interest rates in the eurozone, Italy may be on the brink of sovereign insolvency. As a result, many Italian banks holding large government bonds may collapse. Given that financial markets are intertwined, this will trigger the flight of capital and may provoke a cascade of bankruptcies in the European banking industry. In the end, the EU will have a much deeper financial, currency and debt crisis than it did in 2008.

If the ECB does not raise interest rates to combat inflation in the eurozone, the common currency will likely weaken further. Prices for imported goods, such as energy supplies and raw materials, will continue to rise, fueling higher inflation across the EU. In this case, foreign investors, especially American ones, will probably lose confidence in the euro; as a result, the continent's currency may decline further and eventually collapse altogether.

If that is the case, the eurozone will plunge into chaos and a profound financial, monetary and economic depression fraught with unpredictable ramifications for all EU nations and economies.

The dire consequences of this scenario for continental Europe became evident during the 2008 financial crisis. I am afraid that if the euro does collapse under mounting market pressure, continental Europe will find itself in a tight corner again.

Cui bono, or who benefits from it?

Who stands to benefit from the economic break-up of continental Europe?

The primary beneficiaries are competing economies such as the United States, Britain, China and others. True enough, these economies will also take a hit following a severe downturn in Europe, especially in terms of declining exports to the EU. Still, the balance of power is likely to tilt in their favour. From the standpoint of hegemonistic ambitions, the above countries would come out winners. As they say, when two parties quarrel or split up, it is usually the third party that rejoices.

In addition, an uncontrolled euro could cause a great deal of national discontent. The initial idea behind the euro was the opposite: the common currency was meant to prevent EU members from major national upheavals. However, if national discontent becomes strong, continental Europe will probably be weakened for a long time as an economic competitor and a political force.

Strictly speaking, this turn of events could have been expected from the early days of the euro. Several lawsuits were filed against this initiative when the currency was first introduced. Moreover, some far-sighted economists had genuine concerns about the resilience of the common currency from the very start.

As a matter of interest, why was the euro introduced in the first place? Was its launch accidental? Anyone who thinks ill of the euro may be treated with contempt. However, it often helps to identify opportunistic profiteers to understand the bigger picture.

The next steps

First of all, the shortcomings of the European currency system need to be addressed openly and honestly. One option to remedy the situation is to phase out the euro in a well-managed and gradual fashion over the next twenty years.

This approach would restore national currencies and ultimately transfer decision-making authority back to national central banks. It would also allow local currencies and interest rates to "catch their breath" slowly but surely and adapt to the economic needs of individual countries.

As was the case in 1998-2001, the Pan-European interest-rate policy will prevail initially, but gradually more variance in interest rates and currencies will be allowed over the next two decades.

The interest rate and currency corridors will be introduced annually to prevent excessive currency speculation. This twenty-year plan would be the opposite of the euro's launch strategy over the past two decades.

Fiscal measures should be taken to secure public finances in individual countries and prevent social tensions.

For instance, one strategy is to introduce a progressive land tax, possibly starting from a threshold of EUR 2 million per person. In the long run, this tax could eliminate economically and ethically questionable large private land holdings, stimulating renting or leasing property. Housing, in general, may become more affordable. Initially, substantial revenues from the land tax could be used to reduce the fiscal burden for average taxpayers, which would significantly increase their net income and ensure social peace.

Other fiscal measures to prevent social disorder might include a substantial levy on competitive advertising and a general property tax.

In its current state, the euro does not seem sustainable in the long term. If the continent's policymakers continue to bury their heads in the sand, I am afraid that sooner or later, we will plunge into a grave euro crisis.