



Unemployed youth protest austerity measures in Madrid, Spain.

Whither the **EURO?**

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Historians may wonder how it came to be introduced in the first place

THE euro area economy is in a terrible mess.

In December 2013 euro area GDP was still 3 percent lower than in the first quarter of 2008, in stark contrast with the United States, where GDP was 6 percent higher. GDP was 8 percent below its precrisis level in Ireland, 9 percent below in Italy, and 12 percent below in Greece. Euro area unemployment exceeds 12 percent—and is about 16 percent in Portugal, 17 percent in Cyprus, and 27 percent in Spain and Greece.

Europeans are so used to these numbers that they no longer find them shocking, which is profoundly disturbing. These are not minor details, blemishing an otherwise impeccable record, but evidence of a dismal policy failure.

The euro is a bad idea, which was pointed out two decades ago when the currency was being devised. The currency area is too large and diverse—and given the need for periodic real exchange rate adjustments, the anti-inflation mandate of the European Central Bank (ECB) is too restrictive. Labor mobility between member countries is too limited to make migration from bust to boom regions a viable adjustment option. And there are virtually no fiscal mechanisms to transfer resources across regions in the event of shocks that hit parts of the currency area harder than others.

Problems foretold

All these difficulties were properly pinpointed by traditional optimal currency area



theory. By 1998 Ireland was experiencing an unprecedented boom, and house prices were rising rapidly. Higher interest rates were warranted, but when Ireland joined the currency union in January 1999 the central bank discount rate was lowered from 6.75 percent in the middle of 1998 to just 3.5 percent a year later. With the Irish party well under way the new ECB was busily adding liquor to the punch bowl.

Similar stories were repeated around the euro area periphery, where capital inflows pushed up wages and prices. But what goes up does not come down so easily when there is no independent currency. Labor mobility within the euro area remains limited: young Irish workers emigrate to Australia or Canada, the Portuguese to Angola or Brazil. And with no federal budget to smooth asymmetric shocks, procyclical austerity, which exacerbates rather than ameliorates recessions, has been the policy weapon of choice during this crisis—whether imposed by the markets or by euro area politicians and central bankers. Mass unemployment in the periphery is exactly what theory would predict in such circumstances.

Indeed, since 2008 we have learned that traditional optimal currency area theory was too sanguine about European monetary union. In common with much mainstream macroeconomics, it ignored the role of financial intermediaries such as banks, which link savers and borrowers. Many of the

euro area's most intractable problems stem from the flow of capital from the core to the periphery via interbank lending. When that capital stopped flowing, or was withdrawn, the resultant bank crises strained the finances of periphery governments. That further worsened bank balance sheets and credit creation, leading in turn to worsening economic conditions and rising government deficits—a sovereign bank doom loop that kept replaying.

Political ramifications

Bank crises have had poisonous political ramifications, given their cross-border impact. Panic-driven decision making has been ad hoc and inconsistent—contrast the treatment

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of bank creditors in Ireland in 2010, who were largely made whole, with those in Cyprus in 2013, where they took a big hit. This will have long-term political consequences. Despite the understandable desire of European bureaucrats to regard such matters as water under the bridge, hypocrisy and bullying remain unpopular with ordinary voters. Small, vulnerable countries have had a painful lesson in European realpolitik that they will not soon forget.

Where do we go from here? Since 2010 the focus of most economists has been on how to make the currency union work better. Even those who were skeptical about the European Economic and Monetary Union (EMU) worried sufficiently about the consequences of a breakup to shy away from advocating a country's exit. The result has been a series of suggestions regarding how to prevent a collapse of the euro in the short to medium run, and how to improve its functioning in the longer run.

In the short run, what is needed is looser monetary policy and, where possible, accommodative fiscal policy as well. If economic historians learned anything from the Great Depression, it is that adjustment based on austerity and internal devaluation (as deflation in individual euro area members is termed nowadays) is dangerous. First, nominal wages are sticky downward, which implies that deflation, if achieved at all, leads to higher real wages and more unemployment. Second, deflation increases the real value of private and public debt, raises real interest rates, and leads consumers and businesses to postpone expensive purchases in anticipation of lower prices to come. Britain ran large primary surpluses throughout the 1920s, but its debt-to-GDP ratio rose substantially thanks to the deflationary, low-growth environment of the time.

Third, fiscal multipliers are large when interest rates are near zero, so spending reductions result in hefty declines in national income. The IMF has found that in the current crisis fiscal multipliers are closer to 2 than they are to 1—as was true between the world wars. The inescapable conclusion is

that the ECB must act aggressively, not just to prevent deflation, but to set an inflation target above 2 percent for a transitional period to facilitate real exchange rate adjustment and promote the solvency of its member states. More investment spending by countries with sufficient fiscal capacity, or by the European Investment Bank, would help as well.

For the longer run, there is widespread consensus—outside of Germany—that the euro area needs a banking union that promotes financial stability and that replaces ad

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hoc crisis decision making with a more rule-based and politically legitimate process (see “Tectonic Shifts” in this issue of *F&D*). This process should include common supervision for the euro area, a single resolution framework for failing banks with a euro area-wide fiscal backstop, and a common deposit insurance framework. The Euro-nomics group, made up of noted European economists, has proposed a “safe” euro area asset that national banks could hold. This would help break the sovereign bank doom loop described earlier and make it easier for national governments to restructure their debt when necessary (by reducing collateral damage to their country’s banking system). The example of the United States suggests that an element of fiscal union, beyond what is required for a meaningful banking union, would be an important stabilizing mechanism. A euro area-wide unemployment insurance system would be one small step in this direction.

Less Europe

These are all arguments for “more Europe” rather than less. I and many others have made such arguments over the past five years. But as time goes on, it becomes more difficult to do so with conviction.

First, *crisis management since 2010 has been shockingly poor, which raises the question of whether it is sensible for any country, especially a small one, to place itself at the mercy of decision makers in Brussels, Frankfurt, or Berlin.* It is not just a question of hard-money ideology on the part of key players, although that is destructive enough. It is a question of outright incompetence. The botched “rescue” of Cyprus was for many observers a watershed moment in this regard, though the ECB interest rate hikes of 2011 also deserve a dishonorable mention.

There are serious legal, political, and ethical questions that must be asked about how the ECB has behaved during this crisis—for example, the 2010 threat that if Dublin did not repay private creditors of private banks, the ECB would effectively blow up the Irish banking system (or, if you prefer, force Ireland out of the euro area). A frequent argument is that the ECB cannot loosen monetary policy because it would take the pressure off governments to continue structural reforms that Frankfurt believes to be desirable. Aside from the fact

that there is less evidence of the desirability of these reforms than economists sometimes admit, deliberately keeping people involuntarily unemployed to advance a particular policy agenda is wrong. And it is not legitimate for an unelected central banker in Frankfurt to try to influence inherently political debates in countries like Italy or Spain, because the central banker is both unelected and in Frankfurt.

Second, *it is becoming increasingly clear that a meaningful banking union, let alone a fiscal union or a safe euro area asset, is not coming anytime soon.* For years economists have argued that Europe must make up its mind: move in a more federal direction, as seems required by the logic of a single currency, or move backward? It is now 2014: at what stage do we conclude that Europe has indeed made up its mind, and that a deeper union is off the table? The longer this crisis continues, the greater the anti-European political backlash will be, and understandably so: waiting will not help the federalists. We should give the new German government a few months to surprise us all, and when it doesn’t, draw the logical conclusion. With forward movement excluded, retreat from the EMU may become both inevitable and desirable.

Europe has lived through a golden age, largely as a result of European integration. This helped foster growth in the 1950s and 1960s and has given Europeans freedom to study, work, and retire abroad that is taken for granted. The EMU in its present form threatens the entire project. During the interwar period, voters flocked to political parties that promised to tame the market and make it serve the interests of ordinary people rather than the other way around. Where Democratic parties, such as Sweden’s Social Democrats, offered these policies, they reaped the electoral reward. Where Democrats allowed themselves to be constrained by golden fetters and an ideology of austerity, as in Germany, voters eventually abandoned them.

Divergent paths

Europe is now defined by the constraints it imposes on governments, not by the possibilities it affords them to improve the lives of their people. This is politically unsustainable. There are two solutions: jump forward to a federal political Europe, on whose stage left and right can compete on equal terms, or return to a European Union without a single currency and let individual countries decide for themselves. The latter option will require capital controls, default in several countries, measures to deal with the ensuing financial crisis, and agreement about how to deal with legacy debt and legacy contracts.

The demise of the euro would be a major crisis, no doubt about it. We shouldn’t wish for it. But if a crisis is inevitable then it is best to get on with it, while centrists and Europhiles are still in charge. Whichever way we jump, we have to do so democratically, and there is no sense in waiting forever. If the euro is eventually abandoned, my prediction is that historians 50 years from now will wonder how it ever came to be introduced in the first place. ■

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