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Still an Economic Mistake

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I continue to believe that the creation of the euro was an economic mistake. It was clear from the start that imposing a single monetary policy and a fixed exchange rate on a heterogeneous group of countries would cause higher unemployment and persistent trade imbalances. In addition, the combination of a single currency and independent national budgets inevitably produced the massive fiscal deficits that occurred in Greece and other countries. And the sharp drop in interest rates in several countries when the euro was launched caused the excessive private and public borrowing that eventually created the current banking and sovereign-debt crises in Spain, Ireland and elsewhere.

But history cannot be reversed. Despite these problems, the euro will continue to exist for the foreseeable future. It will continue even though that will require large fiscal transfers from Germany and other core nations to those euro-zone countries with large debts and chronic trade deficits.

One reason for the euro's likely survival is purely political. The political elites who support the euro believe it gives the euro zone a prominent role in international affairs that the individual member countries would otherwise not have. Many of those supporters also hope that the euro zone will evolve into a federal state with greater political power.

There is also an economic reason that the euro will survive. While hard-working German voters may resent the transfer of their tax money to other countries that enjoy earlier retirement and shorter workweeks, the German business community supports paying taxes to preserve the euro because it recognizes that German businesses benefit from the fixed exchange rate that prevents other euro-zone countries from competing with Germany by devaluing their currencies.

The euro will not only survive but will likely continue to increase in value relative to the dollar as sovereign-wealth funds and other major investors shift an increasing share of their portfolios to euros from dollars.

Those investors had been quietly diversifying their investment funds to euros before the crisis began in Greece. They stopped temporarily because of uncertainty about the future of the currency. But they eventually came to recognize that the problems of the peripheral countries were not a problem for the euro and should be reflected in country-specific interest rates rather than in the euro's value. The result was a rising euro and a renewed shift of portfolio balances to euros from dollars. As that process continues, the relative value of the euro will continue to rise.

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