The collateral damage of Europe's rescue
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The eurozone is now in its sixth year of crisis – and of efforts by the European Central Bank and the international community to end it. Policymakers are becoming ensnared in a creeping interventionism that, as British Prime Minister David Cameron has put it, may alter the eurozone "beyond recognition" and violates Europe's basic economic and political rules.

Illustration by Paul Lachine

The newest demand, loudly voiced by French President François Hollande, is for the ECB to manipulate the exchange rate. Hollande is alarmed by the rapid appreciation of the euro, which has risen from $1.21 at the end of July 2012 to $1.36 in early February this year. The strengthening exchange rate is putting additional pressure on the rickety southern European and French economies, undermining their already low competitiveness.

The cheap credit ushered in by the euro fed an inflationary economic bubble in southern Europe that burst when the financial crisis hit. Credit terms worsened abruptly, and what was left was the thoroughly overpriced rump of economies that had become excessively dependent on foreign financing.

The French economy, in turn, is suffering because its customers in southern Europe are in trouble. According to a study by Goldman Sachs, France would have to depreciate by around 20% relative to the eurozone average, and by about 35% vis-à-vis Germany, to restore external-debt sustainability.

The ECB and the international community – particularly the International Monetary Fund – have tried to deal with the crisis by replacing the dearth of private capital with public credit. The ECB shifted its refinancing credit and money creation – to the tune of €900 billion – toward southern Europe and Ireland, as measured by the Eurosystem's Target balances. In doing so, however, it put itself in peril, because the only way to implement the shift was by lowering the collateral requirements for refinancing credit. To a large extent, this collateral consisted of government bonds.

In order to stop these securities' downward slide – and thus to save itself – the ECB bought these government bonds and announced that, if need be, it would do so in unlimited amounts. At the same time, the European Stability Mechanism was established to safeguard states and banks.

These assurances managed to calm the markets and restarted the flow of capital from the eurozone's core to its periphery. But capital is flowing in from other countries as well. Holding euros and acquiring euro-denominated securities have become attractive again around the world, pushing up the exchange rate and causing new difficulties.

Here, it should be said that the Bank of Japan's manipulation of the yen's exchange rate has played only a minor role, notwithstanding Bundesbank President Jens Weidmann's strong condemnation of the policy. Japanese intervention cannot explain the revaluation of the euro against the dollar and many other currencies.
The ECB can curb the euro's appreciation through purchases of foreign currency. But, ultimately, it would have to do so by inflating its own currency until confidence in the euro falls back to the level that it had before the assurances were made.

That is why ECB President Mario Draghi rejected Hollande's suggestion almost instantly. Draghi is well aware of the enormous sums that were lost during the 1970's and 1980's, after the collapse of the Bretton Woods system, in futile and costly interventions to stabilize exchange rates, and he does not want to jeopardize the ECB's goal of maintaining price stability.

The euro's appreciation lays bare the huge collateral damage that Europe's rescue policy has caused. The measures taken so far have opened channels of contagion from Europe's crisis-ridden peripheral economies to the still-sound economies of Europe's core, placing the latter's taxpayers and pensioners at great financial risk, while hindering long-term recovery in the troubled countries themselves.

True, Europe's rescue policy has stabilized government finances and delivered lower interest rates for the over-indebted economies. But it has also led to currency appreciation, and thus to lower competitiveness for all eurozone countries, which may yet turn into a debacle for the southern eurozone and France, which are too expensive anyway, and for the euro itself.

The ECB's rescue operations have hindered the internal depreciation – lower prices for assets, labor, and goods – that the troubled economies need to attract fresh private capital and regain competitiveness, while the euro's appreciation is now compounding the challenge. In short, Europe's rescue policy is making the eurozone's most serious problem – the troubled countries' profound loss of competitiveness – even more difficult to solve.

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