The Euro at a Crossroads

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It was one of the author's predictions in 1998 that the eurozone would end up teaching us more about economics compared to what economics could teach us about the eurozone. While many of the author's predictions of that year did not hold, including the forecast that the euro would challenge the dollar as the world's foremost reserve currency, this particular prediction ultimately turned out to be correct. A monetary union is a hybrid between a fixed exchange rate system and a unitary state, one that is fully captured neither with closed-economy macro models nor classical international macro models of fixed exchange rates.

In this article, I would like to draw a few preliminary conclusions about the lessons of the euro crisis—preliminary for two reasons. The first is that the crisis was still ongoing at the time of writing, and is expected to continue for some time yet. The second is that we are still gathering new information, and our real-time analysis is thus incomplete. With these two caveats, I will try to draw lessons for the eurozone itself, for others who are considering setting up monetary unions in the future, and for the rest of the world.

Lessons for the Eurozone

The fundamental flaw of the Maastricht Treaty, which provided the legal framework for the euro, was that it provided an insufficient framework for a financial crisis, and that it failed to take account of asymmetric shocks. Other criticisms included an inflexible set of

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fiscal rules and a fiscal compliance procedure whose credibility rested on the presence of fines rather than incentives. While many of these shortcomings were recognized at the time, and voiced by critics, it was a consensus among policymakers than none of these shortcomings would be significant in the long run.

The most important shortcoming with regard to the current financial crisis was an assumption that has been frequently summarized as "no bailout, no default, and no exit." The no bailout principle is explicitly enshrined in Article 125 of the current Treaty on the Functioning of European Union. The no exit principle was enshrined by the simple absence of a provision. The no default principle was not enshrined anywhere, but it was not believed by a majority of market participants. The combination of these three factors essentially precluded any form of crisis resolution in case an entity became insolvent. It remains the official policy to this day although the eurozone has created mechanisms for liquidity support (the European Financial Stability Facility, the European stability mechanisms, the three-year long-term refinancing programmes for banks through the European Central Bank, and the program of Outright Monetary Transactions).

The first lesson of the crisis is thus the need to fix the unholy trinity of "no bailout, no default, and no exit," which constitutes a logical contradiction. The eurozone needs to find agreement on which of the parameters to relax. My guess is it will be the no bailout rule or a combination of the no bailout rule and the no default rule. It is my judgement, based on interviews with political actors, that the eurozone will not relax the no-exit rule, as this would, in the eyes of outsiders, transform it from a monetary union with a permanent membership into a fixed exchange rate system with entry and exit routes.

The second task ahead for the eurozone is economic adjustment, the lack of which is widely considered one of the reasons for this crisis. Austerity weighs heavily on growth prospects, and with fiscal multipliers larger than 1, there is a danger that the pursuit of a nominal austerity target has the perverse effect of increasing debt-to-GDP ratios. My preference at this stage would for a rebalancing of policies—less austerity, more structural reforms, tailor-made to the necessities of individual countries—like a reform of labor market contracts in France or Spain, or of the mortgage finance system in the Netherlands. On monetary policy, I would place a much greater emphasis on ordinary policies—such as negative deposit rates—than on unconventional measures, whose ultimate success is questionable.

A third priority, to assure sustainability beyond the crisis, must be the construction of a robust institutional system of economic management through a change of the EU treaties. One has to beware that these processes take time. The last change, which gave rise to the Lisbon Treaty, took nine years from inception to ratification. There is no guarantee that a treaty to include a banking union, a fiscal union, and a political union would take any less time. It might take longer. It would be subject to the same political risks at the negotiation and the ratification stages as the previous treaty. One should thus regard the treaty change as a long-term reform, rather than a short-term fix. This is why I am separating policies of crisis resolution from those of institutional reform.

Of the proposals for institutional reform, the most immediate is the banking union, which is expected to start in the second half of 2013, though recent reports have suggested that its start might be delayed. A properly constructed banking union would (1) separate the risks of the state from the risks of the banks, (2) provide more effective and harmonized resolutions systems, (3) remove incentives for intra-eurozone deposit flight, and (4) act as a transfer mechanism through taxing permanent savings surpluses.

The latest draft proposals on a banking union would suggest that none of the four economic objectives would be met. A resolution fund and deposit insurance will not be included, and the Single Supervisory Mechanism is unlikely to achieve unilateral control over all banks but must share responsibilities with national supervisors.

The second institutional mechanism would be a fiscal union with a joint budget. My estimate is that 5–10 percent of GDP would be sufficient, provided the fiscal union includes cyclical shock absorbers rather than structural policies. Short-term unemployment insurance, a bank resolution fund, and deposit insurance would be examples of such policies to be shifted from a national to a eurozone-federal level.

The third mechanism would be an economic union, which should add to, and possibly replace, Europe's largely dysfunctional single market by adding services and labor markets to the mix, and produce a much higher degree of market integration that what has been possible under the existing single-market program.

The final and most difficult step would include a political union with proper parliamentary supervision of eurozone-level economic policies. An economic union requires legitimate forms of representation and more transparency policymaking.

Lessons for Others Who Want to Form a Monetary Union or a Fixed Exchange Rate System

The main general lesson from the eurozone crisis is that a monetary union is viable only among similar countries with a willingness to integrate their economic systems—or at least among countries wishing to become similar over a clearly defined time-horizon. There would have been no euro crisis, for example, if the initial membership had been confined to Germany, France, Benelux, and Finland.

What constitutes similarity? I list five conditions:

1. Admission criteria for the eurozone were unsuitable. The selection criteria should include not only nominal convergence targets—in the eurozone's case, inflation, short-term interest rates, annual budget deficits, and the ratio of gross debt to GDP—but also real economic indicators such as GDP and employment.
2. Another criterion is the ability to adjust through the real economy. While Germany and the UK are similar in many respects, a monetary union between the two would be hard to maintain—as Germany tends to adjust through wages while the UK finds that much harder.
3. You need a political consensus about the conduct of fiscal and monetary policy in normal times and during crises. There are, of course, different views within countries, but a monetary union would be hard to maintain if countries had wildly different preferences for the level of sustainable debt or for inflation targets.
4. A banking union—for reasons given in the previous section.
5. A willingness to abandon national sovereignty in other areas if the need arises.

The eurozone lacked all five of these conditions during its first 12 years. Southern Europe remains incapable of adjusting through real economy; there is some consensus about economic policy, but divergences about the role of the European Central Bank and austerity; there is, of course, no banking union, not even a proper single market for financial services; there is no sufficient willingness to abandon national sovereignty over the financial system; and in general no appetite for a loss of national sovereignty in other areas either. The eurozone not only lacked the conditions for an optimal currency area, more seriously it lacked the will be become one.

Discussions to create monetary unions elsewhere, for example in Asia though the Chiang Mai Initiative, should take account of this. Policymakers should ask themselves whether the countries involved are sufficiently similar, sufficiently flexible, and willing to yield sovereignty.

A milder form of these conditions also applies to fixed exchange rate systems. If you want to maintain a peg on a sustainable basis, you would need most of these conditions to be in place. The only difference is that a breakup is ultimately less costly in a fixed exchange rate regime than in a monetary union.

Lessons for the Rest of the World

If you consider the eurozone as a microcosm of the global economic system, as some authors have done, the crisis and its policy implications offers a number of lessons to the rest of the world as well.

The first may be that structural current-account imbalances are not self-correcting, and can potentially destabilize the system. Just as national sovereignty over financial systems did not prove sustainable in the eurozone, it may not prove sustainable on a global level either. While the eurozone, or any other monetary union, requires a proper banking union as a precondition for sustainability, the global economy requires a milder version of a banking union.

Minimal sets include a common set of banking regulations with some allowance for anti-cyclical risk adjustments (Basel III is far from perfect, but a big step in the right direction). It also requires principles to bring banking supervision into line. A global coordinating mechanism of bank supervisors would be a sensible first step.

Further issues include, but are not confined to, an agreement on how to handle the intertwined too-big-to-fail and the associated too-big-to-save problems, on which the Financial Stability Board has as yet made little progress, as well as the problems of a global supervision of shadow banking.

The single most important gap is the ineffectiveness of global policy coordination. The G20 has proved useless beyond their initial crisis response in the autumn of 2008. The global community should study some of the lessons and mechanism of the European Union to achieve joint decisionmaking structures without sacrificing national autonomy. The goal cannot be to produce a utopian "global government" but to provide robust global coordination mechanisms with credibility. For example, one lesson from the history of European integration would be that the G20 system should be replaced with an inclusive system with a larger membership base and stronger decisionmaking powers. While such a mechanism would ideally run on the basis of qualified majority voting, as it does in the EU, it would be a sufficient first step if the large economies (United States, China, eurozone, and Japan) would maintain a veto right.

A further lesson of the eurozone crisis is a rethink of fiscal policy targets. The eurozone crisis has shown that supposedly strong fiscal positions, like those of Spain or Ireland before the crisis, can easily reverse during a crisis. One possibility would be to add a qualitative dimension to the fiscal policy framework, in addition to numerical structural and nominal targets. For example, it would be desirable if fiscal policy, in the form of variable real estate transaction taxes, was more reactive to real estate bubbles.

The global financial crisis in general, and the eurozone crisis specifically, also give rise to many questions regarding the conduct of monetary policy—for example, precommitment to zero interest rate policies, the pursuit of quantitative easing and credit easing, and other unconventional policies. It is beyond the scope of this article to discuss the monetary policy implications of this crisis.

Conclusion

This article has looked at some of the early lessons of the eurozone crisis—for the eurozone itself, for others who are considering taking part in a monetary union or fixed exchange rate systems, and for the rest of the world under the current system. The outcome of this crisis is yet uncertain, as a result of which the above list must be treated with a degree of caution. But no matter what the ultimate outcome of the crisis, it is likely to have a profound impact on all aspects of economic policymaking (fiscal policy, monetary policy, national sovereignty, and global and regional policy coordination), and thus constitutes one of the most important watersheds of modern economic history.