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Comment Martin Feldstein

I'm pleased to be a discussant of Barry Eichengreen's chapter about whether the euro and the European Economic and Monetary Union (EMU) will survive.

Before turning to the substance of this interesting chapter, I should say something regarding the views about the euro that I expressed before its launch a decade ago (Feldstein 1992, 1997, 2007). Contrary to what many people think, I did not express doubts about whether the EMU could be launched or whether it could survive. My concern in those papers was that the single currency would have undesirable long-term economic and political effects, including higher average unemployment in the euro zone and a weakening of the political alliance between Europe and the United States. I shall not pursue those ideas here.

Barry has given us a careful and balanced analysis of the possibility that one or more members of the EMU will leave the monetary union in the coming decade. He concludes that one country leaving in the next ten years is unlikely, and a complete breakdown of the EMU during that period is even less likely. He notes that it is difficult to predict beyond ten years but suggests that a political marriage that lasts ten years is likely to keep going.

I will begin by discussing Barry's analysis and then go beyond his framework to consider two other reasons why one or more members of the EMU might choose to abandon the euro.

The draft that Barry circulated at the conference was dated May 2008,

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This is a comment on a paper with the same title presented by Barry Eichengreen at National Bureau of Economic Research Conference in Milan, Italy, on October 17, 2008 (revised November 2008).

indicating that he prepared these remarks well in advance of the meeting. But as he noted in his presentation, the current financial and economic crisis may provide a severe test of the strength of the monetary union. However, nothing Barry said in his presentation makes me think that he changed his mind because of the current situation. I'll return to that at the end of my remarks.

The potential exit of an EMU member is not just a hypothetical question. The interest rate differentials among the ten-year government bonds of the EMU countries show that financial markets consider it a real possibility. The interest rate on the German bond is the lowest. But the ten-year government bonds of Greece and Portugal pay over 100 basis points more than German bonds, and even Italian bonds pay nearly 100 basis points more—indicating that the markets think there is a risk that during the next decade, those countries will not be able to pay in euros—either because they are insolvent, or because they have left the EMU.

Barry's analysis proceeds along two basic tracks. First, he considers whether it could be in a country's rational self-interest to leave the EMU. Second, he considers the barriers—technical, legal, and political—that might cause it to stay in the EMU, even if the government of that country thought it would be desirable to leave.

I will start with the latter issues. Barry notes that many previous currency unions or single currency states have broken up (the Austro-Hungarian empire, the Soviet Union, the Czech-Slovak split). But he then goes on to argue that those splits occurred either at a much earlier time in history, when financial systems were simpler, or in countries with simpler financial systems. He also notes that the exit by one EMU country might not be by mutual agreement, adding treaty complications. But in the end, he concludes that splitting a country out of the EMU would be possible, although the leaver would have a diminished political status in the European Union.

Having set those issues aside, I can focus on why a country might decide to leave the EMU. Of course, countries don't decide. Political leaders decide. I will come back to that important distinction.

Rational Optimal Policy

I will start as Barry does by asking whether it could be in a country's interest to leave the EMU. Barry focuses on the desire of a country to pursue a different monetary policy. He notes that a country with slow growth, high unemployment, and a large trade deficit—he gives Greece, Italy, and/or Portugal as current examples—might be tempted to leave in order to ease monetary conditions and to devalue its currency. Barry explains why that might be a foolish decision, because leaving the euro zone might lead to higher real interest rates and higher inflation.

Conversely, a country that wants a tougher monetary policy—that could

be Germany, if some future majority in the European Central Bank (ECB) is less concerned about inflation than Germany is at that time—could leave the EMU in order to pursue a tighter policy. Barry explains the risks of that strategy—particularly, the capital inflow that might occur—but recognizes that the economic consequences for a strong country leaving the EMU would be less adverse than for a weak-currency country.

Although the problem of a one-size-fits-all monetary policy is the most obvious reason for a country to want to leave the EMU, it is not the only one.

The Stability and Growth Pact that limits fiscal deficits could be 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 of fiscal stimulus. Although the Stability and Growth Pact may be elastic enough to permit some of that stimulus, a country may feel constrained from acting as aggressively as it wants. It is certainly possible that the current downturn—especially if it becomes very deep and very long—will provide a fiscal challenge to EMU solidarity that has not occurred during the past decade.

It is of course also possible that a substantial number of countries will decide at some future time to pursue a very expansionary fiscal policy and that the Economic and Financial Affairs Council (ECOFIN) will choose to allow that because of a significant economic downturn. A country that is opposed to such large fiscal deficits and that sees itself hurt by the resulting rise in euro interest rates and by the induced change in the value of the euro might feel that it would rather pursue a tighter fiscal policy in order to avoid those exchange rate and interest rate consequences and would leave the EMU in order to do so.

The current financial crisis raises another problem—the lack of a clear national 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 be a full lender of last resort. If a country sees its banks failing because the national bank cannot create as much currency as it would have been able to before the EMU, that would be a further reason for a country to consider leaving the EMU.

There is one additional reason that might apply to leaving the European Union as well as the EMU. As of now, taxation is a national responsibility within the European Union. Income redistribution among the EU countries is thus relatively limited. But there is frequent discussion in some circles that this should be a matter for the European Union, opening the way to substantial income redistribution. High-income countries might find this reason enough to want out.

Although each of these four reasons—monetary, fiscal, lender of last resort, and taxation—might be enough to cause a country to want to leave the EMU, Barry might of course be able to explain in each case that doing so would be a mistake. But the economic officials in the EMU countries might not understand the economy as well as Barry does, or they may have

a quite different view of what drives inflation, exchange rates, and other key variables. We certainly know that thinking about those key relations has changed substantially, even in the United States, during the past few decades. So, officials might be provoked by any of these four reasons to believe that withdrawing from the EMU would be helpful, even if the majority of economists at the conference would disagree.

Threats

But for a moment, let's assume that the government officials fully understand the adverse consequences of leaving the EMU and do not want to do so. These officials may nevertheless not like the way policy is going in the EMU—monetary policy at the ECB or fiscal policy because of an inadequately (or excessively) permissive ECOFIN. That may cause the country to threaten that it will leave the EMU 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 an unraveling of the EMU. So, either type of country could make the threat in hopes that the threat 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 between accepting a humiliating defeat or leaving the EMU.

Decisions of Politicians

Finally, I want to return to the idea that policy decisions are made by individual politicians or groups of politicians who are motivated by their own self-interest rather than by a pure interest in the national well-being. Democratic procedures are of course supposed to align the self-interest of politicians and the well-being of at least a majority of the public. But that only works in a complex area such as economic policy if the public is sufficiently wise, technically sophisticated, and farsighted.

If not, and this is certainly a more reasonable description, a politician could make the case for a policy that would help him or her or his or her party to get elected, even if it is not in the long-run national interest.

Here's an example of how self-interested politicians could lead to an EMU withdrawal by building on existing voter attitudes. A recent official Eurobarometer survey indicated that 95 percent of respondents in the twelve euro countries believe that the EMU has raised prices (Lane 2006). In Italy, it was 97 percent, and in Germany, 91 percent. If at some future time inflation is rising rapidly, it might occur to some political group to argue that if they are elected, they will bring down prices or inflation by taking the country in question out of the EMU.

Or, to take a different example, what if the current economic downturn and financial crisis becomes very severe, producing very high unemployment? It is certainly possible that some politicians will argue out of a mixture of conviction and self-interest that if elected to a position of control, they would take their country out of the EMU, permitting the combination of easy money, fiscal deficits, and lender-of-last resort assistance to banks to revive the economy.

It is important in this context that the support for the EMU, and even for the European Union, is generally very weak. For example, when the Eurobarometer recently asked French respondents how attached they are to the European Union, only 16 percent said that they are “very attached.” In contrast, 56 percent of that group said they are very attached to France as a nation.

Barry’s chapter reports a similar lack of support for the EMU among respondents in many countries. When asked in the 2006 Eurobarometer survey whether they thought EMU membership had been to the advantage of their country, only 40 percent of Italians said yes. The proportion was similar in Portugal and even smaller in the Netherlands and Greece. In Germany, it was only about 45 percent. Only four countries showed really substantial belief—more than 60 percent—that EMU membership had been advantageous: Ireland, Luxembourg, Austria, and Finland.

Similarly, when asked whether they had confidence in the ECB, only 44 percent of Italians said yes.

In short, after a decade of experience with membership in the EMU, the public support for EMU is weak at best. A political leader or political party could use this weak support to promote its political power by promising to withdraw the country from the EMU or by saying that they will threaten to withdraw if the other member countries do not agree to their proposed policy changes.

The currently developing economic crisis may provide a significant test of these temptations.

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