Design failures of the euro area¹

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Economists were early critics of the design of the euro area, though many of their warnings went unheeded. This column discusses some fundamental design flaws, and how they have contributed to recent crises. National booms and busts lead to large external imbalances, and without individual lenders of last resort – national central banks – these cycles lead some members to experience liquidity crises that degenerated into solvency crises. One credible solution to these design failures is the formation of a political union, however member states are unlikely to find this appealing.

The Greek crisis exposes the design failures of the euro area. These have long been known. Right from the start of the euro area many economists warned that these design failures would lead to problems and conflicts within the currency union, and that the euro area in the end would fall apart if these failures were not corrected. See, for instance, Feldstein (1997), Friedman (1997) or De Grauwe (1998).²

The first signs of the disintegration of the euro area are visible today. Grexit is temporarily avoided. The punitive program that is imposed on Greece is likely to lead to a Grexit. But that is unlikely to be the end. After Grexit the nature of the euro area will have been changed from a permanent union to a temporary one. This will destabilise the monetary union each time a recession produces rising budget deficits and debt levels. After Grexit there are likely to be more exits; an unravelling of the union.

"Visionary" European politicians brushed aside the warnings from economists in the 1990s that the euro was based on a flawed construction. Nothing would stop their great monetary dream, certainly not the objections of down-to-earth economists. What are these design failures?

¹ This text has also been published in VoxEU.org – CEPR's policy portal.

² See Baldwin (2015) for a list of VoxEU columns that discussed the flaws early on.

The euro area is not an optimal currency area

The European monetary union lacked a mechanism that could stop divergent economic developments between countries. Some countries experienced a boom, others a recession. Some countries improved their competitiveness, others experience a worsening. These divergent developments led to large imbalances, which were crystallised in the fact that some countries built up external deficits and other external surpluses.

When these imbalances had to be redressed, it appeared that the mechanisms to redress the imbalances in the euro area ("internal devaluations") were very costly in terms of growth and employment, leading to social and political upheavals. Countries that have their own currency and that are faced with such imbalances can devalue or revalue their currencies.

In a monetary union, countries facing external deficits are forced into intense expenditure reducing policies that inevitably lead to rising unemployment. This problem was recognised by the economists that pioneered the theory of optimal currency areas (Mundell, 1961, McKinnon, 1963, Kenen, 1969; along with later important contributions, including Bayoumi and Eichengreen, 1993, Krugman, 1993).

The standard response – based on the theory of optimal currency area thinking – is monetary union members should do structural reforms so as to make their labour and product markets more flexible.

By increasing flexibility through structural reforms the costs of adjustments to asymmetric shocks can be reduced and the euro area can become an optimal currency area. This has been a very influential idea and has led euro area countries into programs of structural reforms.

It is often forgotten that although the theoretical arguments in favour of flexibility are strong, the fine print of flexibility is often harsh. It implies wage cuts, fewer unemployment benefits, lower minimum wages, and easier firing. Many people hit by structural reforms resist and turn to parties that promise another way to deal with the problem, including an exit from the euro area.

From an economic point of view, flexibility is the solution; from a social and political point of view, flexibility is the problem.

There is a way to reduce the costs of the adjustment to imbalances in a monetary union if this adjustment can be made to operate symmetrically. Thus, if the inevitable austerity by the deficit countries can be compensated by fiscal stimulus in the surplus countries, the negative aggregate demand effects in the former can be compensated by positive demand effects in the latter (Wolf, 2014).

Such a symmetric adjustment mechanism did not operate in the euro area after 2010, when the large external imbalances in the euro area were exposed. The deficit countries were forced into austerity while the surplus countries tried to balance their budgets. The result has been to create a deflationary bias in the euro area.

This is illustrated in charts 1 and 2.

Chart 1 compares the evolution of real GDP in the euro area with real GDP in the USA and in the EU Member States not belonging to the euro area (EU-10). The difference is striking. Prior to the financial crisis, the euro area real GDP was on a slower growth path than in the USA and EU-10. Since the financial crisis of 2008 the divergence has increased even further. Real GDP in the euro area stagnated: in 2014 it was at the same level as in 2008. In the USA and EU-10, one observes (after the dip of 2009) a relatively strong recovery.

Chart 2 shows the evolution of unemployment in the same group of countries. We observe the same phenomenon. A recovery in the USA and EU-10 after 2010, evinced by the decline in unemployment. This contrasts with the euro area where unemployment continued to increase so that in 2015 it was almost twice as high than in EU-10.

Chart 1: Real GDP in the euro area, EU-10, and USA (prices of 2010)



Source: European Commission, Ameco database.



Chart 2: Unemployment rate in the euro area, EU-10 and USA

Source: European Commission, Ameco database.

Chart 1 and 2 also teach us that the euro area has failed dismally in delivering on the promises that were made at the start of the union; that is, that monetary union would lead to more economic growth and employment. The opposite has occurred. Member countries of the euro area have on average experienced less growth and more unemployment than the EU Member States that decided to stay out of the euro area. Such an outcome, if maintained, undermines the social consensus in favour of a monetary union.

Fragility of the sovereign in the euro area

When the euro area was started, a fundamental stabilising force that existed at the level of the member states was taken away from these countries. This is the lender of last resort function of the central bank. Suddenly, member countries of the monetary union had to issue debt in a currency they had no control over. As a result, the governments of these countries could no longer guarantee that the cash would always be available to roll over the government debt. Prior to entry in the monetary union, these countries could, like all stand-alone countries, issue debt in their own currencies thereby giving an implicit guarantee that the cash would always be there to pay out bondholders at maturity. The reason is that as stand-alone countries they had the power to force the central bank to provide liquidity in times of crisis.

What was not understood when the euro area was designed is that this lack of guarantee provided by euro area governments in turn could trigger self-fulfilling liquidity crises (a sudden stop) that would degenerate into solvency problems. This is exactly what happened in countries like Ireland, Spain and Portugal.³

When investors lost confidence in these countries, they massively sold the government bonds of these countries, pushing interest rates to unsustainably high levels.

The euros obtained from these sales were invested in "safe countries" like Germany.

As a result, there was a massive outflow of liquidity from the problem countries, making it impossible for the governments of these countries to fund the rollover of their debt at reasonable interest rates.

This liquidity crisis in turn triggered another important phenomenon. It forced countries to switch-off the automatic stabilisers in the budget.

The governments of the problem countries had to scramble for cash and were forced into quick austerity programs by cutting spending and raising taxes. A deep recession was the result. The recession turn reduced government revenues even further, forcing these countries to intensify the austerity programs. Under pressure from the financial markets and the creditor nations, fiscal policies became pro-cyclical pushing countries further into a deflationary cycle. In short:

What started as a liquidity crisis degenerated, in a self-fulfilling way, into a solvency crisis.

Thus, we found out that financial markets acquire great power in a monetary union. They can force countries into a bad equilibrium⁴ characterised by increasing interest rates that trigger excessive austerity measures, which in turn lead to a deflationary spiral that aggravates the fiscal crisis, (De Grauwe, 2011; De Grauwe and Ji, 2013). This was the same problem as that identified by Calvo (1988) and Eichengreen and Hausmann (2005) in emerging countries that are afflicted by an "original sin" that forces them to borrow in foreign currencies.

Thus, in a monetary union, sovereigns singled out by financial markets cannot defend themselves unless they get help from other countries and from the ECB. But they are not willing to do this so easily.

The ECB recognised this problem when it started its Outright Monetary Transactions Program in 2012. This certainly helped to pacify financial markets at that time and avoided the collapse of the euro area. The issue arises of how credible the

³ Greece does not fit this diagnosis. Greece was clearly insolvent way before the crisis started, but this was hidden from the outside world by the fraudulent policy of the Greek government to conceal the true nature of the Greek economic situation (De Grauwe, 2011).

⁴ The dynamics that lead to bad equilibria are similar to those analysed by Obstfeld (1986) in the context of fixed exchange rate regimes. See also Gros (2007).

Outright Monetary Transactions Program is for future use. The ECB has been unwilling to use it during the latest Greek crisis. This refusal was based on the view that the Greek government is insolvent and, therefore, liquidity provision by the central bank is not the right remedy. This can lead to doubts about the future willingness of the ECB to provide liquidity to future governments in times of crisis.

Conclusion

The euro area crisis that emerged after 2010 was the result of a combination of two design failures.

• First, booms and busts continued to occur at the national level, leading to large external imbalances.

The lack of a smooth mechanism to correct for these imbalances created large economic and social costs.

• Second, the stripping away of the lender of last resort support from member states allowed liquidity crises to emerge when the booms turned into busts.

These liquidity crises then forced countries to eliminate another stabilising feature that had emerged after the Great Depression; that is, the automatic stabilisers in the government budgets. As a result, some countries were forced into bad equilibria.

As economists we should think harder about what happens to political systems when countries are forced into bad equilibria. As we have seen, in many countries where this happened, the political systems were badly shaken and extreme parties either increased in importance or came to power. In several of these countries the newly emerging political parties exhibit an open hostility to the monetary union and promise a better future outside the euro area.

When individual countries in a currency union get into debt problems, whether of their own making or not, they cannot stand on their own feet. They need the help of other countries and of the ECB. But this help is not unconditionally available. This leads to a potential for political conflicts between member states of the union.

Many argue that countries can avoid being pushed into a debt crisis by adhering to strict fiscal discipline. Surely this is the proper response to what happened in Greece. But it is not for most other euro area countries that experienced a debt crisis after 2010.

• This "discipline" view disregards a fundamental feature of a capitalistic system, which is that it is characterised by booms and busts; bubbles and crashes.

Booms are wonderful. Busts lead to misery for millions. In addition, they lead to dramatic increases in government budget deficits and debt levels even in countries following orthodox fiscal policies (Reinhart and Rogoff, 2009; Shularick and Taylor, 2012). I have argued here that the euro area is ill-prepared to face this instability of a capitalistic system.

The previous discussion points in the direction of a possible solution – it can only be provided by a political union. The latter does two things. Firstly, it can reduce too large divergences in macroeconomic policies that have often been the source of large economic imbalances between countries. Secondly, a political union provides for an automatic and silent assistance between countries.

But there's the rub. Most euro area countries are not prepared to step into a political union because they do not want to create a system of automatic assistance. Their mutual distrust is too large to do this.

The conclusion, I draw from this today is the same as the conclusion I drew twenty years ago. If there is no willingness to step into a fiscal union (which can only exist in a political union), the euro has no future.

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