

Whatever It Takes to Save the European Union

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Europe's monetary union is screeching toward the abyss, unintentionally, but apparently inexorably. Greece will most likely not meet the criteria to receive further financial assistance from its eurozone partners and the International Monetary Fund. Europeans will then need to decide whether to let Greece go. The exit option would not improve Greece's chances of successful adjustment, and it would come at a steep price for the eurozone. It would be "in the money" — and priced accordingly.

A Greek exit could, one hopes, be managed. The European Central Bank would contain the collateral damage by flooding Europe's banking system with liquidity against subpar collateral. Or it will reluctantly relaunch its purchases of public-sector debt in secondary markets, capping the other peripheral eurozone economies' interest-rate spreads relative to the core.

Thus, dire circumstances would once again force the European Central Bank's hand. As

the strongest European institution, it is systematically vulnerable to being taken hostage, compelled to underwrite a further lease on life for the euro. In this light, European Central Bank president Mario Draghi's recent vow to do "whatever it takes" to save the euro came as no surprise.

Back in 1999, it seemed that Jacques Rueff, an adviser to Charles de Gaulle, had been vindicated: *L'Europe se fera par la monnaie*. Eleven European countries chose to give up their national currencies.

These countries understood "one money" as a quasiphysical corollary of "one market." Independent national monetary policies in a common market were rightly seen as infeasible, given Europeans' preference for stable exchange rates and open financial markets. This called for a single currency — and thus shared responsibility for monetary policy.

Today, however, we may need to rephrase Rueff's axiom: *Et l'Europe se défait par les marchés financiers*, unless, that is, Europe comes up with a viable institutional design.

Given the euro's current travails, it is instructive to recall arguments stressed in the run-up to monetary union. As the Nobel laureate economist Robert Mundell and others spelled out in the 1960s, relinquishing nominal exchange rates emphasizes three alternative mechanisms to cushion regional adjustment: interregional fiscal transfers, intraunion migration and, most important, labor markets capable of adapting to shocks.

Unfortunately, these mechanisms were anathema at the time. Conveying the message that nothing would have to change appeared to be far more attractive. Thus, Mundellian arguments were not heeded when the euro's institutional blueprint was conceived. Indeed, the Stability and Growth Pact, like Europe's no-bailout clause, ignored the pertinent economic theory (some say any economic theory). Regional current-account balances were interpreted as the upshot of infallible optimizing behavior by market participants, rather than, for example, the result of a real estate bubble in Spain and elsewhere.

Only after the fact, since the fall of 2009, has it become conventional wisdom that those intraunion current-account deficits, accumulating over a decade, were untenable. Now, given monetary union, the adjustment must be carried out by changing domestic prices relative to tradable goods — that is, by engineering a depreciation of the real exchange rate.

In view of the quite substantial overvaluation in some periphery countries, this will be a time-consuming process. Incidentally, Germany needed almost a decade to adapt to a smaller property bubble in the eastern parts of the country in the early 1990s. But it is difficult to imagine that market participants will have the required patience. That is why supporting the euro requires forceful and credible crisis containment — whatever it takes.

But the ongoing crisis also highlights a second design flaw, unacknowledged in Mundell's argument: the challenges arising from integrated financial markets (including those for the credibility of the no-bailout clause). Under normal circumstances, unimpeded cross-border capital flows come with all of the advertised benefits in terms of better resource allocation and higher productivity. In the wake of the crisis, however, given the shared fate of national governments and banks, a significant home bias re-emerged. Ring-fencing became national supervisors' default option, and monetary conditions became resegmented along national

lines.

This translates into a significant disparity in financial institutions' funding costs. The immediate upshot is a substantial divergence in firms' cost of funds, with many small and medium-size enterprises even losing access to credit completely. As a result, capital expenditure — already a fragile proposition, given weak demand — has plummeted, triggering a vicious cycle of shrinking gross domestic product, lower tax revenues, higher expenditures and further destabilization of public-debt positions.

The problem is not only that such heterogeneity in funding conditions renders a common monetary policy difficult to conduct. More important, given that some regions now face interest-rate spreads that are the functional equivalent of having their own currencies (without a central bank), some eurozone members might at some point wonder why they should not formalize what is de facto a reality. Market participants already do, to a degree.

None of this is inevitable. The euro was not created for purely economic reasons. If it is deemed a worthwhile project and is viewed as mutually beneficial to all participants, the eurozone could be made viable. To achieve this, certain minimum conditions must be met. In addition to flexible labor markets, a viable eurozone presupposes a (minimal) fiscal insurance mechanism. And it calls for not only common financial regulation but also for eurozone-wide supervision of financial institutions, including common deposit insurance and a shared bank-resolution scheme.

This is a tall order. And it will take time to implement. But the immediate short-run alternative — letting Greece and potentially others fall by the wayside — would carry a substantial price. Periphery countries would be forced to pay a significant premium to compensate investors for assuming a redenomination (partial default) risk. With that, the eurozone would become as vulnerable as any fixed-exchange-rate system has historically proved to be.

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