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Chronicle of a Currency Crisis Foretold  
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CAMBRIDGE – The crisis in Greece and the debt problems in Spain and Portugal have exposed the euro’s inherent flaws. No amount of financial guarantees – much less rhetorical reassurance – from the European Union can paper them over. After 11 years of smooth sailing since the euro’s creation, the arrangement’s fundamental problems have become glaringly obvious.

The attempt to establish a single currency for 16 separate and quite different countries was bound to fail. The shift to a single currency meant that the individual member countries lost the ability to control monetary policy and interest rates in order to respond to national economic conditions. It also meant that each country’s exchange rate could no longer respond to the cumulative effects of differences in productivity and global demand trends.

In addition, the single currency weakens the market signals that would otherwise warn a country that its fiscal deficits were becoming excessive. And when a country with excessive fiscal deficits needs to raise taxes and cut government spending, as Greece clearly does now, the resulting contraction of GDP and employment cannot be reduced by a devaluation that increases exports and reduces imports.

Why, then, is the United States able to operate with a single currency, despite major differences among its 50 states? There are three key economic conditions – none of which exists in Europe – that allow the diverse US states to operate with a single currency: labor mobility, wage flexibility, and a central fiscal authority.

When the textile and shoe industries in America’s northeastern states died, workers moved to the West, where new industries were growing. The unemployed workers of Greece, Portugal, and Spain do not move to faster-growing regions of Europe because of differences in language, history, religion, union membership, etc. Moreover, wage flexibility meant that substantially slower wage growth in the states that lost industries helped to attract and retain other industries. And the US fiscal system collects roughly two-thirds of all taxes at the national level, which implies an automatic and substantial net fiscal transfer to states with temporarily falling incomes.

The European Central Bank must set monetary policy for the eurozone as a whole, even if that policy is highly inappropriate for some member countries. When demand in Germany and France was quite weak early in the last decade, the ECB reduced interest rates sharply. That helped Germany and France, but it also inflated real-estate bubbles in Spain and Ireland. The recent collapse of those bubbles caused sharp downturns in economic activity and substantial increases in unemployment in both countries.

The introduction of the euro, with its implication of a low common rate of inflation, caused sharp declines in interest rates in Greece and several other countries that had previously had high rates. Those countries succumbed to the resulting temptation to increase government borrowing, driving the ratio of government debt to GDP to more than 100% in Greece and Italy.

Until recently, the bond markets treated all euro sovereign debts as virtually equal, not raising interest rates on high-debt countries until the possibility of default became clear. The need for massive fiscal adjustment without any offsetting currency devaluation will now drive Greece and perhaps others to default on their government debt, probably through some kind of IMF-supported debt restructuring.

The euro was promoted as necessary for free trade among the member countries under the slogan “One Market, One Money.” In reality, of course, a single currency or fixed exchange rate is not needed for trade to flourish. The US has annual trade turnover of more than \$2 trillion, despite a flexible exchange rate that has seen sharp ups and downs in recent decades. The North American Free Trade area increased trade among Canada, Mexico, and the US, all of which have separately floating exchange rates. Japan, South Korea, and other major Asian trading countries have very flexible exchange rates. And, obviously, only 16 nations within the 27-member EU’s free-trade area use the euro.

Despite its problems, the euro is very likely to survive the current crisis. But not all of the eurozone’s current members may be there a year from now. In retrospect, it is clear that some of the countries were allowed to join prematurely, when they still had massive budget deficits and high debt-to-GDP ratios. Moreover, some countries’ industrial composition and low rates of productivity growth mean that a fixed exchange rate would doom them to increasingly large trade deficits.

For the rest, some mechanism of enhanced surveillance and control may be adopted to limit future fiscal deficits. But, even with a smaller group of member countries and some changes in budget procedures, the fundamental problems of forcing disparate countries to live with a single monetary policy and a single exchange rate will remain.

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