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# COMMENTARY

# The future of the euro: Let's get real

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**ABSTRACT**

After three years of recurrent crisis, what is the future of the euro? For some skeptical observers, mounting tensions in the euro zone are fast approaching a breaking point. Europe's daring monetary experiment, we are told, is doomed to end in spectacular failure. For others, by contrast, the outcome ultimately will be not less union but "more Europe" – an even tighter merger of national economic sovereignty. Tested by adversity, the euro will emerge more successful than ever. Who is right? The correct answer is: Neither. Skeptics are wrong because they underestimate Europe's deep political commitment to the euro's survival, in some form or other. Euro-enthusiasts are wrong because they overestimate the amount of "give" in Europe's domestic politics. The euro will neither fail nor succeed. Defective but defended, it will simply endure.

**KEYWORDS**

Euro; euro zone; Economic and Monetary Union; European Union; European Financial Stability Facility; European Stability Mechanism

After three years of recurrent crisis, what is the future of the euro? Few policy questions these days are potentially more consequential for global economic relations. For some skeptical observers, mounting tensions in the euro zone are fast approaching a breaking point. Europe's daring monetary experiment, we are told, is doomed to end in spectacular failure, radiating harm to every corner of the world. For others, by contrast, the outcome ultimately will be not less union but 'more Europe' – an even tighter merger of national economic sovereignty. Tested by adversity, the euro will emerge more successful than ever, offering a shining model for others. Who is right?

It's a trick question. The correct answer is: Neither. Skeptics are wrong because they underestimate Europe's deep political commitment to the euro's survival, in some form or other. Government leaders know how

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dangerous a monetary breakup would be for their broader commitment to continent-wide integration, which continues to be seen as essential to peace in the region. Policy-makers will go to great lengths to avoid a return to the bad old days when disputes were settled with guns rather than midnight sessions in Brussels. Failure, as the saying goes, is simply not an option. The euro, declares German chancellor Angela Merkel (2011), 'is more than a currency. It is Europe. If the euro fails, Europe fails'. Echoes Mario Monti, prime minister of Italy, 'The euro is here to stay, and we all mean it' (quoted in *New York Times*, 23 June 2012).

But neither is success assured, in the sense of a monetary system that operates smoothly and efficiently to lubricate the wheels of commerce. Euro-enthusiasts are wrong, too, because they overestimate the amount of 'give' in Europe's domestic politics. European governments, like democratic regimes everywhere, remain beholden to constituent demands on behalf of particularist or national interests. Policy-makers, therefore, will also go to great lengths to resist any further encroachments on their remaining policy autonomy. In the absence of a genuine political federation – which no one expects any time soon, if ever – the euro will remain a flawed, imperfectly governed construct (Cohen, 2011).

In short, let's get real. Europe finds itself suspended between the centripetal force of a security-driven imperative to hold together and the centrifugal pressure of recalcitrant domestic politics keeping them apart, snagged in an uneasy equilibrium that is untidy but not necessarily unstable. Euro skeptics and enthusiasts alike are victims of what is known as the Fallacy of the Excluded Middle: a misguided inclination to think only in terms of polar alternatives – extreme black-or-white positions. Either the euro succeeds, or it fails. Reality, however, is messier, allowing for all sorts of shades of grey in between: neither success nor failure. Commenting on the euro zone's anemic efforts to remedy its troubles, *The Economist* (2011) has spoken contemptuously of the monetary union's 'spirit of shoddy compromise'. But in a setting where trade-offs are unavoidable, why should we expect anything more? As any reader of this journal knows – or should know – shoddy compromises are precisely what political economy is all about. They have been the story of the euro from the beginning.

## ORIGINS

Even before Europe's new money was born in 1999, it was clear that compromises would be necessary. One critical question was who would be granted the privilege of being among the first to join the club. The European Union (EU) as a whole, plainly, was not what economists call an optimum currency area. A small, relatively homogeneous core group could be said to exist, comprising Germany and some of its near neighbors like Austria and the Netherlands. But beyond that core, divergences were considerable, whether measured in terms of inflation rates, level of development, or asymmetry of economic shocks. Economies varied greatly in their ability to compete in a single currency zone. Hence the more countries to be included in Europe's grand Economic and Monetary Union (EMU), the greater the risk of mushrooming internal balance-of-payments problems – surpluses for the strong (e.g., Germany) and unsustainable deficits for the weak (e.g., Greece).

In response, two schools of thought developed. One, centered in Germany and dubbed the 'coronation theory', contended that just a small core should be admitted initially – those economies that came closest to the necessary degree of homogeneity. Others might be admitted eventually, but only once they achieved the requisite competitiveness. EMU membership should be the last 'crowning' step in a process of real convergence. The alternative view, sometimes called the 'locomotive theory', argued by contrast for a club that would be as inclusive as possible. A larger number of countries might be admitted, since it could be assumed that the rigorous demands and institutional constraints of a monetary union would act as a locomotive to pull members along, compelling them to undertake the reforms needed to compete effectively. Politics would follow the dictates of economics like the cars of a train.

In the end, the locomotive theory prevailed. For strictly political reasons, EU governments decided to broaden EMU's early membership well beyond Germany and a few of its neighbors, to include even the likes of Italy, Portugal, and Spain. Eleven nations were admitted initially, with Greece added a year later and yet others who followed in subsequent years. Some deference was paid to the coronation theory by including four so-called 'convergence criteria' in the Maastricht Treaty, EMU's founding document – four conditions, involving such matters as interest rates, exchange rates, inflation, and fiscal positions, that would first have to be met before a country could be permitted to join. In principle, the criteria would ensure at least a modicum of *ex ante* convergence. In practice, however, the rules were applied with generous flexibility in order to avoid excluding a number of critical players. Neither Italy nor Belgium, for instance, came anywhere near to reducing their levels of public debt to the declared target of 60 per cent of gross domestic product (GDP), yet they were admitted anyway. It would have been unthinkable to leave out two of the EU's six original members. Others were allowed to join even though it was clear that they would have difficulty keeping their budget deficits below the mandated level of three per cent of GDP.

## AN UNBALANCED CONSTRUCT

What to do, then, about the risk of internal balance-of-payments problems? Europe might have looked to the United States for inspiration. The United

States has been living with a similar risk ever since the Union was founded, with its separate states and its single dollar. America's solution, building on the early reforms of Alexander Hamilton, George Washington's Secretary of the Treasury, was to create a permanent 'transfer union', combining two key features: strict fiscal controls at the state level together with more or less automatic flows of funds through the Federal budget at the center. Admittedly, neither feature took hold immediately. Fiscal controls at the state level, in the form of balanced-budget rules, did not come fully into vogue until the 1840s, following bond defaults by as many as nine states. But since then the rules have worked to reduce (though hardly eliminate) the risk of internal payments imbalances. Large-scale fiscal transfers into and out of Washington, meanwhile, took even longer to emerge. But by the twentieth century a large budget at the center allowed for more or less spontaneous financing of a significant portion of any imbalances that do occur through the operation of so-called 'automatic stabilizers'. While surplus states contribute, on a net basis, to the tax revenues of the Federal government, deficit states receive extra funding through increased payments for unemployment compensation and other welfare programs. The system is hardly perfect, but it does work effectively to help reduce payments strains among the 50 states.

Europe, however, was unwilling to go so far. So, instead of channeling their inner Alexander Hamilton, the Europeans tried to have their cake and eat it, too. Even while monetary policy was to be centralized, individual governments would remain in charge of their own fiscal policy. The aim was to allow all to enjoy the benefits of a supranational currency without actually giving up many of their national rights and privileges.

It was understood, of course, that such an unbalanced construct offered little protection against internal payments problems. The risk of periodic crisis was recognized by many. But without a commitment to a federal Europe, a large central budget, capable of financing imbalances between members on a regular basis, was considered to be out of the question. Instead, policy makers concentrated on trying to reduce the threat. Their solution was the EU's notorious Stability and Growth Pact (SGP), which effectively replicated the Maastricht Treaty's convergence criteria. Here was a shoddy compromise if there ever was one. Under the SGP governments were expected to stick to the Treaty's targets, including especially the three-per cent budget target; and if they failed to do so, they would be fined. But as we know, when push came to shove, the pact could not be enforced, and its strictures came to be observed mainly in the breach. The risk of serious imbalances within EMU remained unresolved.

For a time, it didn't seem to matter. Payments strains were not absent, but they appeared manageable. Unfortunately, though, it was for all the wrong reasons. In the best of all possible worlds, the locomotive theory might have been proved right. Weaker members like Greece or Italy might have been driven to undertake the reforms needed to achieve convergence and compete effectively. Politics would have yielded to market forces. But this was not the best of all possible worlds, since the laggards discovered they had another choice. Rather than reform, governments or their citizens could *borrow* to finance public deficits (as in Greece and Portugal) or to sustain private credit booms (as in Ireland and Spain). With the merger of Europe's capital markets, a huge pool of savings was created; and with interest rates effectively lowered to near Germany's level, the incentive to take on more debt proved irresistible. The result in many of EMU's members was an unsustainable overhang of liabilities, leading to today's crisis.

In effect, Europe's chickens have now come home to roost. Having settled for the shoddy compromise of the SGP, the euro zone left itself vulnerable to ever-greater payments strains. It was only a matter of time before a crisis might hit.

And what a crisis it has been! Since late 2009, when troubles erupted in Greece, a depressingly repetitive pattern has set in. First, one government or another finds itself the target of market pressures because of its fiscal difficulties. On occasion, this has involved each of the so-called PIIGS at the periphery of EMU: Portugal, Ireland, Italy, Greece, and Spain. In each case, initially, the problem is denied, which is understandable since no one wants to spread panic. But that only serves to sow doubt and skepticism. Then vague promises are made, which convince no one. Ultimately leaders are forced to meet and announce an 'unprecedented' and 'comprehensive' solution, which upon closer inspection, after a brief period of euphoria, turns out to be less than meets the eye. And so, within weeks or months, market pressures recur and the cycle begins anew.

The threat of a default by Greece, for example, was first dismissed as inconceivable, only in the end to lead to not just one but two financial bailouts and, for private creditors, the largest 'haircut' on sovereign debt in history. Then we were told that Greece's problems would not spread to other nations, though clearly they have; that Europe's banks, which hold large amounts of sovereign debt, were in no danger, though manifestly they are; that the euro zone's newly created rescue funds would be adequate, though plainly they still are not. Most importantly, were told that the monetary union itself was in no danger, though clearly it is. The crisis has proved remarkably stubborn. As this commentary is written, in the summer of 2012, the fate of the euro is still hanging in the balance.

## LIKE AN ARTICHOKE

To understand why the crisis has been so stubborn, it helps to think of how we eat an artichoke. Peel off one leaf and we find another; peel off that one and we find yet one more; and another and another and another. It takes some time to get to the heart of the matter. The same is true with the euro.

The first leaf, of course, is Greece, where it all began. Following elections in October 2009, the incoming government discovered that the country's fiscal deficit, at some 13.6 per cent of GDP (later revised upward to 15.4 per cent), was far worse than anyone had previously realized. From that moment on, it should have been obvious that this was not a case of mere temporary illiquidity. Most observers, reading the numbers, recognized that Athens was effectively bankrupt, unable under any reasonable scenario to service its overwhelming burden of debt. By early 2010 default seemed imminent. The first reaction of Greece's EMU partners, however, was denial. 'There is absolutely nothing to these rumors', said a German finance ministry spokesperson (quoted in the *New York Times*, 30 January 2010). 'They are without foundation'. And then came carefully worded assurances of 'determined and coordinated action' (to quote from the communique of a February summit of EU leaders), conveniently silent on what form that action might take. These rhetorical devices served merely to delay the inevitable. After months of swelling market pressures – and much agitated debate and negotiation among euro zone governments – a rescue package was announced in late March 2010, amounting to some €110 billion. In return, Athens promised to implement a series of tough austerity measures to restore fiscal balance. Everyone breathed a sigh of relief.

But not for long. Within a year, with Greece's fortunes still waning, protracted negotiations began on a second bailout, to be accompanied by a significant amount of 'private sector involvement' – code for a not-so-voluntary agreement by Greece's market creditors to accept a partial write-down of their claims. By the time the deal was finalized in February 2012, the 'haircut' had grown to a loss in excess of 70 per cent in present-value terms. Yet for all that, Athens was still left with a level of debt above 150 per cent of GDP, even as its economy shrank for the fourth year in a row and protestors rioted in the streets. Following two elections this past spring that clearly signaled the Greek electorate's unhappiness with painful austerity measures, default continued to loom as a real possibility. Even secession from EMU did not seem out of the question.

Which brings us to the second leaf: the other PIIGS. Greece, by itself, is an economic midget, accounting for little more than two per cent of Europe's output. Its importance lies not in its size but in the precedent set by its two bailouts. If one EMU country could be in such deep trouble, why not others? A door was thus thrust open through which the financial markets, not surprisingly, soon began to rush. First to be attacked was Ireland, whose government found itself overwhelmed by the cost of backstopping the country's banks following collapse of the local housing market. In September 2010, an already high budget deficit of 12 per cent of GDP soared to 32 per cent, nearly a third of GDP, as a result of fresh capital infusions into the banking system. Yet again, as with Greece, it took months of rising market pressures and much frenzied negotiation before agreement could be reached in November on the terms of a rescue – a loan package totaling some €85 billion. And just four months later came Portugal, following what was by now becoming a drearily familiar script. Denials went on for months, despite intensifying market strains and repeated downgrades by credit-rating agencies. Then finally, in April 2011, the Portuguese government caved in, suddenly applying for help following parliamentary defeat of a package of domestic austerity measures. The bailout amounted to nearly €80 billion. In June this year, after months of resistance, Spain's government too was forced to apply for help, receiving a pledge of up to €100 billion to help recapitalize its troubled banks. Within weeks Cyprus also came begging for a rescue. Italy, with one of the highest levels of public debt in the world, remained under persistent stress. And after its presidential election in the spring, which brought Socialist François Hollande to power, even France seemed at risk.

Peel off these two leaves and we arrive at a third, Europe's banks, which are the largest holders of European sovereign debt. Once Greece and others got into trouble, a strategy of quick defaults might have seemed attractive. Get the problem over with, swiftly and decisively. But that could have led to massive bankruptcies in Europe's banking sector, with devastating consequences for the broader European economy. As it was, some banks did fail, such as Dexia, a joint Franco-Belgian bank, whose losses had to be covered by the French and Belgian governments; and many other lenders have seen their ratings repeatedly downgraded. To forestall a wider crisis, a recapitalization of Europe's banks was plainly needed. In October 2011 euro zone governments mandated a capital increase in excess of €100 billion, to be completed by June 2012. But this was obviously less than what was needed, as the continuing troubles of Spain's bank testify. And in the meantime banks have been running short of liquidity, owing to a drying up of the interbank lending market. Why should anyone lend to a fellow institution that might go bust tomorrow? Some relief has been provided by the European Central Bank, which dramatically shelled out nearly a trillion euros in two rounds of low-cost lending in December 2011 and February 2012. But the effect was only temporary, leaving the longer-term fate of Europe's banks still at question.

The fourth leaf is Europe's 'firewall' – its pool of rescue money available to stave off messy defaults. Stung by Greece's near-collapse in early 2010 – what many referred to as EMU's own Greek tragedy – authorities moved in May 2010 to create a more formal safety net for troubled debtors. This was the European Financial Stability Facility (EFSF), established for a period of three years with resources advertised at €440 billion supplementing an already existing facility of €60 billion. Together with a parallel pledge from the IMF of an additional €250 billion if needed, this meant that a total of €750 billion might now be available to sustain investor confidence. The hope was to calm roiling financial waters with what amounted to an overwhelming show of force – a strategy of 'shock and awe' as it was called (reminiscent of George W. Bush's failed strategy in Iraq), to forestall any further contagion across Europe.

The impact, however, was short-lived, and Europe has been playing catch-up ever since. Observers were quick to note critical weaknesses in the EFSF – most importantly, the fact that not all of the putative €440 billion would actually be available for lending. Some of the cash would have to be held in reserve to protect the fund's triple-A credit rating. Awe wore off quickly. Repeatedly, over the next two years, EMU's leaders have been forced back to the drawing board to try time and again to stabilize the markets. In November 2010, simultaneous with the Irish bailout, agreement was announced on the creation of a permanent new lending arrangement – the European Stability Mechanism (ESM) – to succeed the EFSF at the end of its three-year life in 2013, with resources to total some €500 billion. In July 2011, an enhancement of the EFSF was negotiated, bringing its lending capacity up to its full advertised €440 billion; in December 2011, the starting date for the ESM was brought forward by a year, to mid-2012; and this past March it was decided that even after then, for an indefinite period, the EFSF would remain in operation alongside the ESM. Each time the numbers get bigger. Yet upon closer inspection the amount of money actually on offer turns out to be, in the words of *The Economist* (28 April 2012), 'a lot of fuzzy maths and wishful thinking'. Despite all the frenzied institution building, legitimate doubts persist about the adequacy of the euro's financial defenses.

And that brings us, finally, to the heart of the matter: Europe's lack of a genuine transfer union. Without automatic stabilizers to help finance imbalances inside the euro zone, every rescue must be negotiated, with terms set largely by the creditors. In practice that means Germany, EMU's paymaster; and the Germans, as we know, can be very stern about economic policy. For the authorities in Berlin, with their deeply ingrained 'stability culture', the key issue has been 'fiscal consolidation' – strict controls over budget deficits. Their strategy has been two-fold. To deal with immediate threats, tough policy conditions would have to be imposed on even the most deeply troubled debtors. Austerity was the price to be paid for a bailout, even if it meant prolonged stagnation or worse. To deal with the longer term, a tighter version of the Stability and Growth Pact would be required, even if it limited national rights and privileges. Discipline would have to be hard-wired into the governance of EMU. There could be no more Greek tragedies.

This past March, after vigorous lobbying, Germany ultimately got its way, when 25 of the 27 EU members signed on to a new 'fiscal compact' calling for formal balanced-budget rules to be written into national law or constitutions. At the heart of the compact is a new 'golden rule' limiting primary budget deficits (i.e., deficits before interest payments) to no more than 0.5 per cent of GDP over the full economic cycle. Fiscal outcomes are to be carefully monitored by the European Commission in Brussels; and unless voted down by a weighted majority, costly sanctions are mandated for governments that breach the old SGP's deficit limit of three per cent of GDP. Henceforth, German stability culture would be the official dogma of Europe.

Will Germany's strategy work? The Germans themselves express no doubt. 'A widespread lack of trust in public finances weighs heavily on growth', says Bundesbank president Jens Weidmann (as quoted in the *New York Times*, 27 April 2012). In these circumstances, he maintains, an emphasis on fiscal consolidation will 'inspire confidence and actually help the economy to grow'. But many others are skeptical, worrying that austerity will mean little more than rising unemployment and economic decline. Says one European diplomat (as quoted in *The Economist*, 31 March 2012): 'The Germans think that the only way to make countries reform is to dangle them out the window. This only reinforces the belief in the markets that the euro zone is on the edge of disaster'. Already, in mid-2012, 12 EU members were officially in recession, and the outlook for Europe as a whole seemed only to be getting worse. Critics speak of a death spiral and economic suicide. Summarizes economist Charles Wyplosz (as quoted in the *New York Times*, 2 January 2012):) 'We're going straight into a wall with this kind of policy. It's sheer madness'.

Nor is there any great faith in the efficacy of the German-sponsored fiscal compact, which few see as much of an improvement over the old SGP – 'little more than a stability pact with lipstick', in the words of Simon Tilford, chief economist at the Center for Economic Reform (as quoted in the *New York Times*, 10 December 2011). For all of the pact's insistence on formal legislation and golden rules, the same fundamental defect remains. Sovereign governments, ultimately, remain in charge of their own fiscal policy, which means once again that if push comes to shove, the pact's strictures may well prove unenforceable. In effect, Europe is still trying to have its cake and eat it too, with yet one more shoddy compromise. Is it any wonder that observers worry about the future of the euro?

## NEITHER SUCCESS NOR FAILURE

For many, the choices are stark: success or failure. Either EMU will fall apart or, hardened by misfortune, will emerge stronger than ever. In the words of Martin Wolf (2011), columnist for the *Financial Times*, 'The eurozone ... has to advance or risk disintegration'. Echoes the *New York Times* (22 July 2011): 'Realities will continue to pressure Europeans toward either abandoning the currency union or accepting much more financial union'.

Moreover, a good number of commentators profess to know just which of the two outcomes to expect. On the one side are skeptics like the economist Robert Barro (2012), who declares flatly that 'The euro was a noble experiment, but it has failed'. Harvard professor Martin Feldstein (2012: 105) too calls it 'an experiment that failed'. Others use the metaphor of divorce, like Nouriel Roubini, well known for his accurate prediction of the global crisis that began in 2008. Roubini (2011) likens EMU to 'a broken marriage that requires a break-up'. Likewise, journalist Gideon Rachman (2010) suggests that 'Europe's brokered marriage is in deep trouble. The partners have not grown together'. Concludes Walter Munchau (2011), another *Financial Times* columnist: 'investors are perfectly rational in betting against the eurozone'.

On the opposite side are enthusiasts like German Finance Minister Wolfgang Schäuble, who never tires of asserting that 'The answer to the crisis can only mean more Europe', or Philip Lane, an influential Irish economist, who sees 'a ray of hope' in the euro's trials. 'It takes a crisis to learn a lesson', Lane says. 'What does not kill you often makes you stronger' (as quoted in the *New York Times*, 31 December 2009.) Even more expansively, German journalist Gabor Steingart (2010) contends that 'what pessimists . . . see as an existential crisis for the continent is really just the latest stage in the birth pangs of a new country . . . the birth of the United States of Europe'. Perhaps most sanguine are Fred Bergsten and Jacob Kirkegaard of the Peterson Institute for International Economics in Washington. 'Europe is well on its way to completing the original concept of a comprehensive economic and monetary union', they assert in a recent policy brief. Europe will 'rewrite the euro area rule book and complete the half-built euro house' (Bergsten and Kirkegaard, 2012: 1–2).

To all of these sensationalist scenarios, my response is: Let's get real. On the one hand, Europe's noble experiment may not have lived up to expectations, but neither will it be abandoned. Though the partners have not managed to grow comfortable together, they still prefer the accommodations of a broken marriage to the risks of an angry divorce. And so they will do what they must to hold things together. On the other hand, 'more Europe' may be on the agenda, but neither will Europe's half-built house be completed. The euro area rulebook will continue to pile up more and more shoddy compromises. Greece will not be released from its painful austerity measures, but terms will be relaxed enough to stave off possible secession. And that in turn will lead to greater leniency as well for some of the other PIIGS, who see no reason why the Greeks should be singled out for special favorable treatment. A central banking supervisory agency will be established, as agreed in principle in late June, but with powers that will have to be shared uneasily with national regulators reluctant to surrender all their traditional prerogatives. Europe's bailout funds will be allowed to operate more flexibly – for example, to recapitalize ailing banks directly, bypassing governments – but with resources still limited to what tough-minded creditors like Germany are willing to provide. And the new fiscal compact, despite German insistence on fiscal discipline, will be gradually watered down and applied selectively to avoid disruptive confrontations.

More radical predictions, whether for success or failure, are simply not persuasive, and for the same reason. Their reasoning suffers from the Fallacy of the Excluded Middle – a sense that the outcome must be black or white, one extreme or the other. In effect, a half-built house cannot stand. Either it must be completed, or it will collapse. Nothing could be further from the truth. In the real world messy shades of grey predominate, and even if they are distinctly sub-optimal they may prove to be remarkably hardy. The euro house, for all its rickety defects, has proved durable through three years of stormy weather, relying on one shoddy compromise after another. The house may sag in places, the floorboards may be warped, and the roof may leak. But for all that, there is no reason to believe that it cannot long remain habitable, albeit uncomfortable. Europe's leaders will not let it fail. Europe's politics will not let it succeed. The euro, defective but defended, will simply endure.

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