

The Eurosystem

Some observations

by Dieter Spethmann¹

The Euro, common currency of at present 13 member states (Euro zone) of the European Union (EU), has been introduced on 1 January 1999. Responsibility for its management and stabilization lies with the European System of Central Banks, which consists of 13 national banks of issue and the European Central Bank (ECB), a common subsidiary of these national central banks.

Like the US Dollar and all other contemporary currencies, the Euro is a "fiat currency". Official gold backing of currencies has ceased to exist decades ago. Nevertheless, in the afternoon of 27 April 2007, Goldseiten.de, an online information service, reported: "ECB attempts to get the price of gold down." Thus, the ECB has become noticeable on the market, as its American sister, the FED, has long since been. These two banks of issue are interested in preventing the gold price per troy ounce from rising above USD 700.

Gold is a stock-listed raw material. These markets have been striving for higher prices for long, looking for a new equilibrium. Official stocks of currency gold amount to approx. 30,000 tons, of which the German Federal Bank (GFB) owns about 3,500 tons. While the Swiss National Bank (SNB) holds 180 kg of gold per capita of its population, the GFB owns as little as 45 kg. Worldwide gold production amounts to around 2,500 tons annually. In my opinion, it is not the ECB's task to squander the gold, which – strictly speaking – is the property of the citizens of the Euro zone, in a hopeless battle on the market.

This having been said, let me present some observations and questions on the basis of eight years' experience with the Euro.

Is the Euro a single currency? Not really, but rather – and this should be borne in mind to understand my presentation – a pool of 13 national currencies.

Firstly. The European Central Bank (ECB) does not print bank notes nor does it issue such. This right is exercised solely by the national banks of issue, in Germany, hence, by the German Federal Bank.

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Secondly. Each of these banks of issue marks each note it issues and puts on the market with a letter preceding the serial number. X stands for Germany, U for France, Z for Belgium, L for Finland, Y for Greece, V for Spain, T for Ireland, S for Italy, R for Luxembourg, P for the Netherlands, N for Austria, M for Portugal.

Thirdly. All of these 13 banks of issue are compelled to finance differing national inflation rates, for these vary from country to country.

Is cross-border payment now easier than before? Yes. An emitted Euro note is the legal tender in each of the 13 member states.

Are the citizens aware of such cross-border payment? Yes, from the percentage composition of the Euro notes they carry in their purses. A person accepting change in Germany will soon realize that the X-marked German Euros account for less and less of his/her pocket money.

Where do these foreign Euro notes come from? People from other countries of the Euro zone have made purchases in Germany: Non-X-marked Euro notes have been spent for merchandise, services or capital assets in Germany. Following the logic of the market, Euros that have been emitted in higher-cost member states buy more favourably in those member states with lower inflation. Thus, owing to the Euro's nature as a legal means of payment that is automatically effective in other Euro countries, the non-X-marked Euros are preferably directed from those countries with higher inflation (which are all of the others) to Germany, the member state with the lowest inflation: We give away merchandise, services and capital assets for foreign paper money.

Is there a detectable inflation differential between the 13 Euro states? Yes. From 1999 to 2006, accrued inflation for the Euro states was as follows: Slovenia 44.9 / Ireland 28.8 / Greece 26 / Spain 25.7 / Portugal 24.3 / Italy 18.6 / the Netherlands 18.4 / Luxembourg 18.3 / Belgium 16.2 / Austria 14.4 / France 13.6 / Finland 12.4 / Germany 11.8. For Germany, this means an annual inflation rate of 1.5%; for Ireland, however, one of 3.6%; for Spain, 3.23% and so on. Also during this period, as already before, the inflation rate in Switzerland, neither a member of the Euro zone nor one of the EU, was even lower than Germany's approx. 1.0% annually in 2005 and 2006.

Which were, from 1999 to 2006, the accrued inflation overhangs as compared with the member state with the lowest inflation, Germany? Slovenia 33.1 / Ireland 17 / Greece 14.2 / Spain 13.9 / Portu-

gal 12.5 / Italy 6.8 / the Netherlands 6.6 / Luxembourg 6.5 / Belgium 4.4 / Austria 2.6 / France 1.8 / Finland 0.6.

Can monetary compensation between the member states for such inflow of foreign Euros be expected at all? I don't think so. A Euro note that has a lower purchasing power in the country of its emission than in all – or at least in some – other Euro countries will in all probability flow to these countries. Thus, higher national inflation will, on the one hand, result in higher money provision of the economy concerned, on the other, in a higher outflow of these bank notes to other Euro countries. They will buy there and thus increase the inflation potential in this country. If one considers – as I do – the inflation divergences to be cultural phenomena, then there is no hope for monetary compensation for the economies concerned, which are forced to give away tangible assets for paper money.

Does the central bank of the country of inflow have any rights connected with the foreign Euros flown in? I don't think so. Even the German Federal Bank cannot prevent such higher inflation in all other Euro countries from encouraging two things: firstly, the printing of money, and secondly, the use of increasingly greater parts of this money for purchases in Germany or in other countries with low inflation.

Is this a new technique of compensating current account deficits between different economies? Yes. In English this is called "Beggary thy neighbour". Thus, the Portuguese government quite frankly admits on the internet: "Portugal's foreign trade regularly shows a high deficit, which Portugal finances through ... net inflows from the EU." Voilà. All you have to do is look there. By the way, in 2006, Portugal's current account deficit amounted to 9.3% of its GDP, which is higher than that of the USA.

Nominal and real rates of interest. The ECB offers each of its borrowers the same conditions, which, of course, concerns the entire Euro zone. The inflation rates, however, have an essentially national effect (economic structure, determination of wages, productivity etc.), which is why real interest rates differ among the countries according to their respective national inflation: higher inflation, lower real rates of interest.

The German borrower, be it the state, an entrepreneur or a private citizen, does pay a higher rate of interest within the ECB system than would be required from an economic point of view. For, given that Germany has the lowest rate of inflation of all Euro states, he, the borrower, will pay an excessive inflation surcharge. I have been publishing this for years, and finally the authors of a new study conducted by the KfW group of banks

(Handelsblatt) agree: „Banking institutions that refinance themselves via the capital markets did no longer profit from the formerly lower capital-market interest rates in Germany, whereas the declined cost of refinancing was of benefit to the European banking competitors.“

Which role does the German Federal Government play in this game? A particularly inglorious one. Initially, it consented to the Euro system, which repealed the indexation prohibition of the DM system. Then, starting in early 2006, for the first time it launched an index-linked loan basing the inflation-related surcharge for interest and redemption on the (higher) average of the Euro zone instead of the (lower) German index. Now the German Government argues that, with its bonds, it only means to satisfy the requirements of the private capital market participants. Thus, the Federal Government pushes inflation in Germany.

Does this mean that borrowers in those states with a lower inflation rate pay higher real rates of interest than in the other member states? Yes. Borrowers in Spain sometimes pay a real rate of interest amounting to zero.

Do different real rates of interest bear an effect on the situation on the labour market ? Yes.

How is it possible that Spain shows a current account deficit of approx. \$ 108 billion or 8.6% of its GDP but has no problem financing it? Take a look at Portugal or Greece or Italy or other countries. The EU/Euro twin system will compensate such deficits painlessly.

How does the ECB acquire the amounts of foreign exchange required to compensate such deficits? By transfer from those countries that have a surplus: Germany, the Netherlands, Belgium, Luxembourg, Austria or Finland.

Do these countries receive a fair consideration for giving away their money? I don't think so. At the end of 2006, the German Federal Bank's stock of gold and foreign exchange was lower than the German current account surplus of that same year.

Will the deficit countries be able to re-establish the balance of their foreign trade in the future? I don't think so. They are the laggards in a globalized competition. Year after year, they consume more than they produce. Nevertheless, they can sleep peacefully. For their Euro-surplus brothers have so far financed almost any malpractice.

Statistics on unemployment back up my theses. France, with an unemployment rate of 8.8%, is the tail ender. Spain and Greece, with 8.6% each, are hardly better off. Also Portugal, with 7.5%, is not convincing. Germany's unemployment rate of 7.1% lies only slightly below the average of the Euro zone, i.e. 7.3%, but shows a more favourable tendency. Switzerland, on the contrary, which is neither a member of the EU nor a member of the Eurosystem, has an unemployment rate of less than 3%.

Also the latest international representative list of rents supports my theses. Average rent in Düsseldorf, Germany, amounted to € 12.5/sqm/month; in Madrid, however, to € 18.8; in Milan, to € 22.5; in Rome, to € 31.2; and in Paris, to as much as € 39.2. Different rents mean different business location cost, which can no longer be compensated by the exchange rate.

Is all this consistent with the solemn exclusion of liability clause in Art. 103 of the Treaty Establishing the European Community? No. It is a violation of this Treaty. Procedures that become a matter of "consolidation" within the Eurosystem, that is, between the 13 national banks and the ECB, are no longer a matter of national "bookkeeping", although they have an enormous influence on the national economies. The deficit brothers buy assets for paper money, and the surplus brothers lose assets for paper money.

Do these facts and figures stand for an optimal currency area? No. They stand for divergence instead of the convergence purported by the EU. Today, there is a higher imbalance between the member states of the Euro zone than at its start. An optimal currency area would comprise the surplus countries: Germany, the Benelux states, Austria and Finland. Such a structure would allow the deficit countries to return to their respective own currencies and by devaluating them regain competitiveness on the global market.

To crown it all, Germany contributes more to the EU budget than would be reasonable from an economic point of view. For as far as the per-capita income is concerned, Germany does no longer hold but a medium rank.

Europe's leading politicians agree in two contradicting convictions. The first – and they do not tell us how they know – is that all, or an overwhelming part of, the citizens of the EU do want the EU constitution. The second is that they would be wise to avoid any acid test in the shape of a referendum. To avoid such an acid test, however, they make every effort to not allow a new referendum under any circumstances. As a leading

Eurocrat admits, the mere thought of a new referendum causes “absolute, pure terror” in Brussels. What falls by the wayside is the German state under the rule of law as it existed before and the currency concept that brought us wealth and justice on the basis of the deutsche mark.

Do I see a connection between economic growth and currency?

Yes. Economic growth in Germany was high during the first two decades of the fixed-rate system of Bretton Woods (until 1969), it varied after the system’s collapse, and only from the mid-1980s, did Germany experience a considerable economic growth again. Expressed as a percentage: 3.7 – 3.9 – 5.3 – 5.1. This is how long it took the German economy after the cessation of the fixed-rate system to find a new equilibrium, given flexible exchange rates. The strain which this equilibrium has been exposed to on account of the extraordinary requirements of the reunification since 1990 is time-limited by nature. What is not limited is the imbalance that we have incurred by the Eurosystem. As is generally known, Friedrich August von Hayek questioned the quality of the state under the rule of law in case too many of the voting citizens would become dependent on governmental transfer income. We Germans are meanwhile confronted with this phenomenon in two respects: on the one hand, within the German welfare state, where there are too many recipients of transfer income, on the other, within the EU/Euro twin system, where nothing is done against the voting rights of the recipients of subsidies.

All this prevents the capital in Germany from flowing where it would be of the greatest use, economically speaking. Quoting the Frankfurter Allgemeine Zeitung, which commented the passing of the enterprise tax reform by the German Diet on 26 May 2007: “This reform does certainly not meet the criteria of good tax politics. But then, Germany’s taxpayers are not fastidious in this regard. Thus, many of them will be glad – after the two years’ tax raising orgy of the grand coalition – that this time a tax relief is on the agenda. One can only hope that such relief will appear sufficiently attractive to investors.”

What do we really need? A Europe of citizens who trust each other across the frontiers, who increasingly visit each other, who freely cross the borders to work and invest and marry, and all this with political intervention limited to a minimum.

Düsseldorf, on 3 June 2007