Holding together

The euro area, sorely tested by the financial crisis, has survived intact and is likely to expand further, says John O'Sullivan.

Illustration by M. Morgenstern

IN THE mid-1980s Rolling Stone magazine published an essay by P.J. O'Rourke, a conservative American humorist, with the splendid title "Among the Euro-Weenies". In it the author poured scorn on Europe, an annoyingly fractured continent with its "dopey little countries", "pokey borders", "itty-bitty" languages and "Lilliputian" drinks measures. The mosaic of countries made the visitor feel claustrophobic: "You can't swing a cat without sending it through customs," he complained.

He will not have been aware, or cared much, that plans were already in train to give "Europe" the continental scale it so painfully lacked, as well as a currency that would rival the dollar. In 1986, the year of Mr O'Rourke's visit, the European Economic Community (as the European Union was then known) expanded from 10 to 12 countries, with the addition of Portugal and Spain. Its members had spent most of the 1970s erecting non-tariff barriers to internal trade, and the early 1980s battling over who should pay for its joint budget (a fight which, to be fair to the others, Britain started). With that settled, there was a fresh desire to make progress towards a genuinely open free-trade block.

The first fruit of that effort was the Single European Act, an agreement to dismantle barriers to internal trade by the end of 1992. A rider to the act sketched out an ambition to complement the single market with a single currency. Few took that seriously, least of all British politicians, who had signed up to the act with enthusiasm because they were keen free-traders, but dismissed the grander kind of Community rhetoric as "euro-guff".

An idea whose time had come

Yet by the time a 1991 European summit was held in the Dutch city of Maastricht, a plan for economic and monetary union (EMU) was written into a new EU treaty, to be ratified by member states later. That the proposal had gained ground so swiftly was a surprise to many. The British government had thought that a committee of EU central-bank governors, charged in 1988 with studying if monetary union was feasible, would quash the idea. Instead the group, chaired by Jacques Delors, then president of the European Commission, the EU's executive branch, gave it qualified approval.

The Delors Report concluded that EMU could work if control of the single currency was kept from meddling politicians and left to independent technocrats at a European central bank, to be modelled on Germany's Bundesbank. The report gave warning, however, that to prevent large trade imbalances, reforms would be needed to make prices and wages more flexible and workers and capital more mobile.

EMU's route from rhetoric to economic blueprint was a familiar one, if unusually swift. The push behind trade integration in Europe has been primarily political rather than economic. The EU itself was born of the catastrophe of two world wars, collisions of competing nation-states. It was designed to avoid a repeat of such conflicts by forging "ever closer union" in Europe. Economic ties were viewed as much as a means to co-operation as an end in themselves. The Delors Commission between 1985 and 1994 marked the zenith of this sort of integrationist zeal.

After many a flap (see article), EMU eventually metamorphosed into a bird of much grander plumage. On January 1st 1999 the currencies of 11 countries were fixed against a new currency, the euro, which became the unit of reckoning in wholesale financial markets. In 2002 euro notes and coins came in and the old paper currencies were phased out. Since the single currency's launch five more countries have joined the euro area. In a unique economic experiment, 16 countries with a combined population of 329m have handed over monetary sovereignty to an entity at arm's length from national politics: the European Central Bank (ECB).

So far the experiment has worked fairly well. The ECB has fulfilled its remit to maintain the purchasing power of the euro. Since the currency's creation the average inflation rate in the euro area has been just over 2%. Fears that the euro would be a "soft" currency have proved unfounded. It is unquestioningly accepted at home and widely used beyond the euro area's borders. (Several countries, including Montenegro and Kosovo, use the euro as their currency without formally belonging to the euro zone.) The switch from old currency to new went remarkably smoothly, though consumers in many countries complained, perhaps predictably, that they were charged higher prices as merchants rounded up to new price-points in euros. But this caused barely a blip in the official inflation figures.

So far the euro has brought neither greater prosperity nor political union. Job-creation improved but productivity increases slowed, leaving the region's trend growth rate much the same as before EMU. In its early years the euro fell against the dollar, but it has since more than made up for its early losses. It has quickly established itself as a global currency without becoming a true rival to the greenback's status. For much of the euro zone's first decade Germany, its largest economy, was in the doldrums, but after a long period of wage restraint its export industries started to lift the economy. Spain, Greece and Ireland proved more dynamic, each enjoying a consumer boom.

All seemed well until the present financial crisis struck. This reawakened worries about the imbalances that have built up inside the euro zone. Germany's huge current-account surplus is matched by big deficits elsewhere, particularly in the Mediterranean countries that German

policymakers had been so keen to exclude from joining. It remains an open question how these will be resolved.

The financial crisis is proving by far the biggest test to date for the euro zone. This special report will look at its effects on the euro area and consider whether such a disparate group of countries can continue to share the same monetary policy. It will ask whether the crisis will spur economic reform and whether it will attract more members to the club or, conversely, whether some of them might be thinking about leaving. Lastly, it will examine the idea that in the longer term a multinational currency area will require greater political union to function properly.

A tortuous path

From Bretton Woods to euro.

THE idea of a single money as a path to European political union goes back a long way. In the 1950s a French economist, Jacques Rueff, wrote that “Europe shall be made through the currency, or it shall not be made.” But the euro had pragmatic roots too. After the breakdown of the Bretton Woods system of fixed exchange rates in 1973 the Deutschmark emerged as the benchmark currency in continental Europe. The instability of floating currencies was a barrier to harmonious trade, but schemes to peg exchange rates frequently had to be redrawn because few countries could consistently match the Bundesbank’s anti-inflation zeal. The might of German manufacturing forced frequent devaluations on others to keep their industries competitive.

Changes to exchange-rate pegs often caused tensions. François Mitterrand, who as French president was one of the signatories of the Maastricht treaty, is said to have remarked that “devaluations are never small enough to avoid losing face and never large enough to make a real difference to exports.” As soon as Maastricht had been signed (with a British opt-out from EMU), those tensions resurfaced. In June 1992 the Danes voted narrowly against ratification, raising a question mark over the assumption that the path to EMU would be smooth. The Irish, in the only other scheduled referendum, voted in favour shortly afterwards, but Mitterrand announced a referendum in France for the following September, a risky gambit because French public opinion was cooling on monetary union.

Currency markets were also stirring. At the time all 12 EU countries, bar Greece, were in the exchange-rate mechanism (ERM), a system that tied currencies to each other within narrow trading bounds. Germany was at the scheme’s heart: currencies were officially pegged to each other in a complex grid of bilateral rates but all were, in effect, tied to the D-mark. That became a problem when economic conditions in Germany and the rest of Europe diverged. To head off inflationary pressures caused by Germany’s post-unification boom, the Bundesbank in July 1992 raised interest rates to 8.75%, a 60-year high.

Those German rates caused strains in currency markets that worsened over the summer. In September first Italy and then Britain were forced to devalue, in Britain’s case after spending billions of dollars trying to defend its ERM parity against speculators. In the following months Spain, Portugal and Ireland too had to let their currencies slide. France battled to hold to its parity and only just succeeded. Its referendum produced a narrow vote in favour of the Maastricht treaty.

Look at it this way

Different countries learnt different lessons from the crisis. Britain saw dangers in fixed exchange-rate schemes. Its economy started to pick up almost immediately after its ejection from the ERM. The French were confirmed in their belief that a monetary union was necessary both to prevent speculative attacks on currencies and to ensure that Europe's monetary policy was not made exclusively in Germany. Some German policymakers, previously sceptical of EMU, fretted that any repeat of the crisis would be a threat to the single market.

It was residual German scepticism that caused stiff tests to be set up for countries that wish to join the euro. The "convergence criteria" set out in the treaty called for would-be joiners to meet targets for inflation, bond yields, exchange-rate stability, budget deficits and public debt. The criteria were criticised as having little to do with a country's ability to cope once monetary policy was no longer tailored to national needs. Instead, they seemed designed to favour a core group of like-minded countries, centred around Germany, and to exclude others, particularly Italy, which it was feared would use EMU's low interest rates to relax fiscal discipline.

Things turned out differently. By 1997, the year in which the tests would be applied to a first wave of would-be entrants, Germany and others in the core group had trouble fitting into the Maastricht straitjacket themselves. The time scale for the fiscal targets had to be fudged, which let Italy and others slip through. France insisted that the "stability pact" proposed in the treaty be renamed "stability and growth pact". Germany demanded a cap on budget deficits of 3% of GDP. When both countries themselves later breached that limit, the rules had to be made somewhat more elastic.

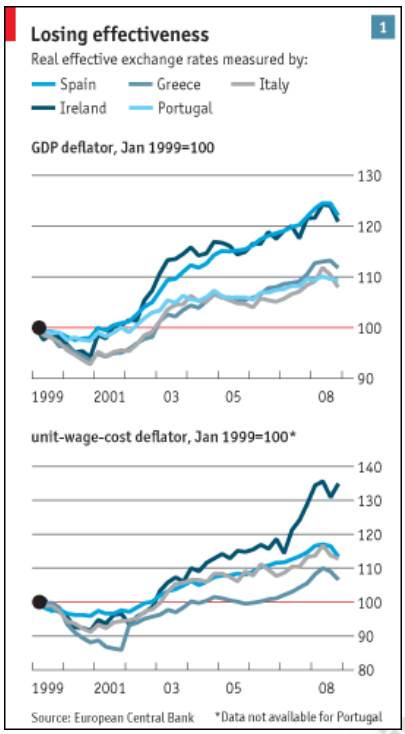
One size fits none

The euro did not cause all the euro area's troubles, but it will make them harder to put right.

TALK of economic hardship seems out of place on a sunny April day in Barcelona, one of Spain's most prosperous cities. Yet for all the bustle along the Rambla de Catalunya, the city's main drag, the restaurants and cafés are not as full as you might expect at the start of the Easter break. Jordi Galí, an economist at the nearby Universitat Pompeu Fabra (UPF), gives a decidedly unsunny assessment of the task facing Spain.

The country is enduring a painful housing bust that has led to a collapse in the construction industry, doubling the unemployment rate to 18.1% in little more than a year. Recovery seems a distant prospect, not least because during Spain's long boom production costs rose far faster than they did across the euro area as a whole. If left unchecked, higher costs will make it hard for exporters to compete with firms from other euro-zone countries, which account for most of Spain's foreign trade.

Locked into the single currency, Spain can no longer regain its lost competitiveness by cutting its exchange rate. Mr Galí frets that this may condemn the country to a protracted slump. "The discipline of living without devaluation is tough," he says. "It's like enrolling your child in a demanding school. Results may improve, but there's also a risk the child will rebel and fail if you push too hard."



Defiance will be all the greater after a long period of relative ease. For most of the euro's first decade Spain was a star pupil. Its economy grew at an average annual rate of 3.9% between 1999 and 2007, almost twice the euro-zone average and much faster than in any of the currency area's other big countries, France, Germany and Italy. Unemployment fell from close to 20% in the mid-1990s to just 7.9% in 2007. Even that startling drop does not do justice to the pace of job creation. Employment rose at an average annual rate of 2.8% between 1997 and 2007. The boom in housebuilding lured in migrant workers, many from Africa. The proportion of women at work increased from 38.5% in 1999 to 54.7% in 2007.

Now the legacy of that long boom threatens to deliver a long slump. Of the 11 countries that adopted the euro in 1999, Spain has seen the fastest rise in output prices. Its real effective exchange rate, which measures the rise in domestic prices compared with those in 36 countries weighted by their trade with Spain, rose by around a fifth in the decade after the euro's launch (see chart 1, top). Competitiveness gauges such as these are notoriously sensitive to the price measure used, but on another indicator, based on relative unit wage costs, the erosion of Spain's cost edge is almost as marked (see chart 1, bottom).

Both gauges point up problems in the same handful of countries: Portugal, Ireland, Italy, Greece and Spain—a group given the ugly acronym PIIGS. All five have seen a sharp deterioration in their current-account balances since the start of EMU (see chart 2). Those shifts testify to unsustainable booms in domestic demand, but also signal that local firms have found it hard to compete with imports at home and to sell their wares abroad. Pay rises ran

well ahead of efficiency gains in all these countries. In Ireland and Greece gains in output per worker were healthy but wage inflation was high. In Portugal and Spain inflation was a little lower but still well above the euro-area norm. The bigger issue was dismal productivity growth, which was Italy's main problem too.

Swines with flu

All these countries suffer not only from a lack of competitiveness but from other, perhaps more damaging, disorders too. Heavy public-debt burdens and chronic deficits were a feature in Greece and Italy long before the current crisis. Ireland and Spain enjoyed house-price and construction booms that have now turned to busts. In Ireland propping up ailing banks that had lent too freely to property developers and homebuyers, at home and abroad, has bumped up the fiscal cost of recession. (Luckily for Spain, its regulators forced commercial banks to behave more prudently in the boom.) A steady accumulation of current-account deficits has left Greece, Portugal and Spain with net foreign debts of 80-100% of their GDP. These frailties are a threat to the stability of the euro area as a whole.

How much of these imbalances are due to the euro itself? The ECB, a fledgling institution, has managed to keep a lid on inflation: in the euro's first decade consumer prices across the currency zone rose at an average of only 2.1% a year. But in such a large and diverse economy price pressures naturally vary. Capping inflation in fast-growing hotspots, such as Greece and Spain, would have needed a far tighter monetary policy than in the cooler northern climes. Interest rates that seemed right for the whole euro area were too high for sluggish Germany and too low for friskier Greece, Ireland and Spain.

The ECB's one-size-fits-all monetary policy can never be perfectly tailored for any individual member country. In principle, higher inflation should act as a coolant to overheating economies by reducing real household incomes and by making firms less competitive, reducing the incentive to invest. In practice, strong real growth and high inflation are a draw to foreign capital, adding more fuel to the fire. For the same exchange-rate risk, a euro put to work in Spain might earn a better return than in slower-growing parts of the euro zone.

The main hazard for investors in high-inflation countries—that a steady loss of domestic purchasing power will drag the currency down—is eliminated in a fixed-exchange-rate zone. The removal of currency risk from within the euro area helps explain why some countries were able to run eye-watering current-account deficits. In 2007 both Spain and Portugal had deficits close to 10% of GDP. Greece's was 13%. In its absolute size, Spain's deficit was second only to America's.

Foreign capital kept booms going for longer, but that was true in many rich countries outside the euro zone as well. There were other factors at play. The euro was created at a point when the Great Moderation, a long period of stable growth and low inflation in rich countries, was in full train. Investors had come to believe that wild swings in the business cycle were a thing of the past, making them all too willing to take on risk, including loans to countries that already had large foreign debts. Exchange rates often provide useful warnings about emerging imbalances, but overconfidence and herd behaviour weakened the signal.

Even if the first wave of currency union had excluded Spain and Greece, as some German policymakers had wanted, their economies might still have sucked in foreign capital. The eight eastern European countries that joined the EU from 2004 attracted huge sums of foreign capital even though for many of them euro membership was a distant prospect. This suggests that, even outside the euro, Spain and Greece would have had access to plenty of foreign credit with which to feed a domestic spending boom.

Ireland and Spain were ripe for housing booms too. Both countries have a high rate of owner-occupancy and space for fresh construction. The obsession with housing spilled over from Britain, a serial miscreant when it comes to house-price booms. When Spain and Ireland adopted the euro, they imported low interest rates from Germany: the ECB was the Bundesbank writ large. By then Britain had already adopted the German model of a central bank free from political influence and determined to fight inflation. The results, inside and outside the euro zone, were much the same: lower interest rates that sent house prices mad. Britain, at least, was able to tailor its interest rates to local conditions, but not by enough to prevent a housing bubble.

If euro membership is only partly responsible for the overheating in Ireland, Greece, Portugal and Spain (sluggish Italy can only dream of such excesses), it will make it harder for these countries to deal with the resulting loss of competitiveness. Spain's unemployment rate is already the highest in the euro area and likely to rise further. If Spain's jobless rate sticks at 20%, will voters blame the euro?

A handy scapegoat

"No one sold the euro as a solution to high unemployment," says Mr Galí. But, he adds, the economy used to benefit when market pressures forced down the local currency: "In 1992 and 1993 a series of devaluations got us out of trouble." Now Spain needs other adjustment mechanisms: lower wages to restore cost competitiveness to its firms and a flexible job market to speed the flow of workers from industries such as construction, which catered to a boom fired by domestic demand, to export firms that can generate the revenues to service Spain's debts.

That transition would be hard enough in the best of circumstances. Spain has one of the most rigid job markets in the developed world. Many jobs are heavily protected and wages are set centrally. That will make adjustment all the more difficult. The fear is that Spain will stagnate even as other economies start to revive. "My nightmare is that the world economy, including Europe, recovers and Spain does not manage to hook up to that," says Andreu Mas-Colell, another economist at UPF. "That would be a disaster. It would strain the link between Spain and the rest of the EU. We will also have to deal with tighter monetary policy if the rest of the euro area picks up, creating more pressure."

That fear of being left behind is widely shared in other countries too. Some economists believe that countries now stuck in a slump and unable to adjust their production costs may well start questioning the benefits of euro membership. But where is the exit sign?

No exit

Staying in the euro will be tough for some members, but leaving would be too awful to contemplate.

Illustration by M. Morgenstern

IN THE weeks following the collapse of Lehman Brothers last September the number of euro banknotes in circulation suddenly increased. Fears about the rickety state of banks had made many people mistrustful of keeping money on deposit. Far safer to keep cash stuffed under a mattress. The more discriminating hoarders, it was said, were careful to squirrel away banknotes with serial numbers prefixed by the letter “X”, indicating currency issued in Germany. Notes with “U” (French) or “P” (Dutch) prefix were also fine, but those with a “Y” or an “S”, issued by Greece and Italy, were shunned.

The logic was that if you were preparing for financial apocalypse, you had better not rely on the euro area surviving intact. In fact, banknotes are a shared obligation of all euro-zone members, no matter where they are printed. If the issuing country were to leave the single currency, a five-euro note would still be worth five euros, whatever the serial number. However, interest-bearing debt denominated in euros is a different matter, and bond markets quickly started to sort the Xs from the Ys.

By early 2009 the yield on a ten-year Greek government bond was almost twice that on a comparable German Bund. The spread over Bunds for Italian, Spanish and Irish bonds also widened dramatically before narrowing again more recently. One explanation was that in skittish markets Bunds were prized for their extra liquidity. Another was that the bond-trading arms of bombed-out banks were less willing to make markets in the issues of small countries, such as Greece and Ireland, which left their prices unmoored.

But at least part of the rise in spreads reflected concern that countries might find it hard to pay back their borrowings. The government bonds of Greece, Ireland, Portugal and Spain were all downgraded a notch by credit-rating agencies. For some, bond spreads are a crude gauge of the risk that the euro will break up. If a euro-zone member were shut out of capital markets and had to default on its debt, it might be tempted to use the opportunity to recreate its own currency and devalue. In that event, creditors could be forced to convert their bonds into claims in a new currency at a discount linked to a new exchange rate against the euro. Default would be one way for countries to free themselves from the euro’s shackles—or, to look at it from the opposite point of view, for the euro zone to rid itself of troublesome members.

A game of consequences

That kind of thinking, however, is found mostly among those who were doubtful that the euro would ever get off the ground in the first place. It is rare in countries seen as candidates for exit. As Eurocrats in Brussels are keen to stress, far from breaking up, the euro zone is growing. Since its launch it has taken on five new members, and more are queuing to join.

The costs of backing out of the euro are hard to calculate but would certainly be heavy. The mere whiff of devaluation would cause a bank run: people would scramble to deposit their euros with foreign banks to avoid forced conversion to the new, weaker currency. Bondholders would shun the debt of the departing country, and funding of budget deficits and maturing debt would be suspended.

Changing all contracts in euros—bonds, mortgages, bank deposits, wage deals and so on—to the new currency would be a logistical nightmare. The changeover to the euro was planned in detail and the exchange rate was fixed in advance, in co-operation with all the euro members. The reverse operation would be nothing like as orderly, not least because the exchange rate would be a moving target.

If businesses converted their debts to a weaker currency, that might constitute default and trigger legal challenges. If they stuck to their covenants, they would have to service their euro debts from earnings in a weaker currency. That would hurt firms which rely mostly on profits

from their domestic market. The convulsions would be felt by other euro-area members too. The writedown of the departing country's government bonds might threaten the solvency of banks in the rest of the euro zone. Around half of Italian government bonds, for instance, are held outside Italy. Other euro-area members could suffer contagion as markets bet on further defaults.

If the act of leaving would be hard, the aftermath might be even harder. A country that forced bondholders to take a loss would be punished. Continued access to bond markets would come at a high price. Investors would ask for a huge premium to cover the risk of further default. On that count alone, borrowing costs would be far higher than they were within the safer confines of the euro area.

Investors would have to protect themselves from two further risks: exchange-rate volatility and inflation. A former euro member would have to reinvent its own monetary policy and would struggle to convince investors that it could keep a lid on inflation. One of the euro's big attractions was that it offered many countries a shortcut to a credible monetary set-up. Devaluation could itself trigger a wage-price spiral. For high-debt countries, such as Greece and Italy, the interest rates demanded by markets to insure themselves against such risks would be ruinous.

And even though the costs are likely to be heavy, the immediate benefits might prove only transitory. A devaluation is a proxy for a national pay cut: it helps exporters but makes consumers of imports poorer. Workforces would put up strong resistance to being paid in a weaker currency. In countries such as Greece and Ireland, whose exports contain a lot of imports, a devaluation would push up inflation. And where a large proportion of wage contracts is indexed to prices, as in Spain, higher inflation would rapidly work its way through to wages.

The wrong cure

An exit from the euro would not tackle weak productivity growth and inflexible wages, which are the root causes of low competitiveness. In time, further devaluations might be needed. Countries with high debts and a history of poor macroeconomic management would be most tempted to leave. But these are also the countries most likely to be hurt.

A more plausible, though still unlikely, scenario would involve a breakaway by a group of low-debt and cost-competitive countries, centred around Germany. Members of a new, "hard" European currency would leave behind a stock of depreciating euro debt and might be rewarded by lower borrowing costs on debt issues in the new currency. Yet a large part of the appeal to Germany of the single currency has been that it rules out revaluations and rewards its firms for being competitive. Germany, France and the rest have too much invested in the success of the EU and the euro to put it at risk. As Daniel Gros of the Centre for European Policy Studies, a Brussels think-tank, puts it: "The weak can't leave and the strong won't leave."

The non-nuclear options

In place of devaluation, troubled members could try reform.

SPAIN may soon be faced with two options, says UPF's Mr Mas-Colell: a permanent slump or economic reform. "A third option, exit from the euro, is not a possibility. Spain won't leave because it is very pro-Europe. To leave would be seen as a national failure rather than a liberation." Euro membership is a symbol of Spain's progress as a democracy as well as its economic development. For some, it is an insurance against a return to dictatorship and

autarky. “Our experience is that when we went for being more European, the results were positive,” says Elena Pisonero, a former vice-minister for commerce, now at the Madrid office of KPMG, a consultancy. “In the past [during the dictatorship of Francisco Franco, which ended in 1975] we were closed off. Opening up our borders brought huge benefits.”

Ireland, like Spain, has been helped by EU funds for roads, farming and universities. According to the most recent Eurobarometer, a twice-yearly opinion poll, 79% of respondents in Ireland believe that overall their country has benefited from EU membership, and only 11% think it has not. The positive response in Greece, Spain and Portugal was above the average for all EU countries (see chart 3).

Most Greeks are in favour of the euro, and only 12% think EU membership is bad for their country. That is poor ground on which to build a case for quitting the euro. Greece’s finance minister, Yannis Papathanassiou, thinks that the recent spike in Greece’s borrowing costs was driven by the mistaken belief that last December’s violent street protests were due to a faltering economy. In fact the demonstrations were sparked by the killing of a 15-year-old boy in Athens by a policeman. Some people had taken rising bond spreads as an omen of default and euro break-up. That prospect, always distant, has now receded further. “Despite the high spreads, we have shown that we can refinance our debt,” says Mr Papathanassiou.

Italy’s economic travails have attracted less attention recently. Unlike Greece, Ireland and Spain, whose economies grew rapidly before crisis struck, Italy has seen its GDP growth drift consistently below the euro-zone average (see chart 4). Its cost-competitiveness has declined and its public debt was already 106% of GDP last year and will now rise still further. Yet in March, when the strains in the euro area’s public-debt markets were at their greatest, Italy’s ten-year bond yields were around 1.5 percentage points above Germany’s, compared with a gap of 2.8 percentage points for Greece.

Nor was Italy's public debt downgraded. "Perhaps the credit-rating agencies are being responsible," an Italian economist suggests by way of explanation. If Italy did get into funding trouble, that would have repercussions for the rest of the euro zone. Its public debt dwarfs that of countries the size of Ireland or Greece.

If the rating agencies have been careful not to sound the alarm, the same is true of Italy's politicians. In the past Silvio Berlusconi, the prime minister, and Giulio Tremonti, the finance minister, have been quick to blame the euro and the ECB for Italy's economic problems. Bashing the euro was a useful way of attacking Romano Prodi, a centre-left opponent, who in his first stint as prime minister, in the late 1990s, took Italy into the euro before becoming president of the European Commission. The rhetoric has noticeably softened. Earlier this year Mr Tremonti described the euro zone as "totally sustainable". The currency crises in Hungary and Iceland were salutary, says Roberto Perotti of Milan's Bocconi University. "No serious politician now says 'let's leave'."

Devaluation by proxy

Is there a way of achieving the effects of a fall in the real exchange rate without going to the extremes of ditching the euro? As long as it does not trigger a burst of wage inflation, a devaluation lowers wage costs relative to those of workers abroad, improving the competitiveness of firms producing things that can be traded across borders. A weaker currency also shifts the balance of demand by making imported consumer goods dearer and exports cheaper. That cools spending at home and tilts the scales towards firms that sell abroad, nudging workers and capital in their direction.

Illustration by M. Morgenstern

In a currency union, pay needs to adjust that much more quickly to changing market conditions to shift workers out of high-cost industries. But until quite recently pay has tended to be "sticky" on the way down: workers have generally been reluctant to take wage cuts, at least in nominal terms, which has made real-wage adjustment slow. On many reckonings, the rate at which Germany went into the euro in 1999 was too high. The traded value of the Deutschmark had not fallen to reflect the higher unit wage costs that were a legacy of the unification boom. It took many years of very low wage growth and rising productivity before Germany regained its edge on costs.

That route to redemption has become even harder for today's high-cost countries because there is little consumer-price inflation around to erode real wages and rebuild profit margins. Unemployment seems likely to rise steeply before wages start to adjust.

Ireland will make the adjustment more quickly than the others. Already there are signs that private-sector wages are falling in response to rapidly rising unemployment. The 7.5% cut in public-sector pay that came into force in May was mostly a response to the fiscal crisis, but was also sold as a remedy for lost competitiveness. Ireland is set to endure a deeper recession

than other rich countries because of its “globalised” economic model. But because of that sensitivity to the world business cycle and its reliance on big multinational firms for investment, wages are unlikely to stay out of whack for too long.

In the Mediterranean economies the pressure on wages is mostly in the wrong direction. In Spain most private-sector pay deals contain clauses that compensate employees if inflation is stronger than expected. The country also has a managed system of wage-setting that fails to make enough allowance for different productivity levels across the economy.

Wages in Italy are set centrally too (as they are in Greece), although compensation for inflation is no longer automatic. The infamous scala mobile, which maintained a rigid link between Italian wages and prices, was scrapped in 1992 after a long struggle.

Here today, gone tomorrow

The spread of fixed-term employment contracts in Spain (from the mid-1980s) and Italy (in the mid-1990s) helped make hiring and firing more responsive to the business cycle. The innovation had an immediate pay-off: it created jobs. Firms were content to take on temporary workers, often immigrants, because they knew they could easily lay them off again. Before the crisis hit, temporary jobs accounted for more than a third of Spain’s total, the largest share in the EU. Tito Boeri of Bocconi University reckons that a fifth of Italy’s workforce are on (short) fixed-term contracts. The rest enjoy a high level of job protection which politicians dare not dismantle. Both countries saw temporary contracts as the only way to free the jobs market.

Jobs that were created in good times are now being shed quickly. The downturn has highlighted the gross unfairness of the dual labour market. It puts the burden of adjustment on groups with no tenure (women, immigrants and the young). Protected workers, the bulk of the workforce, cling to their jobs. That tends to fossilise the structure of the economy. Old industries, where productivity is waning, are slow to die and new firms slow to start up.

The growth of temporary contracts hurts productivity in another way. Firms are obliged to lay off (typically young) contract workers at the end of a fixed period, so they have little incentive to train tomorrow’s workforce. Instead they are stuck with older, tenured workers heading for retirement. The result in Italy, says Mr Boeri, is a “lost generation” of workers with limited skills. Admittedly the growth in temporary contracts has helped many people back into work and has lowered long-term unemployment. But the evidence from Spain suggests that such contracts are rarely a bridge to better things: less than 5% are converted into permanent jobs.

A group of economists led by Samuel Bentolila of CEMFI, a graduate school in Madrid, have set out a reform manifesto for Spain’s jobs market. They suggest that wage-setting could be made more flexible if deals struck at the level of individual firms were allowed to prevail over regional or industry agreements. They also propose replacing fixed-term contracts for new hires with a permanent contract in which firing costs rise with seniority but not as high as at present.

Mr Boeri and his colleagues have called for a similar scheme in Italy, where workers build up employment rights over time. Abolishing job protection makes most workers worse off, so it tends to run into political obstacles. The next best thing is gradually to reduce average firing costs and giving firms better incentives to train their workers. If Italy wants to encourage workers to risk moving jobs, it also needs to beef up its skimpy unemployment benefits. “Italy should say to its partners: ‘our fiscal stimulus is to introduce a welfare safety net to speed up the reallocation of jobs’,” says Mr Boeri.

Never a good time for reforms

Such reforms would be desirable even if nobody had signed up to the euro. When the currency was created, the hope was that the loss of the safety valve of devaluation would help to boost productivity and make markets more flexible. For most of its first decade timid politicians were able to shelter behind the economic stability that the euro helped provide. Without a crisis it is hard to persuade voters of the need for radical change. Yet recession is the worst time to make changes that leave some groups poorer.

Italy's previous big recession, in 1992-93, prompted a wave of reforms: privatisations, changes to pension entitlements, the creation of a competition authority and the demise of the scala mobile. Greece is now inching ahead with some reforms along similar lines. The government has sold Olympic Airways, a subsidy-thirsty airline, and a competition law is going through parliament that will give antitrust authorities more power to challenge—and break up—big companies that can set prices. In Spain one relatively painless reform would be to change the rules for renting out property, which currently overprotect tenants. If owners felt more relaxed about letting out second homes, workers might find it easier to move in search of jobs. It might even lift house prices.

For now, policymakers are too worried about fragile demand to risk tackling the supply side of the economy. Today's economic crisis has little to do with differential wage costs within the euro. In terms of relative unit wage costs, Germany's competitiveness has improved by around 13% since the euro started. Yet this year the German economy is set to shrink by more than any other in the euro area bar Ireland because of its heavy reliance on exports. Greece is expected to hold up better because it is less exposed to the global economy ("a good thing for a bad reason," notes one policymaker). Its GDP is likely to fall by around 1%, making it one of the most resilient economies of the OECD's 30 members. Italy's economy will do far worse, but there is less of a sense of crisis because it has long been struggling anyway.

Root-and-branch structural reform will have to wait a while longer. Germany's travails are not a good advertisement for maximising competitiveness. Only in Ireland, where the economic model is based on openness to trade and foreign investment, is competitiveness a big part of the policy debate. Elsewhere politicians seem somewhat stuck. "At some point we'll have to accept that it's better to have people in work than to have high wages," says Mr Mas-Colell. "In Spain we are not ready for that. There is an illusion, a hope, that we will wake up tomorrow and things will be better."

Yet all the current troubles of the hardest-hit euro-zone countries do not seem to have put off a raft of applicants, mostly in eastern Europe, from trying to join the club. Indeed, if anything, the financial crisis has made many countries even keener to join. Do they know what they are doing?

Fear of floating

The financial crisis has made the euro look more alluring.

IN 1999, the year the euro was launched, the Nobel prize for economics was awarded to Robert Mundell, a Canadian economist. That was good timing because his work was influential in shaping the euro zone. In a 1961 paper Mr Mundell had pioneered the theory of an "optimal currency area", a territory suited to adopting a common monetary policy. A main requirement, he concluded, was that workers throughout such an area would be sufficiently inclined to move jobs to even out regional booms and slumps. In later research others added strong trade links, wage flexibility and a central fiscal authority to the list of necessary features.

Equally important to the decision to join a monetary union was another of Mundell's insights, developed with Marcus Fleming at the International Monetary Fund, which entered the economics textbooks. This was the idea of the "impossible trinity": that a country could not simultaneously have a fixed exchange rate, be open to capital flows and operate an independent monetary policy. It could opt for any two of these features but not all three together. With free capital flows, monetary policy could be directed either at stabilising an exchange rate or controlling inflation, but not both. A country that targets domestic inflation and is open to foreign capital must have a flexible exchange rate.

When Mr Mundell expounded his theory, in the early 1960s, most rich countries were tied to the Bretton Woods system of fixed exchange rates. Because capital flows were tightly controlled, countries could set their own interest-rate policies and still keep exchange rates more or less fixed against the American dollar.

Canada was different. Its long border, heavy trade and strong industry links with America made capital controls impractical. For Canada to have an independent monetary policy, it had to let its currency float. In later writings Mr Mundell expressed regret about Canada's choice, as well as enthusiasm for European monetary union. In principle, a currency adjusts to keep economies in balance, but in practice, argued Mr Mundell, exchange rates veer wildly from their ideal levels. Large and volatile capital flows mean that floating currencies can be a source of instability. They are also a poor substitute for fully flexible wages and prices.

In or out?

The merits of monetary flexibility versus exchange-rate stability have to be weighed up by the 11 EU countries that are not (yet) in the euro. The choice is straightforward for Britain, which has long been reluctant to give up its independent monetary policy and has an opt-out from the euro. Britain's policy brass tend to see a flexible exchange rate as a useful safety valve. Sweden, like Britain, does not seem to have much to gain from hitching itself to the ECB. It has built a credible monetary regime, with an independent central bank, along similar lines. Since a referendum in 2003 that came out against membership, Sweden has shown no interest in getting closer to the euro club.

Denmark's currency is pegged to the euro but the country remains outside the euro zone after twice failing to secure a popular vote in favour of joining. It has the worst of all worlds. The currency peg is open to speculative attack, so its exchange-rate stability is precarious; yet to preserve it, the country has had to sacrifice an independent monetary policy. The government has been mulling a third referendum but the new prime minister, Lars Lokke Rasmussen, said in April that it would not take place this year.

The other eight potential members are former planned economies in central and eastern Europe (CEE) that joined the EU on or after May 2004. All are keen to adopt the euro. Those that had been cool on membership, such as the Czech Republic, have warmed up since last autumn's financial turmoil. Most are small and very open economies whose exports account for a large share of GDP and whose trade ties to the euro area are strong. As emerging economies they are prone to sudden shifts in foreign-investor sentiment, which makes for volatile currencies, so exchange-rate stability holds considerable appeal for them. None of them has a long record of stable money, so loss of monetary independence would not be greatly mourned. For four of the eight the euro is already their monetary anchor. The three Baltic countries, Estonia, Latvia and Lithuania, have long pegged their currencies to the euro, and before that to the D-mark. Bulgaria also has a euro peg.

For small, open economies such as those of the Baltic states (and Iceland, which now plans to join the EU as a stepping stone to adopting the euro), it makes sense to tie currencies to a big

and stable neighbour. Even Milton Friedman, a fervent advocate of floating exchange rates, thought so. In the Baltics, Latvia's euro ambitions are on hold. Following a bail-out led by the IMF in December, its economy and public finances are in intensive care. Estonia wants to join quickly and may do so as soon as 2011. A realistic target for Lithuania is 2012.

For a larger country, such as Britain, the benefits of membership are less obvious. A bigger portion of the goods and services it consumes is produced at home, so there is more scope to manage domestic prices through an independent monetary policy.

The outsiders 5

	% of GDP 2009		GDP at market prices, €bn, 2008	Exports, % of GDP, 2007	Consumer prices*	10-year gov't bond yield, %†
	Budget balance	Public debt				
Euro area	-5.3	77.7	9,209	41.6	2.7	3.69
Britain	-11.5	68.4	1,812	26.4	3.7	4.11
Bulgaria	-0.5	16.0	34	63.4	10.1	7.04‡
Czech Republic	-4.3	33.7	149	80.2	4.7	4.65
Denmark	-1.5	32.5	233	52.3	3.2	4.10
Estonia	-3.0	6.8	16	74.4	8.6	na
Hungary	-3.4	80.8	105	80.3	5.0	9.40
Latvia	-11.1	34.1	23	42.2	13.4	7.90
Lithuania	-5.4	22.6	32	54.4	10.5	7.89§
Poland	-6.6	53.6	362	40.8	4.0	6.02
Romania	-5.1	18.2	137	29.5	7.6	8.95
Sweden	-2.6	44.0	328	52.6	3.1	3.49

Sources: European Commission; Thomson Datastream; Bloomberg

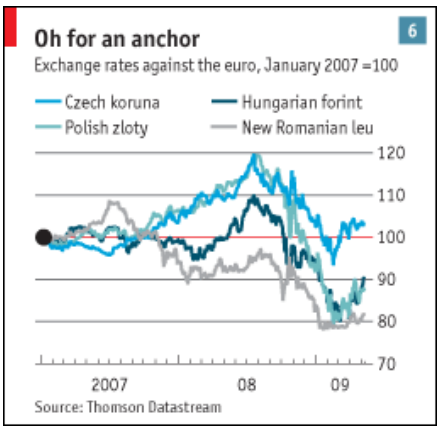
*% increase on a year earlier, latest 12-month average †Latest 12-month average ‡Latest 5-month average §8-year gov't bond

Poland could fit that bill too. It is the largest and one of the least open of the CEE8 (see table 5). Though not nearly as rich as Sweden in terms of income per head, it has many more people, so its economy is bigger. Its exports account for two-fifths of GDP. Because its exposure to world trade is smaller than that of many other EU countries, it has suffered far less from the global recession. The European Commission reckons its economy will shrink by 1.4% this year, which is not a lot by the dismal standards of the region.

The case for a quick dash

Despite the size and resilience of Poland's economy, its government wants to get into the euro as soon as possible. It hopes to join the ERM-2 (a pledge to keep the exchange rate within agreed bounds for two years) early next year in order to qualify for euro membership by 2012. As elsewhere in the region, part of the rush to qualify is to forestall a further drop in the zloty, which would make foreign-currency loans harder to pay off. Around 30% of private-sector debt is in foreign currency, far less than in Hungary but more than enough to hurt the economy if the zloty sinks. Hopes of entry in 2012 may be optimistic, and some economists question the wisdom of forcing the pace. As a fast-changing economy Poland might need the flexibility of a floating exchange rate for a little longer to keep it competitive and to smooth adjustments.

But can it rely on the right kind of help from currency markets? Recent experience suggests that there is no stable link between the economy's vital signs and shifts in its currency. For a while the exchange rate had been a balm. Between 2005 and 2007 the zloty's value increased in line with productivity (as a country becomes richer, its currency tends to rise in real terms). That helped to keep inflation low without harming exports.



The benign period ended in the autumn of 2007. The zloty, and some other eastern European currencies, were driven up (see chart 6) as investors piled into emerging markets in the belief that they would soon "decouple" from troubled rich-world economies. A year later, following the collapse of Lehman Brothers, the markets made a U-turn. Capital flooded out of eastern Europe, starving the region of foreign currency and plunging it into a severe crisis.

When a floating exchange rate proves to be an irritant rather than an emollient, fixing it once and for all has greater appeal. Most of Poland's trade is with the euro area and much of that is intra-firm trade: between, say, a German firm and its Polish subsidiary. Adopting the euro should open Poland up to more of that sort of trade and the stable, long-term capital investment that goes with it. And once currency risk vanishes, government, firms and households will all be able to borrow more cheaply—and, as important, given the recent freeze-outs—more easily.

In purgatory

The financial crisis may have increased the allure of the euro zone, but it has also made it trickier to get in. To join, countries must first meet the "convergence criteria": targets for inflation and public finances, as well as market-based tests for low long-term interest rates and a stable exchange rate (ie, two years in ERM-2). Slovakia made the cut when the criteria were last assessed, in May 2008, and joined in January. Of the eight CEE countries still outside, all bar Poland and the Czech Republic missed the mark on inflation, which was supposed to be no more than 1.5 percentage points above the average of the three EU countries with the lowest rate. Poland, for its part, failed to qualify because of doubts that it could control its budget deficit and worries that it owed its low inflation to the rise in the zloty (which was not in ERM-2).

With economies facing a deep recession, inflation is set to drop sharply (though the benchmark for the test is falling too). The public-finance criteria will be far harder to meet. Euro aspirants must show that they can keep their budget deficits below 3% of GDP and cap their debt ratio at 60%. That is tough in a downturn: most countries inside the euro area are already in breach of these rules. But hopes that the rules might be relaxed have been dashed. Those inside the euro fear that easing up on potential entrants would undermine the single currency. There may be a feeling that "we had to suffer to get in; so should you." Some outside the ark are also against a free-for-all. The stronger aspirants, Poland and the Czech Republic, have distanced themselves from calls by troubled Hungary (like Latvia, an IMF supplicant) to shorten the qualifying period in ERM-2 from two years.

Would fast-track entry really harm the euro? The worry that euro-zone countries such as Spain may suffer prolonged slumps because they lost control of unit wage costs lends the inflation test some weight, though not much. Willem Buiter at the London School of Economics is not

convinced. He thinks that inflation convergence is something to be expected after adopting the euro, not before. Getting rid of anything that may give rise to inflation is in the self-interest of new joiners. So is fiscal discipline. But insisting on them prior to entry amounts to “misplaced paternalism”, according to Mr Buiter. “If you have time to get inflation down, fine. But floating exchange rates are dangerous. The main thing is to get in.”

On one count, the would-be entrants are more flexible than the incumbents. Migrants from Poland and other eastern European countries have shown themselves willing to move in search of work. Lessons can also be learnt from the mistakes of others. Andrzej Slawinski, a member of the Polish central bank’s monetary-policy council, believes there is less of a risk that the new member states will follow in the footsteps of Greece, Ireland, Portugal and Spain. They are still poor by EU standards, so can look forward to a period of fast productivity growth. Were unit wage costs to rise too far, they could recover competitiveness more quickly.

Poland may be able to guard against the risk of credit and housing booms because the climate now favours tighter bank regulation. “Banking supervisors must have the authority to react to the business cycle in a dynamic way,” says Mr Slawinski. Governments must also be careful not to fuel housing booms with tax breaks. Instead property taxes could be used to cool overheated housing markets.

Once Poland and the smaller CEE countries adopt the euro, might Britain’s attitude change? If Denmark were to join too, the euro area would cover almost all of the EU’s member states, so Britain might once again look like the odd one out. Even so, it is likely to draw the same lesson from this crisis as it did from the ERM expulsion in 1992: that devaluation is a good thing. There is chagrin in some European capitals (especially in Dublin) that sterling has dropped so far and fast against the euro. A weaker pound, even with world trade in retreat, still cushions the profit margins of struggling exporters. It will only harden the belief in Britain that currency flexibility should not be lightly given up.

In any case, no British government could now consider signing up to the euro without first winning a referendum, and opinion polls have shown a fairly consistent two-to-one majority against joining the single currency. Even if Britons could be sold on the narrower issue of economic benefit, they are more likely than most Europeans to see national control over monetary policy as indivisible from other kinds of sovereignty. The euro’s success so far has suggested that a currency can be stable without the backing of a unitary state. But the financial crisis has raised a fresh question mark over that idea.

Soft centre

Can a currency survive without a state?

Illustration by M. Morgenstern

LAST November the European Commission set out its proposals for a Europe-wide fiscal stimulus, worth a combined €200 billion, roughly 1.5% of the 27-nation block’s combined GDP.

The commission has a relatively small budget and no authority to compel member states to shell out extra cash or cut taxes (and, to its regret, little clout to stop them from running up budget deficits). So it had to content itself mainly with a co-ordinating role.

The commission, along with the European Investment Bank, found €30 billion of EU money to contribute towards the €200 billion target, mostly by speeding up spending programmes. Of this, €5 billion was unspent infrastructure money from the EU budget which would normally be returned to the rich member states that had provided it. Three months later governments were still arguing about where or indeed whether this money, a trifling sum in the scheme of things, should be spent. Brussels insiders see this episode as typical of the painfully slow process of putting plans into action. It also illustrated how reluctant governments are to cede control over their own revenues.

There had been hopes that they might become more co-operative. Helmut Kohl, who as German chancellor was one of the midwives of the Maastricht treaty, thought a single currency could not survive without political union; indeed its main appeal was that it would make such union more likely. In November 1991, a month before the Maastricht summit, he told the German parliament that it was a “fallacy” that monetary union could last without political union. By the time the euro was launched in 1999, many people thought that some form of fiscal counterweight to monetary union would soon follow. “You didn’t have to be a federalist to believe then that the euro would prompt more political integration,” says Jean Pisani-Ferry of Bruegel, a Brussels think-tank.

The belief seemed well founded on several counts. Money is a form of government debt, so a paper currency, it was thought, must need a state behind it. Historical examples of a currency block not backed by a unitary state are rare, and such few as there have been did not last long. According to the theory of optimal currency areas, a central fiscal policy is necessary because a single interest rate will not suit conditions in all parts of a currency zone. Just as welfare spending and revenue raising help to smooth out regional kinks in national business cycles, a “fiscal euro zone” would act as a stabilising force for a shared currency area.

Rules of the game

What institutional structures would be needed for political union was rarely made clear, only that there would soon be more of it. In the meantime a set of fiscal rules—the stability and growth pact, which put a cap on budget deficits and public debt—would take the place of a central system of revenue sharing. Each country would insure itself against a downward lurch in its economy by running a balanced budget or, in good times, a surplus.

These fiscal rules had another purpose, which was often given greater emphasis: to prevent imprudent countries from imposing costs on others. Big deficits in one country might make it harder for others to compete for funds from savers, driving up interest rates for all. If such deficits were to add materially to the average debt burden, investors might fret that governments will attempt either to inflate away their debts or to pass them on to other countries, so will demand higher rates from all borrowers as protection. The EU treaty contains two clauses to try to limit this transfer of costs. The first bars the ECB from creating money to finance deficits. The second forbids countries from assuming the debts of others (the “no bail-out” clause).

The pact did not work well. The emphasis on the costs to others of fiscal indiscipline meant that countries were careful to behave no worse than their peers, rather than trying to be prudent on their own behalf. In good times public finances tended to add to, not subtract from, demand pressures: fiscal policy often worked against the monetary sort rather than complementing it, as the pact intended. The costs of fiscal laxity were low. Before crisis struck,

the slack attitude towards credit risk in bond markets meant that borrowing costs for high- and low-debt countries were similar. When in 2003 the European Commission threatened to impose penalties on France and Germany for excessive deficits, the pact was first suspended and then amended, with get-out clauses for “exceptional” events.

Ireland and Spain had complied with the pact in good times, but had relied too heavily on windfall revenues that evaporated along with their housing booms. Ministers had been able to insist that their fiscal policies were sound because they fitted in with the pact’s narrow guidelines, says Mr Pisani-Ferry. Since fiscal soundness was central to “stability”, they could claim that their overall economic policy was fine too.

Once the crisis had blown up last autumn, the lack of a fiscal centre to the euro zone became a live issue. Initially the euro rallied, but haphazard efforts to shore up banks, and later the economy, undid that early vote of confidence. Scared investors rushed into the safest dollar assets, lured by the liquidity of the vast market for US Treasuries, as the euro area was revealed as a mess of fragmented bond markets. Small euro-area countries with oversized banking industries, such as Ireland and Belgium, found that their bonds were shunned, driving up their borrowing costs relative to Germany’s. Markets were becoming increasingly anxious that a euro-zone issuer might run into funding difficulties, since there was no system for countries to help each other out.

The clunky governance of the EU and euro area worked against a rapid response to the crisis. Political power within the EU is dispersed, residing in state capitals rather than in Brussels. There is no powerful executive to take and enforce quick decisions. National interests got in the way of fiscal-stimulus packages and efforts to co-ordinate bank guarantees and rescues. Germany has the deepest pockets, but its instinctive thrift (and the suspicion that the benefits would be felt mostly outside Germany) militated against swift and co-ordinated action. That made it harder for less affluent countries to loosen their purse strings, as they could not risk looking in worse fiscal shape than their peers.

Good old ECB

The one euro-zone institution that could—and did—act decisively was the ECB. But even its ability to tackle slumps is constrained. Were there just one sovereign issuer of euro-zone debt, rather than 16, the ECB could more easily engage in unorthodox policy measures, such as buying up government bonds to drive down long-term interest rates. It would also find it easier to negotiate an indemnity against capital losses on asset purchases.

Despite the crisis, there are few signs of progress towards better fiscal co-ordination. Earlier this year, as bond spreads continued to rise, policymakers dropped heavy hints that struggling sovereign borrowers would not go unaided. Peer Steinbrück, the German finance minister, said in February that if a euro-area country found itself in trouble, “we will show ourselves to be capable of acting.” The following month Joaquín Almunia, head of the commission’s economics directorate, said that a European “solution” was in place so that any cash-starved country would not have to go to the IMF for an emergency loan. Mr Almunia did not give any details. The German finance ministry later denied that it was working on bail-out scenarios.

The panic revealed another gap in the euro area’s fiscal set-up: a process for dealing with a sovereign default, or the threat of one. The larger the number of countries that have adopted the single currency, the more likely it is that one will get into trouble. It would be sensible to have a contingency plan.

One idea is a dedicated bail-out fund for euro-zone members, along the lines of the IMF. This is proposed by Thomas Mayer, an economist at Deutsche Bank, who started his career at the

fund in the 1980s. Like the IMF, a European Monetary Fund (EMF) would offer emergency loans for governments unable to finance their budget deficits or roll over maturing debts. In return for this insurance, each member would contribute capital to the fund in proportion to the size of its population or GDP. Loans would come with conditions. A supplicant would have to pledge to put its public finances in order and undertake other economic reforms to persuade bond markets to renew lending.

This sort of proposal attracts two main criticisms. First, it is wasteful to duplicate the efforts of the IMF. Until very recently the fund was struggling to define its role (and raise money) because it had so few lending opportunities. Now it is busy fighting fires again, many of them in eastern Europe, so there is far less talk of staff cuts. But an EMF could stand idle for even longer before it saw action. A second quibble is that a euro fund may find it difficult to impose tough conditions on rescue loans. Better to let the IMF play the role of bad cop, say some, than have protesters burning the EU flag in countries forced to slash public spending or hike taxes.

Mr Mayer retorts that even the IMF has learnt that its interventions work only if countries co-operate. The idea that a financial policeman has to be strict to be effective is dated. He sees a European fund as more than an emergency kitty for cash-starved euro members. It could act as a permanent monitor of economic policies, including government budgets, and issue a seal of approval for countries wishing to take part in a joint bond issue. Over time, the emergency fund could evolve into an institution that improves the euro area's fiscal co-ordination.

The beauty of a euro bond

The hurdle for membership of such a programme would need to be high to persuade countries with good credit, such as Germany, to sign up to it, and to convince credit-rating agencies and investors to rank its bonds highly. But a large collective bond issue could have benefits even for countries with low credit risk, as it would rival America's Treasuries market for liquidity. A single issuer would make euro-area bonds more attractive to managers of foreign-exchange reserves, who want safe stores of value that can be converted into cash quickly and cheaply in an emergency. A joint bond issue could thus enhance the euro's standing as a reserve currency, as well as lowering borrowing costs for all countries that took part in it.

The idea of a shared euro bond has been pushed by Italy's Mr Prodi, George Soros, a veteran investor, and others. That Italy is keen on the idea is hardly surprising: pooling its poor credit ratings with others of higher standing would lower its borrowing costs and reduce the risk, albeit small, that it might have its financing cut off. Germany is understandably cool on the idea. Mr Steinbrück has said that the extra cost to his taxpayers would make it hard to sell politically. Many in Germany feel that even temporary help for cash-strapped partners should be provided by the IMF only, and on strict terms. They resent the fact that Greece and Ireland enjoyed years of prosperity and still found themselves in fiscal trouble. Bail-outs, they feel, only encourage profligacy.

A rescue of one country by its partners could undermine popular support for the euro, says Otmar Issing, the ECB's chief economist for its first eight years, because it would imply a transfer of taxpayers' money without endorsement from the voters in countries that have to pay.

Mr Issing, who had previously sat on the Bundesbank's rate-setting council, once believed that the euro needed more political union to thrive, but has modified his views. Political union, he now thinks, may even work against monetary union if it is founded on a model that would make economies more rigid. EU policies, once in place, are hard to reverse even if they are

clearly harmful, as decades of farm subsidies have shown. The euro has little bearing on ambitions for a common foreign or defence policy.

The euro's short history suggests that a successful monetary union does not necessarily need deeper political integration. True, by American standards the euro area's response to the crisis was slow and lacked co-ordination. But that is part of the price countries pay (and consider worth paying) for retaining full fiscal sovereignty. In any case, since welfare benefits are more generous and taxes heavier in Europe than in America, automatic fiscal stabilisers are more powerful in the old continent. A measure of co-ordination is already built into the euro area's fiscal policy.

The stability and growth pact is now too full of holes to be a binding constraint on fiscal policy. In an important sense it was always redundant. If monetary financing is banned and the "no bail-out" commitment is real, then fiscal discipline is largely an issue for individual countries. If they let finances slip, bond markets will exact a penalty in higher borrowing costs, as they have done in recent months.

There are nevertheless a few minimum requirements for a fiscal euro zone. The first is a set of clear rules for what would happen if a euro-zone member were frozen out of market funding. This will be become more important as more countries join. Second is an agreement on how the ECB would be recapitalised in the unlikely event that bank failures were to leave it with big losses on its loan book, or that it were to make large outright purchases of securities that subsequently went bad. A third element of fiscal union is needed to bind not just the euro area but the EU's entire single market: a shared fund for cross-border bank bail-outs. Without an agreement on support for troubled multinational banks, an open EU market in financial services may be impossible to maintain. Ironically, such a scheme would have to include Britain and Sweden, two countries that are outside the euro zone but have lots of banking interests in other EU countries.

Warmer inside

The gains outweigh the losses.

THIS crisis has tested many schemes and wheezes (some to destruction), from securitised mortgages to collateralised-debt obligations, from light-touch regulation to inflation targeting. How does the euro fare in this reckoning? According to one school of thought it is a fair-weather set-up, seemingly effective when economies are expanding but poorly equipped to deal with crises and manage the pressures and conflicts of a sinking economy. Conversely, many in Brussels and Frankfurt argue that being in the euro zone helped member countries emerge relatively unscathed from the worst financial crisis since the 1930s. Which view is right?

The extreme lurches in markets during the worst of the crunch last autumn made the certainties of fixed exchange rates look enticing. One lesson from the crisis is that asset prices can be unduly volatile and often veer wildly from their true values, in ways that undermine economic stability. That goes especially for housing but is also true of other asset prices, such as exchange rates. Another message is that interest-rate policy is not as powerful a stabilising force as had been thought. Other means of shaping demand are needed to complement it. Swapping an independent monetary policy for the stability of a fixed exchange rate now seems less of a sacrifice. That also closes off the escape route of letting the currency slip if wages move out of line with productivity. Yet deflation seems such a threat precisely because prices

and wages are proving less “sticky” on the way down than macroeconomic textbooks had reckoned with.

On standard gauges of competitiveness, such as real effective exchange rates, a number of euro-zone countries appear to have big problems. Yet things may look worse than they are. Measures based on relative unit wage costs across the whole economy are crude. In booming Spain and Greece, much of the heat in wages was in parts of the economy, such as construction, that serve domestic spending and are sheltered from foreign competition. Export industries may have a better chance of benefiting from a global recovery than the figures suggest at first glance.

Spain, in particular, may not be quite as uncompetitive as it seems. José Luis Escrivá, an economist at BBVA, a Madrid-based bank, reckons that Spanish exporters have performed fairly well in retaining export market share against other countries, bar super-competitive Germany. “What Spain had mostly was an import boom,” he says. Now imports are declining at a much faster rate than GDP, which will trim Spain’s current-account deficit to a more manageable size.

A recent study by the European Commission lends some support to that view. The export-market shares of Spain and Greece fell only slightly between 1999 and 2008 (see chart 7). Export growth was stronger than in Belgium, France and Portugal, if not as vibrant as in Austria, Finland, Germany and the Netherlands. Ireland’s export-market share increased over the period, even if the greatest strides were made in the euro’s early years. Perhaps its exporters, many of them big American-owned firms, were wise enough to hold back on big wage and price increases in a country that could not devalue.

Italian exports, however, were dismal. Firms in Italy lost market share faster than in any other big euro-zone country. Italy’s undoing is to specialise in industries such as textiles and furniture where competition from China and other emerging markets is particularly keen.

A devaluation might offer temporary respite for Italian exporters, but it would not be a lasting solution to being in the wrong businesses. Neither could it disguise the economy’s real problems: legal protection for jobs that stops workers moving from dying industries to growing ones; a wage-bargaining system that has made for poor matches between pay and productivity; and an unimpressive record on innovation that has inhibited the emergence of new firms in high-value-added industries. This familiar Italian litany is the “never-ending story of things that need reform”, sighs one economist.

However, there are signs of progress. Confindustria, Italy’s biggest employers’ body, recently signed an accord with two of the three largest trade-union confederations to overhaul the

national wage system. CGIL, the largest union group, did not sign up to the deal, but the Italian government said it would go ahead anyway.

Deconstructed

Spain and Ireland have more to worry about than wage costs in export industries. Big construction busts are, as a rule, hard to recover from. At the peak of their housing booms, up to a fifth of their workers had jobs related to construction or property sales. Many of those jobs will not come back, and finding other things to do for such an army of redundant workers will take time. Ireland has a more flexible jobs market, so its recovery is likely to be swifter, if still far from painless. Its GDP is set to shrink by as much as 9% this year. Spain's economy is more hidebound, so it will take longer to revive.

Illustration by M. Morgenstern

It is hard to see how a devaluation would help much even if that option were available. "If Spain's main problem were competitiveness, I wouldn't worry," says Mr Gros of the CEPS: "The Phillips curve [which suggests an inverse relationship between wage inflation and unemployment] would take care of it."

The lack of a "fiscal euro zone", a central spending body financed by a shared pool of tax revenues, has hampered an effective response to the economic downturn. Yet without the euro things might have been a lot worse. Co-ordinating a European response amid a series of currency crises or exchange-rate rows would have been far trickier. Bond investors have become choosier about sovereign credit risk, so some euro-area borrowers have had to stump up higher coupons for their recent bond issues. But no one was frozen out of markets. Even when spreads were at their widest, Greece and Ireland, the euro-zone's high-yielders, were able to finance their borrowing needs at a reasonable cost. The security of access to financing has made the euro area even more attractive to the EU's eastern states, some of which have had to fall back on rescue loans or precautionary credit lines from the IMF.

The prospect that a euro-zone country might default on its loans, never mind leave the euro, is fairly remote. But the taboo around the subject leaves bond investors uncertain about how such a problem might be resolved if it did occur. That uncertainty should be dealt with. Policymakers have dropped hints that should one country's financing troubles spread to another, a bail-out plan is in place. Yet the risk of contagion is overblown. An orderly debt restructuring for a country within the euro zone would not be the end of the world, or indeed of the single currency. A bail-out by fellow members might do greater harm by damaging popular support for the single currency.

There is a central irony about the euro. Many of its architects saw it as a means of advancing political union in Europe and were barely interested in a monetary union as an economic venture. Their hopes have been dashed, but as a technical exercise the euro has been a huge success. The currency is accepted in vast swathes of the rich world and quite a bit of the poor

world too. The value of euro banknotes in circulation and the market for euro-denominated securities already rival the dollar, a long-established currency backed by a single nation-state.

For economists such as Robert Mundell and others, who saw huge benefits in shared currencies but had despaired of politicians giving up monetary control, the euro is an exciting experiment. By contrast, the politicians that made the leap have been disappointed by the euro's failure, so far, to spur deeper political integration.

For all its shortcomings, the euro zone is far more likely to expand than shrink over the next decade. Most EU countries that remain outside, bar Britain and Sweden, are eager to join. The harm done by housing and construction booms in Ireland and Spain should be a caution to would-be members who, once inside, may get carried away by low borrowing costs. Against that, a big lesson from the crisis is not to rely too much on short-term interest rates to rein in credit and home-loan booms. The rush to join the euro zone is surely a vote of confidence. It must be doing something right.

Sources and acknowledgments

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