A SYMPOSIUM OF VIEWS

Improving *the* Euro

If you were a European economic policy leader with a time machine and could roll back the clock to the late 1990s, what if anything would you do differently with the introduction of monetary union and the euro? In retrospect, what changes would have been both constructive and politically feasible? And if you would not have proceeded with the common currency, what reason would have driven your decision?

More than two dozen policy experts share their views.

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EMU was an incomplete monetary union. Also, policymakers wrongly focused on nominal instead of real convergence.

JÖRG ASMUSSEN
State Secretary, Federal Ministry of Labour and Social Affairs, and former Member of the Board, European Central Bank

Let me start with a clear answer: If I could roll back the clock to the late 1990s with a time machine, I would create the single currency again. The creation of the Economic and Monetary Union, culminating in the launch of the euro in 1999, was a landmark in European integration. EMU reflected both economic and political aspirations, and the euro became the most tangible symbol of European integration.

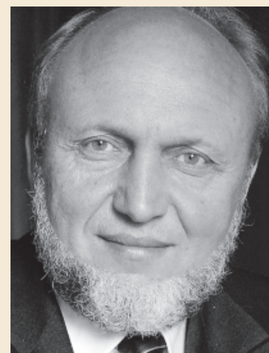
EMU involved a unique architecture combining a centralized monetary policy conducted by the European Central Bank with largely decentralized fiscal and economic policies implemented by the participating member states. As the adoption of a single currency would eliminate the disciplining factor of exchange rate risk premiums and was expected to reduce the disciplining factor of interest-rate risk premiums, the risks of countries attempting to free-ride by running budget deficits without taking into account long-term sustainability considerations and possible negative spill-over across the monetary union was recognized. In addition, it was acknowledged that in the absence of the possibility of exchange rate adjustments and a cross-border fiscal transfer mechanism, and given the likely limitations in alternative adjustment tools (stemming from low labor mobility and price and wage rigidities), divergences in business cycles could create tensions among member states and hamper the effectiveness of a single monetary policy.

Therefore, the founders of EMU specified four strict convergence criteria that member states had to fulfil in a sustainable manner before entering the euro area: Price stability, exchange rate stability, sustainable public finances, and long-term nominal interest rate convergence. The convergence criteria were already being criticized at the time of inception for being arbitrary, too stringent, or inadequate in ensuring the needed discipline. This criticism was partly justified. The deficit level, for example, was much more prominent than the debt level, even though the latter was much more important for long-term fiscal sustainability. The main weakness in my view is the focus on nominal convergence, which diverted attention from factors that matter for real convergence, notably productivity and competitiveness developments, the composition of growth supporting the catching-up process in some member states, and private sector balance sheets. Indicators to be used could have been GDP per capita or real unit labor costs.

The same was true for the instruments available to ensure fiscal discipline once the euro had been adopted, in particular the Stability and Growth Pact. Again the developments in the real economy were neglected, something that became evident in the case of Spain much later on.

These deficiencies were not corrected regarding the convergence criteria, which have remained unchanged since the start of the whole project, while the Stability and Growth Pact was complemented by the so-called Macroeconomic Imbalances Procedure in 2011, with the aim of identifying potential risks stemming from the real economy at an early stage.

The crisis that affected a number of member states in the euro area demonstrated that EMU was an incomplete monetary union. The aim now is to complete it. The report "Towards a genuine Economic and Monetary Union" by the president of the European Council in collaboration with the president of the European Commission, the president of the Eurogroup, and the president of the European Central Bank shows the way forward: The creation of a banking union as the crucial step to break the sovereign bank nexus, followed by a real economic union, a fiscal union, and a democratically legitimized political union.



Europe needs a debt conference and a program for orderly temporary exits from the currency union.

HANS-WERNER SINN
President, Ifo Institute for Economic Research, and Professor of Economics and Public Finance, University of Munich

What is the most important problem for the eurozone? Clearly, the competitiveness and debt crises in southern Europe, both of which resulted from

inflationary credit bubbles. Excessive capital imports ended up burdening the southern countries with unsustainable debt and making them too expensive. To solve their competitiveness crisis, they now need to deflate to lower their overblown prices, in some cases by 30 percent or more. However, that will drive many debtors into bankruptcy, cause unsustainable mass unemployment, and bring the unions to the barricades.

To cut the Gordian knot, Europe needs a debt conference to forgive some of the bank debt, the government debt, and the debt built up between the central banks (Target debt). Also needed is a program for orderly temporary exits from the currency union to realign exchange rates. Re-entry after the realignment and after structural reforms are completed should be envisaged.

Once these immediate measures are implemented, the rules of the Eurosystem as such need to be amended so as to discourage excessive capital flows and avoid the emergence of renewed bubbles in the future. First, new rules for state bankruptcies are necessary to clarify the procedure for the provision of debt relief. Second, the European Central Bank has to abstain from acting as a lender of last resort for regional (member-state) debt, following the rules of the U.S. Federal Reserve and the Swiss National Bank, which would never bail out states or cantons. Third, an internal gold standard for settling the inter-district imbalances between national central banks is necessary, such as the one that existed until 1975 in the United States, so as to make the ECB's bail-out with the printing press less likely in the future. All these measures will make it convincingly clear to investors that bail-outs are not an option, prompting them to demand higher yields from states that borrow too much. The higher interest rates will in turn prevent excessive borrowing and the emergence of new inflationary credit bubbles.

In the long run, Europe could and should develop along the lines of the Swiss confederation, that is, creating a common state with a common government, parliament, and army. Only after that should it develop into a fiscal union, but hopefully never into a debt union, in order to avoid the terrible consequences that Alexander Hamilton's debt mutualization program brought to the United States around the 1840s. At that time, twenty-nine states and territories went bankrupt because debt mutualization had encouraged them to borrow excessively. This added to the tensions that later drove the United States into a devastating civil war. It would be wise for Europe to learn from the U.S. experience.

A single services market would have made more sense.

MIROSLAV SINGER
Governor, Czech National Bank

Let me start by observing that there are only twenty-four hours in a day, even for the European political and economic elite. The members of that elite therefore tend to have time to pursue just one grand project on top of their mundane tasks. The question is, then, whether forming the eurozone was the right way for the European elite to invest its time around the end of the last millennium.

The euro crisis is mercifully receding, but our relief has caused us to forget the two original main selling points of the common currency. First, the euro was meant to speed up growth by making the economic area work more efficiently, allowing it to compete with the fastest developing areas of the world in terms of growth and prosperity. Second, it was supposed to foster further political integration and mutual recognition and friendship between European citizens of different nations.

Let's face facts. Yes, the damage caused by uncontrolled dissolution of the eurozone would be dramatic, and certainly higher than the costs so far of keeping the eurozone together. But the eurozone has been a manifest failure in both its noble goals—prosperity and friendship. Growth is stagnating in both the eurozone and the European Union as a whole. Meanwhile, tensions are mounting between the "South" and the "North."

Why? Because the eurozone was a project implemented by politicians and supported by economists motivated by overblown expectations about the allocation efficiency and trade gains the common currency would deliver. The reality is that we live in a world in which the costs of information transfer and computing are plummeting. As a result, the gains arising from better price comparability across the single currency area are shrinking substantially over time. For example, trade between the United Kingdom and Germany is growing much faster than trade between France and Germany, and the share of exports to the eurozone in total German exports is steadily falling.

What is more, goods trade stems essentially from industrial production, yet industry accounts for a much smaller share of EU economic activity than services. So,

instead of the eurozone, a single services market would have been a far more successful path to prosperity.

As to friendship, the outcome could hardly have been worse than the current state of relations between the eurozone nations. Relations between the policymakers responsible for this outcome remain, of course, as cozy as ever.

There should have been strong surveillance.

JOSÉ DE GREGORIO
Professor of Economics, University of Chile, and former Governor, Central Bank of Chile

The monetary union was certainly incomplete. In hindsight, clearly the absence of a fiscal and banking union aggravated the crisis to the extreme that put the euro in serious risk of collapse. This lack of full union reduced the scope for implementing stabilization policies, induced financial instability, and limited the space for efficient economic adjustment. If an appropriate fiscal and banking union had been implemented, the impact of the crisis would have been limited. Partial and slow progress in these areas is underway. There have been political obstacles and the current risk, as economic performance improves, is that authorities will ignore the urgency of reforms. Complacency could delay progress in completing the union.

However, I want to highlight another very important institutional failure that could have lessened the euro crisis. European authorities, and most of the economic profession, remained silent as evident imbalances grew over time. There was a lack of strong surveillance.

One of the goals of the euro was to introduce elusive macroeconomic discipline all over Europe, especially in the southern countries. Joining the euro would bring more fiscal and monetary responsibility. However, the main result was a sharp decline in borrowing costs for countries that had formerly paid high interest rates. This led to a spending spree, without improved fiscal and financial discipline.

The increase in spending had its counterpart in large and unsustainable current account deficits. Some countries in southern Europe, such as Greece, Portugal, and Spain, were running current account deficits close to 10 percent of GDP in the years prior to the crisis. By the mid-2000s, they all had deficits above 7 percent of GDP. With no exchange rate flexibility, these economies had no way to adjust without a major recession, with its negative consequences to the fiscal side and to financial stability. Their situation was aggravated by financial and economic repercussions all over the euro area. Moreover, as we well know in emerging market economies, it does not matter whether these imbalances are private or public. In the end, the collapse happens anyway. The idea that countries are going through a productivity catch-up supports a benign view of the imbalances. Most of the time, however, this view is wrong and leads to negligent policy inaction.

There was a need for an independent and powerful institution in charge of monitoring macroeconomic developments in the area. Perhaps the International Monetary Fund could have done more, and should do more through its surveillance activities. The European Central Bank could play a role, but excessive efforts in monitoring member countries' fragilities could jeopardize much-needed monetary policy independence. Any emerging market running for some years a growing current account deficit of 10 percent of GDP with a fixed exchange rate would have collapsed. There is no reason to think that European countries are different. The recent crisis is a clear demonstration that alarming imbalances do not take place only in developing countries. Even today, with financial and currency tensions around the world, exchange rate flexibility is a major achievement in emerging markets, allowing economies to accommodate volatile international economic conditions. Europe needs much more discipline, integration, and surveillance since exchange rate adjustment is not possible.

We needed greater political will and an institutional framework.

JACQUES DE LAROSIÈRE
Advisor to the Chairman, BNP Paribas, and former Governor, Bank of France

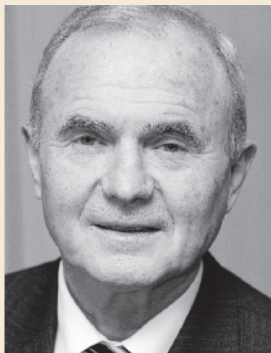
The problem was that, after a period of convergence towards the Maastricht criteria, eurozone members started to diverge when the euro was launched in

1999. Public deficits and private borrowing ballooned in a number of peripheral countries from 2000 to 2009. Unit labor costs also seriously diverged. And balance of payments deficits went out of control.

With hindsight, it is clear the eurozone lacked the political will and institutional framework to contain public deficits as well as wage increases. Monetary policy was, undoubtedly, a factor that favored excessive private leveraging in the "overheated" part of the zone. But regulatory policies should have been put in place locally (such as counter-cyclical capital requirements on banks, and loan-to-deposit or loan-to-value ratios) in order to mitigate the effects of the single monetary policy on different country situations.

Those safeguard measures would have been technically possible to implement. Whether they would have been politically feasible is another matter. Indeed, the markets turned a blind eye to those first ten years of macroeconomic divergences and made almost no distinction between the yields of Bund instruments and those of the worst performing states. This market behavior—which only changed after 2009—provided no incentive for reform and adjustment.

But the magnitude of the adjustment that has been implemented after 2009–10 (in terms of fiscal deficits, labor costs, export growth, and labor market and pension reforms) shows that, eventually, things did change. All this demonstrates that monetary union is here to stay in a much more coherent setting than was the case in the first years of its existence.



We should not have set a fixed date, January 1999.

OTMAR ISSING
President, Center for Financial Studies, Goethe University Frankfurt, and founding Member, Executive Board, European Central Bank

The final decision on the shape and starting date of European Economic and Monetary Union was taken at the summit in Maastricht on December 9–10, 1991. The Maastricht Treaty—not only in retrospect—was the triumph of political ambition over economic reservations. On the one hand, it took account of economic considerations by laying down preconditions—the so-called convergence criteria—for entry into EMU. Only those countries sufficiently prepared for the single monetary policy regime would be allowed to take part. On the other hand, setting an irreversible deadline for the start of EMU (January 1, 1999) foreseeably implied irresistible pressure for a future decision in which politics would dominate over economics.

In its statement of February 1992, the Council of the Deutsche Bundesbank warned that to successfully pursue a policy of stability in EMU, it was crucial that the convergence criteria be strictly applied in selecting the countries that would participate. As it turned out, this warning was more than justified, but no corresponding precautionary measures were taken.

The Council had stated in 1990 that "a Monetary Union is thus an irrevocable joint and several community which, in the light of past experience, requires a more far-reaching association, in the form of a comprehensive political union, if it is to prove durable." In 1998, no progress in this direction could be observed.

Against the background of these warnings, it was a bold decision to start EMU in January 1999 with eleven vastly heterogeneous countries. In retrospect, probably not setting a fixed date for the start could have prevented the unstoppable political dynamics which developed later.

They should have waited.

EDWIN M. TRUMAN
Senior Fellow, Peterson Institute for International Economics

At the time of the Maastricht treaty, many people inside and outside the European Union thought that it was unwise to move to economic and monetary union without supporting economic and political institutions at the level of the Union. European leaders at the time felt that the institutions would follow and economic and financial convergence as well. In retrospect, they were wrong though it is possible that in time the European integration project will get there but with high cost.

The political leaders also sold this project in each of their countries, including both creditor countries like

Germany and elsewhere, as a net benefit for all countries all the time. Any observer knew that was wrong. Would it have been feasible to wait? Yes, but that did not happen. Moreover, when it came to the decision about which countries would join monetary union without the economic and political conditions in place or full compliance with the Maastricht criteria, the politicians prevailed. They admitted Italy and Belgium. At that point, the die had been cast, and the rest of the sorry history has played out with great cost to the economies of Europe and the world and to the coherence of the European integration project.

The euro came too soon for some countries.

JÜRGEN STARK
Former Member, Executive Board, European Central Bank

The euro was introduced on the assumption that Europe would not be able to develop into a political union for the foreseeable future. This is why the economic and monetary union is based on principles and rules for its member states.

Two aspects in particular should have been dealt with differently. First, the currency union shouldn't have been allowed to start out with too many unqualified member countries. And it shouldn't have been allowed to expand so quickly.

Second, the restrictions of the Maastricht Treaty should have been implemented and adhered to consistently. The principles and rules were intended to make the policymakers of the member states responsible for their respective countries' public finances, sustainability, and long-term convergence. But this was not the case.

Having ascertained these two factors, the introduction of the euro should have been followed by an insolvency code for countries.

So the issue is not so much the assumed shortcomings in the EMU's original institutional setup. The main reason for the as-yet-unresolved crisis is the political deformation of the prescribed institutional architecture since 1998. There is no doubt that the introduction of the EMU in tandem with a political union would have been necessary and consistent.

If a smoothly functioning currency union was to be guaranteed, then countries with doubtful economic and fiscal track records dating back decades should not have been allowed to join at the launch back in 1999. It is no surprise that these countries were ill-prepared, or unable to cope with the high demands of a currency union in economic, institutional, political, or cultural terms.

False political ambition created false incentives. The euro came too soon for these countries. It would have made more economic sense to start out with just the countries from the "deutsche mark bloc" of that time. Then after about a decade, we could have gradually expanded the currency union. This would have given the non-euro countries more time to make progress on the road to medium-term sound economic and fiscal policy and structural changes.

The level of economic convergence reached in 1998 was an illusion. It was promoted by the financial markets just as much as through manipulated statistics and creative accounting in the member states. The level of convergence was measured politically.

There were attempts in 1997–98 to counteract the expected reform fatigue following the introduction of the euro in the critical member states, by tightening budget rules and establishing specific obligations for continued consolidation of public budgets. However, the new procedures for monitoring fiscal policies and coordinating economic policies were not supervised or enforced by either the European Commission or the Eurogroup. All parties were potential "sinners"—and in order to be politically correct, peer "pressure" was transformed into peer "support." This proved to be—to quote Mario Monti—"unhealthy politeness."

I would have changed the framework in three key ways.

REZA MOGHADAM
Director, European Department, International Monetary Fund

Everywhere, but especially in Europe, the crisis has exposed gaps in our belief systems and institutions. Maastricht is no exception. Given political constraints and risks as they were perceived in the 1990s, Maastricht's focus on fiscal sustainability and its reliance on the "no-

bailout" clause to encourage markets to discipline sovereigns are understandable, but were revealed to be insufficient.

With the benefit of hindsight, it is clear that the framework neglected the risks associated with excess private sector leverage and the divergence of competitiveness, provided insufficient incentive for market discipline, and led to procyclical fiscal stances. Moreover, the crisis has shown that there is no simple separation between private and public sector balance sheets: in many cases, private imbalances eventually end up as public sector liabilities.

Accordingly, I would have changed the framework in three key ways: (1) added means to assess and address emerging competitiveness gaps and imbalances; (2) improved incentives for market discipline; and (3) incorporated some fiscal risk-sharing.

What form would these changes take?

If something like the current Macroeconomic Imbalances Procedures had been part of Maastricht and had tracked competitiveness as a sign of rising vulnerabilities, the build-up of imbalances might have been addressed more quickly. But even MIP needs to be enhanced. It needs to put greater emphasis on emerging competitiveness gaps and include stronger corrective mechanisms.

Strengthened market discipline could have helped to better differentiate risk across the euro area and reduced the build-up of large cross-border debts via the banking system. Greater harmonization of financial sector regulations—including insolvency regimes, robust bail-in, and burden sharing frameworks—and a credible single supervisor, underpinned by a powerful single resolution mechanism, are essential for effective market discipline. The emerging banking union advances many of these objectives, but to make the whole edifice credible, there needs to be a strong single resolution authority and credible common backstop.

At the time monetary union was negotiated, a move towards fiscal risk-sharing was politically challenging given fears that it would engender permanent fiscal transfers and an additional loss of sovereignty. By contrast, a backstop for a resolution authority is well-grounded in the need to promote financial stability in the single market. To avoid free-riding, any pooling of resources, either through the requisite common backstop or other centralized fiscal policy, would need to be combined with stronger fiscal governance from the center. Additional fiscal risk-sharing also could have helped avoid excessively restrictive fiscal stances during severe recessions.

Inevitably, crises will emerge. But if these components had been part of Maastricht from the outset, private sector imbalances would have been less, market discipline would have been more effective, and fiscal policies would have been more countercyclical. The crisis might not have been avoided, but the fallout would have been more manageable. Progress has certainly been made, but Europe still has much work to do on some of these post-Maastricht adaptations if it is to create a more stable and resilient European monetary union.

The euro needed substantially more political union and integration.

DOUGLAS J. ELLIOTT
Fellow, Economic Studies, Brookings Institution

Given the pain of the last several years, it is tempting to say that Europe would have been better off without the euro and therefore the better decision would have been not to launch it. However, this ignores the strong negative effects of historical currency volatility. Among other things, interest rates had to be significantly higher on average to compensate for currency risk. Further, the temptation to use the drug of devaluation spurred the deferral of painful, but necessary, policy reforms.

The better answer would have been to go forward with the euro, but in a sound way. This required greater commonalities among member states, stronger economic integration, and stronger political union. Starting with only those member states that had a sufficient degree of commonality in their economies would have considerably reduced the potential strains that came with including Germany, Spain, Ireland, and Greece in the same union.

Stronger integration among the economies would have further reduced strains that arose from disparate levels of development and divergent evolution. The ability to move resources more easily within the monetary union would have helped smooth out problems that came up, including from the financial crisis and ensuing recession.

The euro also needed substantially more political union than the zone has now. Without a stronger political union, it is very difficult to achieve the necessary economic integration. There needs to be a belief that the citizens of the zone are part of a mutual endeavor that requires common sacrifices from time to time. Common political structures with appropriate powers are necessary to make this work.

It was probably politically impossible to do the euro the right way. It will be up to historians to decide, years from now, whether the great damage Europe has just under-

gone was ultimately worth it to achieve a currency zone that might never have occurred if it had to be done correctly from the beginning.

We should have better monitored capital flows and current account imbalances.

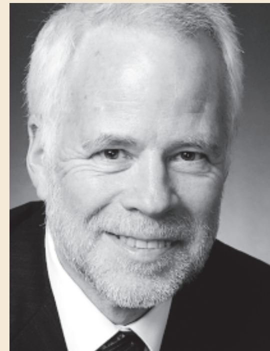
WILLIAM R. WHITE
Chairman, Economic Development and Review Committee, OECD

The challenge is not to make constructive suggestions about what might have been otherwise decided in the late 1990s. Rather, it is to make suggestions that would have been politically feasible. Harold James' 2012 book, *Making the European Monetary Union,* makes clear that the Maastricht Treaty was the end result of decades of discussion. Shortcomings concerning fiscal union, banking union, economic union, and political union were generally recognized but measures to deal with them simply could not be agreed politically.

Yet one crucially important measure might have been possible. I believe that the eurozone crisis had its origins in massive capital flows from core to peripheral European countries that generated excessive demand and large current account imbalances. These flows were encouraged by the single currency, by the growing "elasticity" of the global financial system, and by unnaturally easy global monetary conditions. Moreover, policymakers welcomed these flows, and the narrowing of sovereign borrowing spreads, as proof that the eurozone economies were converging as desired. However, far from resulting in productive investments that could support rising debt service obligations, these flows actually contributed to a variety of "boom" conditions in peripheral countries that eventually led to "bust." As in so many crises in history, a sudden stop in capital flows was the trigger for the turn.

Had these growing current account imbalances been monitored, and seen as a sign of prospective problems, steps might have been taken to damp them down. Indeed, explicit consideration of current account imbalances is now part of the new eurozone "surveillance" procedures. I think it might have been politically possible to focus on such indicators much earlier. Recall that balance of payment problems within Europe were a traditional source of exchange rate crises, often triggered by upward pressure on the deutsche mark reflecting persistent German trade surpluses. The problem then was well known. The fundamental fallacy was the widely held assumption that balance of payment crises would be impossible within a single currency area. This belief was comforting since it implied there was no longer any need to debate the contentious issue of the respective roles of debtors and creditors in the adjustment process. And being comforting, it was not challenged.

Had this false belief been contested earlier, and appropriate indicators included in the Maastricht treaty, things might have turned out very differently. Not only might preventive steps have been taken, but more attention might even have been paid to *ex ante* processes for handling such crises when they did occur. Admittedly, this latter possibility might have been even less politically feasible at the time of the euro's introduction. Recognizing a new potential problem, along with appropriate counter measures, would have been one thing. Admitting that it could end in a serious crisis would have been quite another.



I would seek to convince European policymakers that monetary union without banking union will not fly.

BARRY EICHENGREEN
George C. Pardee and Helen N. Pardee Professor of Economics and Political Science, University of California, Berkeley

If I could turn the clock back to 1999, I would seek to convince European policymakers that monetary union without banking union will not fly. A single currency and a single financial market with eighteen separate national bank regulators is madness. Prudential supervision that fails to take into account the impact of domestic decisions on one's partners is a recipe for destabilizing cross-border capital flows guaranteed to create and exacerbate imbalances within the monetary union.

This may be contrary to the conventional narrative that emphasizes fiscal excesses and flawed fiscal rules in the genesis of the crisis. But with time will come a better apprecia-

tion of how unstable banks and destabilizing capital flows were at the heart of post-1999 Europe's problems. It is understandable, perhaps, that European policymakers and the fathers of optimum currency area theory did not adequately appreciate the need for banking union to accompany monetary union, banks having been heavily regulated and controlled when that theory was originally developed and the decision to go forward with monetary union was taken. But were I able to turn the clock back, that would be the flaw in European economic policy that I would seek to correct.

Monetary union should have involved fewer countries.

MARTIN FELDSTEIN
Professor of Economics, Harvard University, former Chairman, Council of Economic Advisors, and President Emeritus, National Bureau for Economic Research

Even before the euro was launched, I argued against imposing a single currency on a disparate group of twelve countries ("The Case Against the Euro," *The Economist,* 1992, and "European Monetary Union and International Conflict," *Foreign Affairs,* 1997). A single currency implies a single monetary policy and a single exchange rate. The single monetary policy is inappropriate when countries have different business cycles and lack the geographic mobility and centralized fiscal system such as that of the United States. The single exchange rate is unsustainable when individual countries differ in productivity trends and international competitiveness.

Going back to 1999, if I could not persuade the members of the Common Market to limit their plans to a free trade area without a single currency, I would suggest that the European Economic and Monetary Union be limited to fewer countries, eliminating those most likely to diverge from the business cycle and trend competitiveness of the core countries.

In the same spirit, I would recommend a mechanism by which any country could take a temporary leave of absence from the eurozone in order to lower the value of its currency when doing so would permit increased domestic demand and a reduced foreign trade deficit.

Membership should have been limited.

MOHAMED A. EL-ERIAN
Former CEO and co-CIO, PIMCO

Two things tend to happen when a group comes together to form a much-heralded exclusive club, especially one that is highly visible and deemed very desirable. First, group members are inclined to believe that they are truly "special" and that "normal" rules no longer necessarily apply to them. Second, their friends bombard them with calls begging for entry to the club.

Being human after all, it is very hard for club members to effectively resist both factors. Hubris often sets in. Standards are lowered to enable the entry of others. And, with time, the group weakens from within.

This risk is why many of the more successful groupings opt for structure to protect them. They put in a place a set of rules and procedures that limit their vulnerability to as many aspects of self-inflicted weakness as possible; and always strengthen structural discipline.

Europe would have been well advised to remember this approach back in the 1990s when it opted for a monetary union and a common currency—a "historical project" that even today engenders a great sense of regional pride. For example, it could have done better by hardwiring two practices: treat monetary union as a springboard and not as an end in itself; and start and remain small for a while.

Too early into the life of the single currency, eurozone governments lost sight of the fact that monetary union is necessary but not sufficient for durable regional integration. As a result, little progress was made in the equally important areas of banking and fiscal union—leaving the eurozone not just fundamentally vulnerable but also with insufficient policy tools.

Too rapid and lax expansion accentuated the problem. With hindsight, and as arbitrary as this would have inevitably been, it would have been better for the eurozone to impose a rule that precluded expansion negotiations for the first five to seven years. Instead, it opted for bigger membership well before the discipline of a monetary union was sufficiently understood and entrenched within the original members.

The new entrants were less prepared for monetary union. And the temptation for them to cut corners was

accentuated by the fact that some of the established members were doing so. (Remember, Germany was the first to break the fiscal rules that accompanied monetary union—though it did compensate by being the boldest in implementing structural reforms.)

Ironically, these steps would have been both constructive and politically feasible in 1999. They would have put the eurozone on a firmer footing from day one. They would have enabled a more rational and sustainable expansion over time. And, most importantly, they would have avoided European citizens quite a bit of pain.

Debt should have been consolidated. A banking union was essential.

RICHARD N. COOPER
Maurits C. Boas Professor of International Economics, Harvard University

I can start by mentioning the advice that I actually gave in the mid-1990s, and then add a few retrospective observations. I urged the Europeans to consolidate the national sovereign debt as of the inauguration of the euro. Debt levels (relative to GDP) varied widely in the mid-1990s, with Belgium and Italy having exceptionally high debt, inherited from the past. Consolidating the debt into a eurozone-wide obligation would have created a common starting place for all member countries going forward. It also would have stimulated a eurozone-wide capital market by creating a common benchmark set of securities. Of course, Germans did not want to take on Italian debt. But they would not have to, at least as far as servicing the debt was concerned; each country could have taken full responsibility for servicing its portion of the common debt. If one country defaulted, others would have had to cover for it; but default under the postulated circumstances was an extremely improbable event.

Second, I argued against creating the Stability Pact. With monetary and exchange rate policies being framed jointly and denied to each country separately, I felt each country should retain flexibility to manage its own fiscal policy to help deal with asymmetric shocks. I assumed that fiscal policy would be used sensibly, not squandered. And I assumed, incorrectly as it turned out, that the rating agencies and investors would be able to distinguish among countries with sensible fiscal policy and others, as they do among state governments of the United States. In this connection, I would not have admitted Greece to the eurozone in 2001. It was known or at least suspected then that Greece's figures were not reliable by European standards; it should have been subject to much more severe scrutiny, with lessons for treatment of future applicants.

In retrospect, I would have planned from the beginning to create a banking union, with common rules, supervisory oversight, resolution authority, and deposit insurance financed by the banks. It is worth recalling that the United States introduced deposit insurance before it allowed interstate banking; it was designed to prevent depositors from demanding cash, not mainly running to other banks. It was difficult to bank out of state in the 1930s and indeed through the 1960s.

Finally, contrary to what seems to becoming conventional wisdom, I do not believe it is necessary to have political union—although it may be desirable—to have a functioning monetary union. Several monetary unions exist in the world today, two of which have run for five decades. Each has its special characteristics, but they all function. Switzerland has a functioning monetary union among highly autonomous cantons; it is a confederation with a relatively weak national government. Provinces in Canada and states in Australia and the United States are all constitutionally sovereign entities. It is true that the authority of national governments has grown over time in all of these countries. But national currencies pre-date that growth.

What we needed was better management.

HEINER FLASSBECK
Director, Division on Globalization and Development Strategies, United Nations Conference on Trade and Development

Indeed, I was an economic policy leader at the end of the 1990s and I tried my best to prevent those events that are called the euro crisis now. In particular, I had a very

clear vision of the diverging and eventually lethal forces that were implanted into the currency union by the German attempt—under enormous pressure from the government—to go for the neoclassical experiment of cutting wages. I pushed for a coordination mechanism that would allow bringing wage developments in line with the commonly agreed inflation target of close to 2 percent. And that coordination mechanism, called the macroeconomic dialogue, was installed at a European summit in spring 1999, but it was ignored by the leading politicians as well as by the monetarist technocrats at the European Central Bank and the bureaucrats at the European Commission, who were strong believers in neoclassical economics and the virtue of wage cuts.

A monetary union, contrary to what many critics today and at the outset of EMU hold, doesn't require countries of similar strength and similar productivity. But it asks for the adjustment of wages to the national productivity trend and the commonly agreed inflation target. Unit labor costs at the national level had to grow in line with the inflation target set by the ECB. This simple and straightforward rule was violated by Germany more than any other country. Germany undershot the target, while the countries in the south overshot. France was the only country fully in line with the target. The resulting real depreciation of Germany and the real appreciation of the rest was the nucleus of the crisis and it will destroy the eurozone if Germany is not willing to destroy its weaponry. Germany has to encourage an increase of wages and a rate of inflation that amounts to a real appreciation instead of forcing the others to opt for deflationary wage policies to achieve a real depreciation.

A common currency in the heart of Europe replacing a system of fixed exchange rates was a very good idea. It ended German dominance in terms of monetary policy and allowed a common monetary policy for countries that had sacrificed their national monetary policies a long time ago. But the exercise was poorly managed. If exchange rates are no longer available, the most important task of economic policy is to avoid a divergence of unit labor costs and the implied real depreciations and appreciations. This is the core of the matter. Government debt and public deficits are a marginal affair, but all the political energy was wasted there while the core was ignored. European monetary union could have been a success story. But if I had known about the managerial shortcomings, I would have recommended the continuation and improvement of the system of fixed but adjustable exchange rates. Giving up national currencies and being driven by the major economic force into an overvaluation is the worst of many bad outcomes.

Needed was a credible mechanism to enforce fiscal discipline.

ANDERS ÅSLUND
Senior Fellow, Peterson Institute for International Economics

The euro was introduced for many reasons. The old idea of a common European currency represented a reestablishment of the gold standard prior to World War I. In the 1970s and 1980s, high inflation and competitive devaluations had harrowed Europe. Many looked up to the financial stability of the Bundesbank. The German reunification convinced France and others of the need for further political European integration to tie Germany more deeply into Europe.

In the years between the conclusion of the Maastricht Treaty in 1992 and the introduction of the euro in 1999, fiscal discipline in Europe improved impressively. Inflation and budget deficits declined, containing public debt because the Maastricht criteria restricting the public budget deficit and the public debt were taken seriously as entrance conditions to the future euro club.

The euro crisis has primarily been a public debt crisis. Everything else has been secondary. After countries had entered the euro club, the Maastricht criteria were no longer respected. In November 2003, the Economic and Financial Affairs Council, ECOFIN, declared that France, Germany, and Italy would not be punished for exceeding the budget deficit limit of 3 percent of GDP. In 2005, the same countries "reformed" or destroyed the Stability and Growth Pact. Smaller euro countries followed suit.

In 2008 and 2009, the G20 exhorted all countries "to do what it takes" in terms of fiscal stimulus. The International Monetary Fund admonished countries that were traditionally fiscally conservative, such as Spain, Cyprus, and Slovenia, to boost their budget deficits to 6 percent of GDP. In 2010, the IMF warned against withdrawing fiscal stimulus "too early." These three euro countries have been driven into various degrees of financial hazard by this misadvice.

The eurozone's fundamental problem is that it does not have a credible mechanism to enforce fiscal discipline. The big countries get a free card through their weight in the European Council of Ministers. The easiest solution would be that the European Commission rather than ECOFIN impose fiscal discipline. Partially this has been done, but

the last vote rests with ECOFIN. Alternatively, constitutional amendments could impose the necessary discipline, as is now being done in many countries, but many European countries have constitutions that guarantee a large number of social "rights," prohibiting cuts in pensions and public salaries or the sacking of public servants. Such constitutional rules should be outlawed. A third option would be the formation of a European Fiscal Council with the singular task of imposing fiscal discipline in the member countries. In the end, however, people need to learn the risks and costs of poor fiscal discipline. Any institution can be changed if people do not appreciate its value.

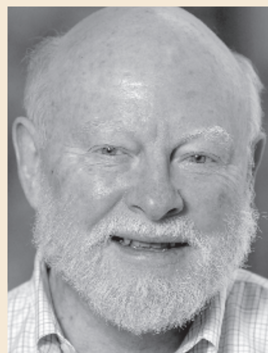
There should have been rules and a system of transfers.

BERNARD CONNOLLY
CEO, Connolly Insight, LP

In the 1950s, French President Charles de Gaulle's financial adviser, Jacques Rueff, wrote that *"L'Europe se fera par la monnaie ou elle ne se fera pas"*—the single currency was always a political project. In the event, whatever may have been the case in the 1950s (any possibly benign motivation having been rendered redundant by the middle of that decade by NATO and by democratic capitalism), the only shared aims of the project have been to eliminate, to the benefit of a *nomenklatura,* the nation-state, which is the only feasible repository of political legitimacy and accountability and of democracy, to "prevent the encroachment of Anglo-Saxon values in Europe" (in the words of one of the "fathers of the euro") and to make "Europe" a "player on the world stage" in an attempt to re-create globally the conditions of competing, elite-dominated empires which in Europe led to the First World War. Layered onto those ambitions was always a struggle between France and Germany for mastery in Europe.

Just ahead of Maastricht, the Bundesbank pithily stated the conditions for monetary union to be anything other than a disaster: "monetary union must display the degree of solidarity characteristic of a nation." In other words, the abolition of adjustment mechanisms by monetary union meant there must be both acceptance of the rules—possible only if the rules are democratically legitimate—and a system of transfers at least as extensive as within any existing nation-state. But "Europe" was and is all about destroying democratic legitimacy. And in a monetary union with countries as poor as Greece and Portugal and as "strategically" slippery as France and Italy, the potential burden of transfers would be huge—and with no national "solidarity" of the sort which has, just about, made the much smaller transfer costs of German monetary union acceptable to the former West Germans.

Given that political backdrop, monetary union could never have been anything other than the economic and social catastrophe it has proved to be, in which, as in the First World War, the suffering of ordinary human beings seems to have been of no consequence to the power-hungry would-be imperialists in their manoeuvrings. We are now left in a situation in which acceptance of German rules—austerity—is no longer possible in the peripheral countries without risking making them failed states; and open-ended perpetual transfers from Germany are not possible without risking making Germany a failed state. In sum, what was needed to make a monetary union work, as enunciated by the Bundesbank (and insistently repeated by outside observers such as Mark Carney), was always going to be made impossible by the underlying political ambitions of the project. So to avoid accepting the failure of the monetary union project, the *nomenklatura* is attempting, with considerable success, to re-inflate a credit bubble which will mask the failure of monetary union for a time but will inevitably end in a financial, economic, social, and political crisis far worse than anything that has yet occurred.



What was needed was a better understanding of the interaction between sovereign risk and banking risk.

RONALD MCKINNON
Professor Emeritus of International Economics, Stanford University, and author,* The Unloved Dollar Standard: From Bretton Woods to the Rise of China *(Oxford University Press, 2013)

In 1999, neither proponents or opponents of the new euro system recognized the potential serious interaction between sovereign risk and banking risk. True, sovereign

risk was recognized as a serious problem, and the Maastricht Accord and follow-up Growth and Stability Pact both placed limits on government debt and deficits. (But Greece violated these accords by massive fudging of its national income accounts.) However, unlike American financial markets where government bond holding is disbursed among insurance companies, pension funds, bond funds, and so on, European countries' national debts are heavily concentrated in that country's commercial banks.

Before the euro, each central bank acted as a lender of last resort to its commercial banks—many of which are state-owned. So if some shock, such as a collapsing real estate bubble, impaired bank-held mortgages, the central bank could lend to its stricken commercial banks.

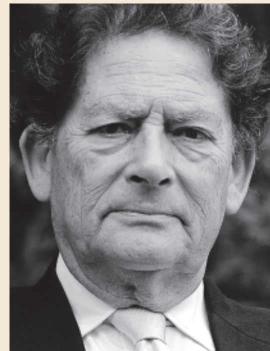
But with advent of the euro and the European Central Bank, central banks lost their money-creating power. The national government would have to borrow euros to support its commercial banks, and thus impair its own credit standing. Banking risk created sovereign risk—as was largely the case of the real estate crises in Spain, Portugal, Ireland, and Italy. (In Greece, sovereign misbehavior created its banking crisis.)

Ironically, external forces greatly aggravated this European problem. The Basel Accord(s) based on risk-weighted capital requirements for commercial banks actually classify sovereign bonds as risk-free with a zero weight! Presumably that could have been easily fixed a long time ago.

But also unluckily for Europeans, American monetary policy began to go wrong in 2002 when the Fed drove its policy interest rate down to just 1 percent. This not only set off the huge U.S. property bubble, which began collapsing in 2007, but hot U.S. money outflows to Europe set off (with a lag) parallel property bubbles in Ireland, Spain, Portugal, and Italy that ultimately collapsed in 2011. The resulting banking crises created a panic in their sovereign bond markets—with sharp spikes in interest rates that forced "austerity" programs on governments that further steepened the collective economic downturn. (Greece was always ahead of the pack.) This forced the ECB into its Outright Monetary Transactions program, promising to do whatever it took to drive down government bond yields. So far, just the announcement of OMT itself has been successful in bringing interest rates on sovereign bonds back down without actual ECB purchases. But the eurozone economy still languishes.

What have we learned? Certainly the Basel Accords on treating sovereign debt were (are) inadequate. But even if central banks can no longer create base money in euros to control interest rates, they should be better prepared to deal with bubbles in asset markets that are mainly national, and not Europe-wide. (The property manias did not affect Germany). One example: if a property bubble threatened, the national central bank could be empowered and obliged to raise required down payments on mortgages.

Finally, for better or for worse, the world is on a dollar standard. Although the ECB was applauded for its early success from 2002 to 2008, erratic U.S. monetary policy led to the property crash and ultra-low interest rates that unhinged the European economy and emerging markets more generally. For Europeans, however, it is important to realize that many of the euro's travails have been externally imposed, and not to lose confidence in the common currency.



There needed to be a United States of Europe.

NIGEL LAWSON
Former Chancellor of the Exchequer, United Kingdom

I don't need a time machine to roll back the clock. I have been opposed to European monetary union from the word go. As Chancellor of the Exchequer, I gave a speech at Chatham House on January 25, 1989, entitled "What Sort of European Financial Area?," the second half of which discussed the proposal for EMU and explained why I was wholly opposed to it. Here is an excerpt:

> *"It would be impossible, for example, to have irrevocably fixed exchange rates while individual countries retained independent monetary policies. Quite apart from the theoretical problems, it is clear that such a system could never have the credibility necessary to persuade the market that there was no risk of realignment. Thus EMU inevitably implies a single European currency, with monetary decisions—the setting of monetary targets and of short-term interest rates—taken not by national Governments and/or central banks, but by a European Central Bank.*
>
> *Nor would individual countries be able to retain responsibility for fiscal policy. With a single European monetary policy there would need to be central control over the size of budget deficits and, particularly, over their financing. New European institutions would be required, to determine overall Community fiscal policy and agree the distribution of deficits between individual Member States.*

These are not technical issues. The setting up of a European Central Bank or a new European institution to determine Community fiscal policies go to the very heart of nationhood. What organization would really be the government? It is clear that Economic and Monetary Union implies nothing less than European Government—albeit a federal one—and political union: the United States of Europe. That is simply not on the agenda now, now will it be for the foreseeable future."

Subsequent events have, to say the least, done nothing to cause me to change my mind. The eurozone countries would be well advised to abandon this disastrous enterprise, but I do not expect them to do so.

Economic and monetary union, by contrast, is incompatible with independent sovereign states with control over their own fiscal and monetary policies.

Several steps would have made a difference.

JAMES E. GLASSMAN
Head Economist and Managing Director, JPMorgan Chase & Company

Europe's common currency was a big step forward. Perhaps Europe didn't initially meet the optimal currency area criteria for a common currency and many made that case at the time. Nonetheless, the creation of the euro has been an important impetus behind the drive toward greater economic integration. More importantly, the common currency has helped to pull together a region that was deeply scarred by a long history of conflict. That's why the European community faced considerable pressures in the wake of World War II to integrate their economies.

Back-to-the-future scenarios—what could have been done differently to avert the recent existential crisis—tend to point in one direction: finish the project that was started long ago by creating a banking union, a financial resolution mechanism, and a fiscal transfer mechanism. There's a reason why these issues were not completed. They involve difficult political questions about how much the citizens of one country should be asked to shoulder the burdens of others. That question is easier to answer when citizens across the region embrace common goals about the proper role of the public sector. So it's politically unrealistic to list these as measures that could have averted the financial crisis. Anyway, Europe's economies performed reasonably well in the 1990s and 2000s even though these issues were unresolved.

What fueled the European crisis? The expanding fiscal deficits that fueled speculation Europe was on an unsustainable path echoed similar trends in the United States. Investors didn't question U.S. fiscal sustainability. The stable value of the euro amid the financial crisis implies it was largely a domestic crisis, not a currency crisis. Fears that the monetary union might fail and force vulnerable members to default—a fear that was reflected in widened sovereign spreads—triggered "runs" by depositors who worried that their own deposit insurance backstops would fail. Funds moved from periphery countries to Germany. As a result, several governments were forced to seek financial rescues that required stringent fiscal austerity measures.

With that in mind, several small steps might have made a difference.

First, the European Central Bank could have headed off the panic about the survivability of the monetary union when such speculation first arose in 2010. Mario Draghi, president of the ECB, eventually did just that. His remarks on June 29, 2012, that the ECB would do whatever it took to preserve the euro, and the ECB's subsequent announcement of open market transactions is widely believed to have broken the crisis. U.S. Federal Reserve Chair Ben Bernanke had already provided a precedent for this approach when he announced aggressive plans for large-scale asset purchases in March 2009 that reminded market participants the Federal Reserve had many options, and that proved to be the beginning of a long recovery of sentiment.

Second, a concerted public education effort by the Federal Reserve, the ECB, and other key central banks to inform the public what asset purchases were (an effort to dampen long-term interest rates) and what they were not (creation of money) would have quieted the intense political criticism of the central banks' efforts and given financial markets a better understanding about how the ECB could contain Europe's financial crisis.

Third, failure to distinguish between cyclical and structural deficits, a discussion that is more mature in the United States thanks to the efforts of the Congressional Budget Office, would have helped to calm investors' fears that the European Union was doomed. That fear played a big part in the financial crisis. After all, the fiscal positions of both the United States and virtually all members of the European Union were sustainable prior to the recession, implying that the deterioration in budget deficits was largely a cyclical problem. The U.S. deficit was about 1 percent of GDP in 2007 and all members of the European Union other than

Greece met the 3 percent of GDP Maastricht fiscal targets. In contrast to what happened in the United States, widening budget deficits triggered a crisis of confidence in the European Union. The United States made no effort to shrink deficits and they have narrowed from 10 percent of GDP in 2009 to 3.3 percent most recently. In contrast, austerity measures in Europe inflicted significant economic harm.

The U.S. discussion has long recognized the difference between cyclical and structural deficits, thanks in part to the analytical work provided by the Congressional Budget Office. European conversations about fiscal matters tend to blur these distinctions. Surely that confusion contributed to the fiscal pessimism in financial markets when Europe stumbled.

The tragedy of the European financial crisis is that it was a crisis of confidence that likely could have been managed better with an aggressive response by economic leaders.

The criteria for membership might have been substantially strengthened.

ANNE O. KRUEGER
Research Professor of International Economics, SAIS-Johns Hopkins, Senior Fellow, Center for International Development, Stanford University, and former First Deputy Managing Director, International Monetary Fund

In retrospect, having a common currency without a strong fiscal rule was destined to lead to difficulties sooner or later. While a policymaker might have thought that there would be time to adopt a rule before a crisis once the euro was adopted, it is doubtful if that such a rule could have been agreed without a crisis once the common currency was in force. A strong fiscal rule would have required a hard budget constraint of some kind and greater oversight of reporting of economic statistics as a corollary. And, as eurozone members have discovered, greater integration of banking systems was also essential.

With the wisdom of hindsight, it would have been preferable to insist upon a hard budget constraint and refuse to agree to a common currency until it had been achieved. If that had been politically infeasible, policies that would enforce and make clear that each individual country's sovereign debt would not be honored by other eurozone countries may have at least reduced the magnitude of the likely dangers of the currency union.

If it was politically essential to agree to a common currency in the late 1990s, the criteria for membership might at least have been substantially strengthened so that weaker countries would have to take stronger measures than they in fact did before joining. Such strengthened criteria would almost certainly have delayed the entry into the common currency of some countries and, if not, required stronger adjustments prior to the launch of the euro. Under that scenario, some of the "southern" countries would have undertaken stronger fiscal and monetary measures than they in fact did, and the macroeconomic misalignments could conceivably have been considerably smaller.

Of course, it could have been argued that a severe crisis would provoke the necessary fiscal and banking integration, and that without a crisis, these measures would never be agreed. The severity of the eurozone crisis strongly suggests that that argument would have been wrong, both because the costs of the crisis have been so high, and because the evolution of policies to date does not indicate that this would have been a reasonable expectation.

Despite shortcomings, the euro remains a great success.

HOLGER SCHMIEDING
Chief Economist, Berenberg

Like many adolescents, the euro has had its stormy days. The region would have passed its youth more easily if it had had the comfort of a lender of last resort and the convenience of a banking union from the beginning. Despite these shortcomings, which are being dealt with now under the pressure of crisis, the euro remains a great success.

Despite the recent euro crisis, the eurozone still has 12.3 million more jobs than it did at the start of the euro in early 1999, ahead of the 11.6 million gain in the United States. While almost ten million discouraged U.S. workers have withdrawn from the labor market, the participation rate has risen on trend in the eurozone.

The United States has an edge over the eurozone in terms of total GDP growth. But the United States paid a high price for that. During the fifteen years of the euro, the ratio of public debt to GDP has risen by 23 percentage points in the eurozone. In the United States, artificial life-support for aggregate demand has boosted the debt ratio by 45 points to 105 percent at the same time. It now exceeds that of the eurozone by ten points.

Being a euro member can be tough. The common currency denies its members the easy but ultimately futile escape route of devaluation. Instead, the euro forces its members to tackle problems the hard but lasting way, through sweeping structural reforms. Ten years ago Germany turned itself from the sick man of Europe into the continent's growth engine within the straitjacket of the euro. Spain, Portugal, and Ireland are now following suit. Even recalcitrant France has finally started to embrace some reforms.

In addition, the eurozone's macroeconomic management has been less disastrous than that of the United States. When the United States faced financial problems in early September 2008, it mishandled the situation so badly that it pushed the entire Western world into its worst recession in eighty years. When the eurozone faced financial problems in 2011, it merely caused a mild recession in the region itself.

The euro crisis did expose one major birth defect of the eurozone. The region had not designated a lender of last resort. When it suddenly needed one amid trouble in a remote corner, Greece, in spring 2010, it took the region more than two years until the European Central Bank finally assumed that role wholeheartedly in mid-2012. Ever since the ECB promised it would henceforth behave like other central banks such as the Fed, the Bank of England and the Swiss National Bank and intervene with full force to stop a market panic if need be, the euro crisis has faded away.

But unlike other central banks, the ECB has not turned itself into a lender of first resort to governments. Instead, the ECB insists that countries meet conditions set by the other member countries through the European Stability Mechanism in order to be eligible for panic control support. Help within the eurozone is conditional. It is no coincidence that the four eurozone countries which had to apply for external help, Greece, Ireland, Portugal, and Spain, took the top four spots among all OECD members for structural reforms in the OECD's "Going for Growth" ranking in early 2013.

By ending the irrational panic in sovereign bond markets and the recession, the ECB has also defused the two major problems plaguing many European banks. The upcoming asset quality review and stress tests are likely to reveal some residual capital shortfalls. Once these are dealt with and the ECB has taken on the supervisory role for the major banks, the eurozone can move forward into calmer adulthood.

Member countries needed a joint inflation target.

GUSTAV A. HORN
Director, Macroeconomic Policy Institute (IMK) of the Hans Böckler Foundation

Assume it is 1992 and negotiations on a common currency have begun. The first prerequisite is to understand a currency union properly. The conclusion should be that a currency union is a confederation that is based on achieving a joint inflation rate. This was a key reason why many economies wanted to join the currency union: it was a chance to get their high inflation rates down. Against this backdrop, the first decision to be taken should have been the determination of a joint inflation target. This was not done in reality—the decision was left to the subsequently established European Central Bank.

That was a fundamental mistake, because proceeding like this seemingly shifts the responsibility to meet the target exclusively to the ECB. And that was wrong, although it seemed to be corroborated by the policy assignment recommended in leading textbooks. But textbooks analyze standard economies with one currency and one government. Instead, the euro area is an economy with one currency but many governments and this makes things different. There is indeed a responsibility of the central bank to meet the inflation target but only on an aggregate level, and this is simply not enough to achieve the necessary price stability within a currency union of different and otherwise sovereign economies. While fiscal rules were put in place, they were not conducive to achieving similar rates of inflation in the different countries.

Within a currency union, deviations from the joint inflation target affect the competitiveness of national economies. Countries with a too-low inflation rate compared to the target increase their competitiveness compared to the rest; in other words they depreciate in real terms. Usually that leads to current account surpluses and an accumulation of foreign wealth. The flip side of the coin is that economies with above-average inflation rates have negative trade balances and accumulate foreign debt. These macroeconomic imbalances are at the root of the present crisis.

The crisis might have been avoided if governments in both above- and below-average inflation countries had

accepted a national responsibility to meet the inflation target by taking the respective decisions and if an appropriate framework for the coordination of fiscal policy to achieve this goal had been established at the European level.

In any case, such a decision would have promoted the proper understanding of a currency union. Also helpful would have been to establish an institution like a European Monetary Fund that would have helped as an emergency lending agency in case of severe current account imbalances.

In the light of these arguments, a valid reason not to proceed with the euro would have been that member countries had not accepted a joint inflation target. This is a recipe for a severe crisis. In fact, they accepted a joint inflation target by accepting the Maastricht convergence criteria, without, however, really understanding what it meant. The resulting crisis was in that sense inevitable.

The biggest structural deficiency was distributional.

HANS-JOACHIM DÜBEL
Finpolconsult, Berlin

The euro crisis is a debt crisis by nature. Its causes lie in the financial liberalization of the 1980s and the asymmetric credit and price inflation boom of the 2000s. The latter was fuelled by both global and regional investors, including by Germany returning to surplus again after having absorbed reunification costs in the 1990s. The construction of the euro primarily impacts the distribution of the cost of the crisis, while its contribution to the genesis of the crisis was limited.

With the "big bang" in the mid-1980s, European commercial banks started entering consumer lending based on variable interbank indices. A decade later, much of Europe had shifted their mortgage products from fixed or reviewable to floating. This meant swifter pass-through of falling interest rates post-Maastricht and both faster credit and economic growth. Time-proven leverage rules were eliminated or arbitraged, and lax mortgage securities laws were introduced to keep fuelling growth. Spain and Ireland in this period laid the foundation for their crises.

The risks that the private sector posed were omitted when a few numbers guiding public sector borrowing—debt levels and deficits—were negotiated for the euro introduction in 1999. The arbitraging—first by Italy, and later by Greece—of even these was stimulated by weakening corporate accounting standards laid bare by the collapse of Enron. Investors put their doubts aside given the strong regulatory preferences for public sector credit. Their indifference *de facto* created eurobonds even though formal debt mutualization in the eurozone was explicitly prohibited. Low rates incentivized massive public over-borrowing followed by loss of market access.

In the real economy, Europe was unable or unwilling, due to internal divisions, to defend her social standards to govern trade with the rest of the world. Much of the periphery saw their labor-intensive manufacturing decline and rather than raising capital intensity—as Germany did during reunification—compensated with additional public debt and increasing consumer lending. Surplus countries were deploying their savings thus into income substitutes.

In light of declining lending standards, weak public sector governance, and macro imbalances, could changes in the currency regime have mitigated or pre-empted Europe's debt crisis?

The isolated effect of a fixed exchange rate regime on debt dynamics is small in a liberalized financial environment. Foreign creditors tend to be myopic and will drive up flexible exchange rates, rather than just bidding down rates as under the fixed-rate regime, until they collapse.

Regimes differ primarily by their loss incidence: the lender of last resort and fiscal backups installed in a currency union or credible fixed-rate regime create a quasi-automatic debt transfer from private to public creditors. Bailouts on grand scale are less certain in a flexible regime.

The biggest institutional deficiency of the euro thus is distributional. While wage adjustment is rather swift, imposing market discipline on creditors is sluggish, with the implication of ballooning public debt and austerity measures to control it. The result is a politically explosive double hit for lower-income households.

A better agreement governing the euro would have positively defined mutual support and in return imposed creditor participation from the beginning of any public intervention. Experiences with this were available from the preceding Latin America crisis of the 1980s. Partial mutualization would have forced Europe to monitor individual debt levels more carefully, and address the pathology of the combination of financial liberalization and loss of competitiveness early.

Now Europe is slowly moving there, first through banking union and going forward likely in sovereign finance. At the time of the introduction of the euro, imposing discipline on creditors and comprehensively cutting back on debt dynamics were possibly two too many political fights to take on. ◆