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Will the Euro Survive the Current Crisis?

by Martin Feldstein

CAMBRIDGE – The European Economic and Monetary Union (EMU) and the euro are about to celebrate their tenth anniversary. The euro was introduced without serious problems and has since functioned well, with the European Central Bank delivering the low inflation that is its sole mandate.

But the current economic crisis may provide a severe test of the euro's ability to survive in more troubled times. While the crisis could strengthen the institutions provided by the EMU, it could also create multiple risks, of which member countries need to be aware if they want to avoid them.

The primary problem is that conditions in individual EMU members may develop in such different ways that some national political leaders could be tempted to conclude that their countries would be better served by adopting a mix of policies different from that of the other members. The current differences in the interest rates of euro-zone government bonds show that the financial markets regard a break-up as a real possibility. Ten-year government bonds in Greece and Ireland, for example, now pay nearly a full percentage point above the rate on comparable German bonds, and Italy's rate is almost as high.

There have, of course, been many examples in history in which currency unions or single-currency states have broken up. Although there are technical and legal reasons why such a split would be harder for an EMU country, there seems little doubt that a country could withdraw if it really wanted to.

The most obvious reason that a country might choose to withdraw is to escape from the one-size-fits-all monetary policy imposed by the single currency. A country that finds its economy very depressed during the next few years, and fears that this will be chronic, might be tempted to leave the EMU in order to ease monetary conditions and devalue its currency. Although that may or may not be economically sensible, a country in a severe economic downturn might very well take such a policy decision.

The Stability and Growth Pact, which limits euro-zone members' fiscal deficits, is another reason why a country might want to leave the EMU. In a serious downturn, a country may wish to pursue a traditional Keynesian policy through large-scale, deficit-financed fiscal stimulus. Although the Stability and Growth Pact may be elastic enough to permit some deficit stimulus, a country may feel constrained from acting as aggressively as it wants.

The current financial crisis raises yet another problem: the lack of a clear "lender of last resort." It remains to be seen how willing the ECB will be to provide national central banks with the volume of euros needed to play this role fully. If a country sees its banks failing because its national bank cannot lend them enough, it may chose to leave the EMU so that its central bank can provide whatever amount of local currency it deems necessary.

Moreover, the current economic crisis has led to renewed talk about the need for the European Union to have taxing authority. Whatever the logic of that proposition, it would open the door to much greater income redistribution. High-income countries might find that reason enough to want out.

Even if officials do not want to abandon the euro, they may come to do so as a result of a strategy of trying to get other countries to agree to a policy change. A country that believes that monetary or fiscal

policy is too tight may threaten to leave if policy is not changed.

That is clearly a substantial risk if the country is Germany or France. But even if it is one of the smaller countries, it might be a serious threat because it could be seen as the beginning of the end. So either type of country could make the threat in the hope that it would be enough to cause their EMU colleagues to agree to their desired change in policy. The risk, of course, is that the other countries may not be intimidated. The threatening country would then have to choose whether to accepting a humiliating defeat and stay, or stand on “principle” and leave.

All of this assumes that political leaders would select only a policy change that they think will be in their nation’s long-term interest. But there is also a risk that some politicians act solely out of self-interest, seizing on the economic downturn as an opportunity to get elected by promising to withdraw the country from the EMU, or by saying that they will threaten to do so if the other member countries do not agree to their proposed policy changes.

None of these risks implies that the monetary union will inevitably be a victim of this severe economic downturn. But the downturn will be a more severe test for the euro than any that it faced during its first ten years.

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