

# CSFI

## CENTRE FOR THE STUDY OF FINANCIAL INNOVATION

5 DERBY STREET  
LONDON W1J 7AB

TEL: 020 7493 0173  
FAX: 020 7493 0190

### **“The Crash of 2003”: A round-table discussion on the CSFI’s 1996 paper, with the author David Lascelles, Ruth Lea (Global Vision), Mats Persson (Open Europe) and Lord Haskins.**

**Held on Thursday, April 22, 2010, from 12:30-2:15pm.  
at Innholders’ Hall, 30 College Street, London, EC4R 2RH.**

This round table was held to discuss a CSFI report, written 14 years earlier but describing an imaginary event in 2003 in which the euro collapsed. One of the authors outlined the thinking behind the report and its satirical format. At the time it was felt that the issue of Euro membership was so contentious and the atmosphere so politically charged, that the contributors wanted to ensure that the CSFI wasn’t ‘branded’ as Eurosceptic. However, given that it was so widely assumed that the Euro was a good thing, that the UK would suffer from not joining and that it would definitely happen; the CSFI felt compelled to challenge those assumptions whilst highlighting some of the flaws in the proposals.

The satirical format of the report allowed the contributors and author to provide a fictional account of a break-up of the EMU that illustrated those flaws. In this fictional account it was France that ran into deep trouble and was unable to manage her external payments (at the time of writing it was assumed that a large country would have to falter in order to have a real impact. It was never suspected that Greece would be in the Eurozone let alone precipitate a crisis). Then in 2000 a global economic crisis led to a banking crisis and a crash of global markets. France turned to Germany in hopes of a bailout but shifts in the political environment (a rightward shift in Germany) meant that none was forthcoming. France withdraws from the Euro, followed the other countries and monetary union shrinks to essentially a DM bloc. The end result is a single market with several currency blocks.

The main points of the paper were that EMU was a politically driven project and that it was not sufficiently thought through, i.e. how to handle country failures. It was noted by the author that if it was obvious to those that worked on the report 14 years ago, why didn’t anyone do anything to address those weaknesses? It was noted by one of the panel, however, that the practical difficulties were considered and worked through by the ECB. He felt that the EMU functioned pretty well until the recent financial crisis, which had affected all countries. He also highlighted the fact that the value of the Euro had fluctuated but that was ‘normal’ behaviour for any currency.

One of the speakers noted that she felt, at the time, that Euro membership was not good for the UK given what she deemed was the incompatibility of the UK and German economies. There was not sufficient structural convergence that would enable the two countries to live with similar exchange and interest rates. In essence, a country should not adopt policies that would undermine growth. Her analysis and strong opinions were informed by the experience of the ERM. The inflexibility of the interest rate (with German rates essentially setting the floor) exacerbated the 1992 recession and though the sterling exchange rate was perhaps also overvalued, the main problem was that interest rates were too high. After the pound was evicted from the ERM, interest rates dropped quickly. If the UK couldn’t live within the ERM, how would she have fared in the single currency?

The experience of the ERM – basically a trial run for EMU, didn’t dissuade the political project of further integration and EMU moved ahead, seemingly unstoppable. The speaker felt that an expanding Deutsche Mark area, that grew ‘organically’ based on economic criteria, would have been sensible but the political emphasis was on EMU. Another panelist agreed that conditions had to be right for a country to enter EMU and that it had been a mistake to include Greece, Italy and Spain. Another speaker pointed out that political ambition can’t change economic realities and that further political and economic integration was needed in order for EMU to work.

And the stability and growth pacts had serious implications for the EMU, in particular, for the peripheral countries. Lower long term interest rates fuelled credit growth in these countries, while wage inflation eroded their competitiveness. A second source of divergence was the split between surplus countries and those with big deficits (Greece, Ireland). In vulnerable countries borrowing had exploded. Now Greece, for example was faced with the prospect of a draconian austerity package but without the added policy tool of devaluation.

The political complexity of the German position was noted, such as the constraints of using German tax revenue for a bailout and the fact that German banks held a lot of Greek debt. Likewise was the response of countries to an unelected commission imposing conditions on member states. In the near-term, the panel agreed that Germany has too much to lose and would, in the end, bail Greece out. The long-term sustainability of those transfers was, however, questioned by both the panel and many attendees.

So, while noting that there was a broad consensus that the EMU project had been too political, what were the lessons to be learned? And looking forward, where was it heading? One speaker felt that although the financial crisis had been a challenge (for those in and out of the Euro), that it may well lead to further integration through regulatory cooperation and greater convergence of fiscal policies. Others were far less optimistic and felt that tensions would persist; a North South divide, problems of competitiveness, political changes and, in particular, uncertainty surrounding the unfolding situation in Greece.