Can the Euro Zone Survive Economic Recovery?

November 2009

By MARTIN FELDSTEIN

CAMBRIDGE – The economic recovery that the euro zone anticipates in 2010 could bring with it new tensions. Indeed, in the extreme, some countries could find themselves considering whether to leave the single currency altogether.

Although the euro simplifies trade, it creates significant problems for monetary policy. Even before it was born, some economists (such as myself) asked whether a single currency would be desirable for such a heterogeneous group of countries. A single currency means a single monetary policy and a single interest rate, even if economic conditions – particularly cyclical conditions – differ substantially among the member countries of the European Economic and Monetary Union (EMU).

A single currency also means a common exchange rate relative to other currencies, which, for any country within the euro zone, precludes a natural market response to a chronic trade deficit. If that country had its own currency, the exchange rate would decline, benefiting exports and impeding imports. Without its own currency, the only cure for a chronic trade deficit is real wage reductions or relative productivity increases.

The European Central Bank is now pursuing a very easy monetary policy. But, as the overall economy of the euro zone improves, the ECB will start to reduce liquidity and raise the short-term interest rate, which will be more appropriate for some countries than for others. Those countries whose economies remain relatively weak oppose tighter monetary policy.

The contrast between conditions in Germany and Spain illustrates the problem. The unemployment rate is now about 8% in Germany, but more than twice that – around 19% – in Spain. And Germany recorded a trade surplus of $175 billion in the 12 months through August, whereas Spain has run a trade deficit of $84 billion in the past 12 months.

If Spain and Germany still had the peseta and the D-mark as their respective currencies, the differences in trade balances would cause the mark to appreciate and the peseta to decline. The weaker peseta would stimulate demand for Spanish exports and reduce Spain's imports, which would boost domestic demand and reduce unemployment.

Since the interest rate set by the ECB is now less than 1%, there is little difference between its current monetary policy and what the Bank of Spain would do if it could set its own interest rate. But when the euro zone starts to recover, the ECB might choose to raise the interest rate before a higher rate would be appropriate for Spain, which could exacerbate Spanish unemployment. Spain and other high-unemployment euro-zone countries might oppose this policy but face monetary tightening nonetheless, because the ECB deems the overall state of the euro zone to warrant higher interest rates.

Spain is not the only country that would have an incentive to leave the EMU. Greece, Ireland, Portugal, and even Italy are often cited as countries that might benefit from being able to pursue an independent monetary policy and allow their currencies to adjust to more competitive levels.

The widening spreads between the interest rate on German eurobonds and some of the other countries' euro bonds show that global bond markets take this risk seriously. For example, while the current yield on 10-year German government eurobonds is 3.33%, the corresponding yield on Greek eurobonds is 4.7% and 4.77% for Ireland's eurobonds. These divergent yields reflect the market's perception of the risk of default or of effective devaluation associated with leaving the euro.

Leaving the EMU would, of course, involve both technical and political issues. A government that wants to replace the euro with, say, the "new franc" (which is not to suggest that France or Belgium would be likely to abandon the

euro) would have to reverse the process by which its currency was originally swapped for euros. But, having learned to do that once would make it easier to do it again in the opposite direction.

How would the exchange rate be set for the new currency? The obvious choice would be to start by exchanging one “new franc” for one euro and then leave it to the global currency markets to re-price the new currency. A country with a large initial trade deficit would expect to see its currency decline relative to the euro, say, to 1.2 “new francs” per euro, which would make its products 20% cheaper than products in other euro countries and would make imports more expensive. If that causes a rise in the departing country’s price level, the nominal exchange rate would have to decline further to achieve the same real adjustment.

Because individuals from the departing country could continue to hold euros, leaving the EMU would not cause a loss of existing wealth. But such a country would have to worry about more substantial economic consequences. Global capital markets would recognize that a country with high unemployment might choose to pursue an inflationary policy or a policy or exchange-rate depreciation. That could lead international investors to withhold funds from a departing country and raise substantially the interest rate on its national debt.

There would also be political problems. Would a country that leaves the EMU be given a diminished role in EcoFin, the European Economic and Financial Affairs Council? Would its voice be diminished in European discussions about foreign and defense policy? In the extreme, would it be forced out of the European Union altogether, thereby losing its trade advantages?

These economic and political risks may be enough to deter current EMU members from deciding to leave. But remaining in the euro zone could impose significant costs on some of them. At some point, the inability to deal with domestic economic problems within the EMU framework may lead one or more countries to conclude that those costs are simply too high to bear.

Martin Feldstein, a professor of economics at Harvard, was formerly Chairman of President Ronald Reagan’s Council of Economic Advisors and President of the National Bureau for Economic Research.
