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The Little Currency That Couldn't

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THE EURO should now be recognized as an experiment that failed. This failure, which has come after just over a dozen years since the euro was introduced, in 1999, was not an accident or the result of bureaucratic mismanagement but rather the inevitable consequence of imposing a single currency on a very heterogeneous group of countries. The adverse economic consequences of the euro include the sovereign debt crises in several European countries, the fragile condition of major European banks, high levels of unemployment across the eurozone, and the large trade deficits that now plague most euro-zone countries.

The political goal of creating a harmonious Europe has also failed. France and Germany have dictated painful austerity measures in Greece and Italy as a condition of their financial help, and Paris and Berlin have clashed over the role of the European Central Bank (ECB) and over how the burden of financial assistance will be shared.

The initial impetus that led to the European Monetary Union and the euro was political, not economic. European politicians reasoned that the use of a common currency would instill in their publics a greater sense of belonging to a European community and that the shift of responsibility for monetary policy from national capitals to a single central bank in Frankfurt would signal a shift of political power.

The primary political motive for increased European integration was, and may still be, to enhance Europe's role in world affairs. In 1956, just after the United States forced France and the United Kingdom to withdraw their forces from the Suez Canal, German Chancellor Konrad Adenauer told a French politician that individual European states would never be leading global powers, but "there remains to them only one way of playing a decisive role in the world; that is to unite to make Europe.... Europe will be your revenge." One year later, the Treaty of Rome launched the Common Market.

The Common Market expanded in 1967 to form the European

Communities, and then, in 1992, the Maastricht Treaty gave rise to the European Union, which created a larger free-trade area, provided for the mobility of labor, and set a timetable for adopting a single currency and an integrated European market for goods and services. The European Commission cast this arrangement as a steppingstone toward greater political unity and made the specious argument that the free-trade area could succeed only if its member countries used a single currency. (There is, of course, nothing in economic logic or experience that implies that free trade requires a single currency. The North American Free Trade Agreement, for example, has stimulated increased trade without anyone thinking that the United States, Canada, and Mexico should have a single currency.)

Germany resisted the decision to create a single currency, reluctant to give up the deutsche mark and the price stability and prosperity it had brought to the country's postwar economy. But Germany eventually gave in, and France and others succeeded in establishing a schedule that would lead to the launching of the euro in 1999. Germany was, however, able to influence some of the characteristics of the ECB: the bank's formal independence, its single policy goal of price stability, the prohibition on purchasing bonds from member governments, a "no bailout" rule for countries that became insolvent, and its location in Frankfurt. Germany also forced the creation of a stability agreement that established financial penalties for any country that had a budget deficit of more than three percent of its GDP or a debt that exceeded 60 percent of its GDP. When France and Germany soon violated these conditions, the Council of Ministers voted not to impose penalties, and the terms of the pact were weakened so that they became meaningless.

A DEATH FORETOLD

LONG BEFORE the euro was officially introduced, economists pointed to the adverse effects that a single currency would have on the economies of Europe. (See, for example, my *Economist* article from 1992, "The Case Against the Euro," or my essay from these pages, "EMU and International Conflict," November/December 1997.) Single currencies require all the countries in the monetary union to have the same monetary policy and the same basic interest rate, with interest rates differing among borrowers only due to perceived differences in credit risk. A single currency also means a fixed exchange rate within the monetary union and the same exchange rate relative to all other currencies, even when individual countries in the monetary union would benefit from changes in relative values. Economists explained that the euro would therefore lead to greater fluctuations in output and employment, a much slower adjustment to declines in aggregate demand, and persistent trade imbalances between Europe and the rest of the world. Indeed, all these negative outcomes have occurred in recent years.

Here is why: when a county has its own monetary policy, it can respond to a decline in demand by lowering interest rates to stimulate economic activity. But the ECB must make monetary policy based on the overall condition of all the countries in the monetary union. This creates a situation in which interest rates are too high in those countries with rising unemployment and too low in those countries with rapidly rising wages. And because of the large size of the German economy relative to others in Europe, the ECB'S monetary policy must give greater weight to conditions in Germany in its decisions than it gives to conditions in other countries.

The tough anti-inflationary policy of the ECB caused interest rates to fall in countries such as Italy and Spain, where expectations of high inflation had previously kept interest rates high. Households and governments in those countries responded to the low interest rates by increasing their borrowing, with households using the increased debt t finance a surge in home building and housing prices and the governments using it to fund larger social programs.

The result was rapidly rising ratios of public and private debt to GDP in several countries, including Greece, Ireland, Italy, and Spain. Despite the increased risk to lenders that this implied, global capital markets did not respond by raising interest rates on those countries with increasing debt levels. Bond buyers assumed that a bond issued by one government in the European Monetary Union was equally safe as a bond issued by any other government in the union, ignoring the "no bailout" provision of the Maastricht Treaty. As a result, the interest rates on Greek and Italian bonds differed from the rate on German bonds by only a small fraction of a percent.

Before the monetary union was put in place, large fiscal deficits generally led to higher interest rates or declining exchange rates. These market signals acted as an automatic warning for countries to reduce their borrowing. The monetary union eliminated those market signals and precluded the higher cost of funds that would otherwise have limited household borrowing. The result was that countries borrowed too much and banks loaned too much on overpriced housing.

When, in early 2010, the markets recognized the error of regarding all the eurozone countries as equally safe, interest rates began to rise on the sovereign debts of Greece, Italy, and Spain. Market dynamics put in motion a self-reinforcing process in which rising interest rates led countries to the brink of insolvency. In particular, the fear that Greece might have trouble meeting its debt payments caused the interest rate on Greek debt to rise; the expectation of higher future interest payments implied an even larger future debt burden. What started as a concern about a Greek liquidity problem—in other words, about the ability of Greece to have the cash to meet its next interest payments— became a solvency problem, a fear that Greece would never be able to repay its existing and accumulating debt. That pushed interest rates even higher and led eventually to a negotiated partial default, in which

some holders of Greek sovereign debt agreed to accept a 50 percent write-down in the value of their bonds. In turn, the Greek experience raised the perceived risk of Italian government debt, causing the interest rate on Italian government bonds to rise from less than four percent in April 2010 to more than seven percent in November 2011— a rate that will cause government debt to rise faster than national income, pushing Italy to the brink of insolvency.

A different market dynamic affected the relationship between European commercial banks and European governments. Since the banks were heavily invested in government bonds, the declining value of those bonds hurt the banks. The banks then turned to their governments to protect their depositors and other creditors, thus magnifying the original problem. In Ireland and Spain, this cycle began with mortgage defaults, harming the banks and leading governments to guarantee the holdings of the banks' depositors and other creditors, thus adding to government debt. The banks' heavy investment in government bonds then meant that the weakness of Irish and Spanish government debt further hurt the banks.

THE EURO ON LIFE SUPPORT

BY THE fall of 2011, several European countries had debt-to-GDP ratios that were high enough to make default a serious possibility. Sharp write-downs in the value of their sovereign debts are not a feasible solution because they would do substantial damage to European banks and possibly to banks and other financial institutions in the United States.

European political leaders have proposed three distinct strategies to deal with this situation. First, led by German Chancellor Angela Merkel and French President Nicolas Sarkozy, eurozone officials agreed last October that commercial banks should increase their capital ratios and that the size of the European Financial Stability Facility (EFSF), which had been created in May 2010 to finance government borrowing by Greece and other eurozone countries, should be expanded from 400 billion euros to more than a trillion euros. This latter move was meant to provide insurance guarantees that would allow Italy and potentially Spain to access capital markets at reasonable interest rates.

But the plan to increase the banks' capital has not worked, because banks do not want to dilute the holdings of their current shareholders by seeking either private or public capital, and so instead they have been raising their capital ratios by reducing their lending, particularly to borrowers in other countries, causing a further slowdown in European economic activity. Nor can the EFSF borrow the additional funds, since such a move is opposed by Germany, the largest potential guarantor of that debt. Moreover, even a trillion euros would not give the EFSF enough funds to provide effective guarantees to potential buyers of Italian and Spanish debt if those countries might otherwise appear insolvent.

The second strategy, advocated by France, calls for the ECB to buy the bonds of Italy, Spain, and other countries with high debt to keep their interest rates low. The ECB has already been doing this to a limited extent, but not enough to stop Greek and Italian rates from reaching unsustainable levels. Asking the ECB to expand this policy would directly contradict the "no bailout" terms of the Maastricht Treaty. Germany opposes such a move because of its inflationary potential and the risk of losses on those bonds. (Two German members of the ECB'S executive board have resigned over this issue.)

The third strategy is favored by those figures, such as Merkel, who want to use the current crisis to advance the development of a political union. They call for a fiscal union in which those countries with budget surpluses would transfer funds each year to the countries running budget deficits and trade deficits. In exchange for these transfers, the European Commission would have the authority to review national budgets and force countries to adopt policies that would reduce their fiscal deficits, increase their growth, and raise their international competitiveness.

This transfer arrangement has already happened with Greece and Italy. The case of Greece has been the most dramatic. By last October, Greece was unable to borrow in the global capital market and therefore had to depend on credit extended by the ECB and the International Monetary Fund to pay civil servants and maintain its social welfare programs. Merkel and Sarkozy summoned Greek Prime Minister George Papandreou to Brussels and told him that he must abandon the plan he had announced to hold a national referendum on the austerity measures being imposed by the other eurozone members.

They told him that instead he must persuade the Greek parliament to accept the tough strategy to reduce the budget deficit created by Merkel and Sarkozy or face expulsion from the eurozone. Papandreou agreed and forced the necessary legislation through parliament. He then resigned, and Lucas Papademos, a former vice president of the ECB, was appointed as a temporary prime minister with the responsibility of implementing the budget cuts designed in Brussels. But the subsequent parliamentary defections and public riots have shown how much the Greek people resent being forced by Germany to change their economic behavior, accept layoffs of government employees who thought they had lifetime jobs, and reduce demand at a time of double-digit unemployment and rapidly falling GDP. At the same time, many voters in Germany resent sending money to the Greeks and seeing the rules of the ECB undergo radical change.

The situation in Italy is different because Italy is not yet dependent on explicit transfers from the ECB or the International Monetary Fund. But Italy does depend on the support of the ECB to limit the rise of the interest rate for its government bonds. France and Germany pressured Italy to adopt new budget policies, leading to the resignation of Prime Minister Silvio Berlusconi in November and the appointment of a technocrat government committed to resolving Italy's fiscal problems. The euro has thus caused tensions and conflicts within Europe that would not otherwise have existed. Further steps toward a permanent fiscal union would only exacerbate these tensions.

Greece's impossible math

Greece's budget deficit of nine percent of GDP is too large to avoid an outright default on its national debt. With Greece's current debt-to-GDP ratio at 150 percent and the current value of Greece's GDP falling in nominal euro terms at an annual rate of four percent, the debt ratio will rise in the next year to 170 percent of GDP. Rolling over the debt as it comes due and paying higher interest rates on it would raise the total debt even more quickly.

Even if a more general write-down of Greek debt were to cut Greece's existing interest payments in half, the deficit would still be six percent of Greece's GDP and the debt-to-GDP ratio would rise to 165 percent of GDP at the end of 12 months. And this does not even take into account the adverse effect the debt write-down would have on Greek banks. The Greek government would be forced to provide payments to Greek depositors, further increasing the national debt.

To achieve a sustainable path, Greece must start reducing the ratio of its national debt to GDP. This will be virtually impossible as long as Greece's real GDP is declining. Basic budget arithmetic implies that even if Greece's real GDP starts growing at two percent (up from the current seven percent real rate of decline) and inflation is at the ECB target of two percent, the deficit must still not exceed six percent of GDP if the debt ratio is to stop increasing. Since the interest alone on the debt is now about six percent of GDP, the rest of the Greek budget must be brought into balance from its current three percent deficit.

Cutting the interest bill in half and simultaneously balancing the rest of the budget would reduce the ratio only very slowly, from 150 percent now to 145 percent after a year, even if no payments to bank depositors and other creditors were required. It is not clear that financial markets will wait while Greece walks along this fiscal tightrope to a sustainable debt ratio well below 100 percent.

The situation in Italy is much better. Italy already has a slightly positive growth rate and a primary budget surplus, with tax revenues exceeding noninterest government outlays by about one percent of GDP. The country's total budget deficit is about four percent of GDP; a reduction of the deficit equivalent to two percent of GDP would be enough to begin reducing the ratio of debt to GDP. That should not be difficult to achieve, since government spending accounts for roughly 50 percent of GDP. The prospect of a declining budget deficit has already reduced the interest rate on new government borrowing from 7.5 percent to 6.5 percent. Eliminating the budget deficit and starting to shrink the debt ratio more rapidly could bring the interest rate back to the four percent level that prevailed in Italy before the crisis began.

TRADING PLACES

EVEN 1F the eurozone countries reduced their large budget deficits and thereby alleviated the threat to the commercial banks that have invested in government bonds, another problem caused by the monetary union would remain: the differences among eurozone members in terms of long-term competitiveness, which leads to sustained differences in trade balances that cannot be financed.

During the past year, Germany had a trade surplus of nearly $200 billion, whereas the other members of the eurozone had trade deficits totaling $200 billion. A more comprehensive measure that factors in net investment income reveals that Germany has a current account surplus of five percent of GDP, whereas Greece has a current account deficit of nearly ten percent of GDP. Put another way, Germany can invest in the rest of the world an amount equal to five percent of its GDP, whereas Greece must borrow an amount equal to nearly ten percent of its GDP to pay for its current level of imports.

If Greece were not part of the eurozone, its exchange rate would adjust over time to prevent this large and growing trade deficit. More specifically, the need to finance that trade deficit would cause the value of the Greek currency to decline, making Greek exports more attractive to foreign buyers and encouraging Greek consumers to substitute Greek goods and services for imports. The rising cost of imports would also reduce real personal incomes in Greece, leading to lower consumer spending and freeing up Greek goods and services to be exported to foreign buyers.

But since Greece is part of the eurozone, this automatic adjustment mechanism is missing. Greece faces the persistent problem of a rising current account deficit, which has now reached ten percent of GDP, because Greece's productivity (output per employee) increases more slowly than Germany's, causing the prices of Greek goods to rise relative to the prices of German and other European goods. More specifically, if output per employee in Germany increases by three percent a year, real wages can also grow by three percent. If the ECB keeps inflation in the eurozone at about two percent, German wages can rise by five percent a year. If Greek wages also rise by five percent a year while productivity in Greece grows by only one percent a year, the prices of Greek goods and services will increase two percent faster than the prices of German products. That increase in the relative prices of goods and services would cause Greek imports to rise and exports to stagnate, creating an increasingly large trade deficit. This problem could be avoided if the annual rise in Greek wages were limited to two percent less than the rise in German wages. This may, of course, be politically difficult in the highly unionized Greek economy.

But limiting the growth of Greek wages would address only further deterioration of Greek competitiveness in the future. Stopping a further decline in Greek competitiveness would not correct the existing annual current account deficit of nearly ten percent of GDP that Greece must continue to finance. Eliminating the existing current account deficit would require making Greek prices much more competitive than they are today, by reducing the cost of producing Greek goods and services by about 40 percent relative to the cost of producing goods and services in the rest of the eurozone. Since that is not likely to be achieved by increased productivity, it must be achieved by lowering real wages relative to the real wages of Germany and other countries in the eurozone. This would be a very painful process, achieved at the cost of years of high unemployment and declining incomes. Greece now has an official unemployment rate of 16 percent, and its real GDP is falling by seven percent per year. Continuing such poor performance for a decade or more is virtually unthinkable in a democracy. Moreover, since such a process would shrink the current account deficit only over a long period of time, Greece would need to continue borrowing to finance its current account imbalance. Even if Germany were willing to formalize such long-term financial assistance by establishing a transfer union to provide those funds, the controls that Berlin would demand to keep wages and incomes declining would create severe political tensions between Germany and Greece.

THE TEMPTATION OF DEVALUATION

THE ALTERNATIVE is for Greece to leave the eurozone and return to its own currency. Although there is no provision in the Maastricht Treaty for such a move, political leaders in Greece and other countries are no doubt considering that possibility. Although Greece is benefiting from its membership in the eurozone by receiving transfers from other eurozone countries, it is paying a very high price in terms of unemployment and social unrest. Abandoning the euro now and creating a new drachma would permit a devaluation and a default that might involve much less economic pain than the current course. This devaluation-and-default strategy has been the standard response of countries in Asia and Latin America with unsustainably large fiscal and trade deficits; they were able to devalue because they were not part of a monetary union.

Germany is now prepared to pay to try to keep Greece from leaving the eurozone because it fears that a Greek defection could lead to a breakup of the entire monetary union, eliminating the fixed exchange rate that now benefits German exporters and the German economy more generally. If Greece leaves and devalues, global capital markets might assume that Italy will consider a similar strategy. The resulting rise in the interest rate on its debt might then drive Italy to in fact do so. And if Italy reverts to a new lira and devalues it relative to other currencies, the competitive pressure might force France to leave the eurozone and devalue a new franc. At that point, the EMU would collapse.

Even though Germany is prepared to subsidize Greece and other countries to sustain the euro, Greece and others might nevertheless decide to leave the monetary union if the conditions imposed by Germany are deemed too painful. Here is how that might work: although Greece cannot create the euros it needs to pay civil servants and make transfer payments, the Greek government could start creating new drachmas and declare that all contracts under Greek law, including salaries and shop prices, are payable in that currency; similarly, all bank deposits and bank loans would be payable in these new drachmas instead of euros.

The value of the new drachma would fall relative to the euro, automatically reducing real wages and increasing Greek competiveness without requiring Greece to go through a long and painful period of high unemployment. Instead, the lower value of the Greek currency would stimulate exports and a shift from imports to domestic goods and services. This would boost Greek GDP growth and employment.

Withdrawing from the eurozone would of course be difficult and potentially painful. The announcement that Greece was leaving the eurozone would have to come as a surprise—otherwise, a bank run would be likely, as Greek depositors would have the time to move their euro-denominated funds to banks outside Greece or to withdraw them and hold euros in cash. Since some flight of deposits from Greek banks is already happening, Athens would have to act before this became a flood of withdrawals.

Another serious problem for Greece in making the transition to the new drachma would be the political risk of being forced out of the EU.

Since the Maastricht Treaty provides no way for a member of the euro-zone to leave, there is the risk that the other eurozone members would punish Greece by requiring it to leave the EU as well, causing Greece to lose the benefits that the EU offers of free trade and labor mobility. They might do so to discourage Italy and others from pursuing a similar exit strategy. But not all EU members would necessarily seek such a punishment, especially since ten of the 27 EU member countries do not use the euro and Greece's situation is clearly more desperate than that of Italy or Spain.

The primary practical problem with leaving the eurozone would be that some Greek businesses and individuals have borrowed in euros from banks outside Greece. Since those loans are not covered by Greek law, the Greek government cannot change these debt obligations from euros to new drachmas. The decline in the new drachma relative to the euro would make it much more expensive for Greek debtors to repay those loans. Widespread bankruptcies of Greek individuals and businesses could result, with secondary effects on the Greek banks that those individuals and businesses have borrowed from.

But as the experience of Argentina after it ended its link to the dollar in 2002 showed, domestic Greek debtors might end up paying only a fraction of those euro debts. For Greece, the option to leave the monetary union may therefore be very tempting.

Greece's departure need not tempt Italy, Spain, or others to leave. For them, the cost of leaving could exceed that of adjusting their economies while remaining inside the eurozone. Unlike Greece, they can avoid insolvency by adjusting their budget and trade deficits without radical changes in policy.

Looking ahead, the eurozone is likely to continue with almost all its current members. The challenge now will be to change the economic behavior of those countries. Formal constitutionally mandated balanced-budget rules of the type recently adopted by Germany, Italy, and Spain would, if actually implemented, put each country's national debt on a path to a sustainable level. New policies must avoid current account deficits in the future by limiting the volume of national imports to amounts that can be financed with export earnings and direct foreign investment. Such measures should make it possible to sustain the euro without future crises and without the fiscal transfers that are now creating tensions within Europe.©