**“The State of the Euro” panel, Prof. Jeffrey Frankel, HKS,   
Dec. 6, 2016, Center for European Studies, Harvard University.**

**8 Mistakes**  
In many of these CES sessions on the state of the euro in past years, I have taken the approach that if the Europeans wanted monetary integration it could have been made to work, were it not for a series of implementation mistakes that policy-makers made. By now my list of mistakes is up to eight.

1. The **membership** should not have been expanded so quickly. [19 countries fail the OCA test.]
2. The fiscal moral hazard problem, though correctly identified at Maastricht, had not been effectively addressed, especially because of an optimism bias in official **forecasts**.
3. When net capital flowed copiously to Greece and other periphery countries after joining the euro and their **interest rate spreads** fell almost to zero, this was viewed as a good thing rather than as a sign that the moral hazard problem had not been solved.
4. **Monetary policy** was too tight, 2008-12.
5. The **failure to send Greece to the IMF early** in the crisis, in January 2010
6. The **failure to write down more of the debt,** earlier, at a time when most was still held by private creditors.
7. The stubborn **belief, esp. in Germany, that fiscal austerity is not contractionary**, even in the short run.
8. When Prime Minister Alexis Tsipras came to power in January 2015, he grossly misplayed his hand.

**What is new?**   
If I one were to continue the process of updating the list of mistakes, I would add the mistakes of European leaders gambling recklessly on referendums, most recently of course Italian PM Renzi’s referendum Sunday, Dec.4, but preceded by UK PM David Cameron’s Brexit vote in June of this year, the referendum held by Greek PM Tsipras in July of 2015 year. (And others before that, going back at least to France in 1992.) The most striking fact about these votes is that the extent of miscalculation: the leaders who call for them always seem to lose.

The particulars differ widely. But in each case voters are expressing strong dissatisfaction with the European project and with the elites who have led their countries into it – views that they have expressed almost every time they have gotten the opportunity. I think it is probably time to conclude that the leaders have comprehensively gotten out too far ahead of their publics and that even if ever-closer integration is a good thing on economic grounds, it is a mistake to do it without greater popular support than is available.

We could stick to the narrower subject of the euro, and make the point in terms of Optimum Currency Area theory: if a country is to give up having its own monetary policy, the public needs to understand and accept that there will be times when the monetary policy set in Frankfurt differs from the setting that would best suit domestic economic conditions. A small set of small highly open countries are likely to be willing to make this sacrifice. But as the group gets larger, it becomes less and less likely that they will be willing to give up the advantages of running individual monetary policies. Ireland, for example, needed a tighter monetary policy 10 years ago, and an easier one 5 years ago.

What we are seeing now is this principle writ much larger. Britain chose in its referendum to give up membership in the European Union, which not long ago we hadn’t even thought was in any doubt. Even worse, the US has apparently chosen in our own presidential election to give up our leadership of the highly successful postwar liberal international order.[[1]](#footnote-1)

**On the economic consequences of Mr. Trump:**

Mr. Trump’s policies are likely to set the trade deficit back on a deteriorating path. I refer to apparent plans for massive tax cuts and big increases in spending. It is hard to predict what the carryover will be from statements in the campaign to actual policies. But Congress is likely to support this sort of fiscal expansion.[[2]](#footnote-2)

It will be a repeat of what Ronald Reagan and George W. Bush did. The budget deficit will reduce national savings which would worsen the current account deficit, an example of the “twin deficits” that we saw under Reagan and Bush.

Through what causal channel would the trade balance worsen? The fiscal expansion will put upward pressure on interest rates, especially since we are already essentially at full employment. Of course the Fed had already been expected to raise interest rates Dec.14. Recent developments augur more interest rate hikes in 2017 and 2018.[[3]](#footnote-3) It will also put upward pressure on the dollar, because higher interest rates attract a capital inflow, as in the classic Mundell-Fleming model :  
BD ↑ => NS↓ => i rate ↑ => $ ↑ => TD↑.

Indeed the increases in US interest rates and the value of the dollar have already gotten underway, ever since the election.

That reasoning assumes that Europe does not match US fiscal expansion with similar moves of its own. In fact, they need it more. But Germany’s austerity view mostly continues to prevail. And it is true that Germany itself is close to full employment like we are. On purely domestic grounds but the US and Germany could profitably spend a lot more on infrastructure even if cyclical considerations are deemed to dictate that it should be financed with taxes (ideally, pro-environmental taxes). But in Germany’s case, the additional arguments for fiscal expansion are its very large current account surplus and the spillover effects that the spending could have for its neighbors like Italy, where output and employment remain very depressed. (I mentioned that membership in a monetary union requires sometimes adopting monetary stance different from the one that would precisely suit domestic economic conditions. That is also true of fiscal policy.)

But perhaps Italy, or another country, will decide that the whole project was a mistake, decide to withdraw, and essentially end the euro project... but for a much-reduced core of countries that *are* willing to bestow democratic approval, preferably by some mechanism that is less easily reversed than a referendum.

1. Chancellor Merkel is now leader of the free world. China is already filling the leadership vacuum in Asia and the Pacific. For the world as a whole, nobody is ready to take our place, just as Charlie Kindleberger said of the interwar period that the UK was no longer able to play the role of global hegemon and the US was not yet interested if fulfilling that role. [↑](#footnote-ref-1)
2. Talk in the US or in Europe of a switch from monetary stimulus to fiscal stimulus “because money has reached the limits of what it can do” is misleading. It seems to imply that fiscal expansion is more appropriate now than 5 years ago. The reverse is true. [↑](#footnote-ref-2)
3. The new Administration will probably oppose the increases, notwithstanding that during the campaign the candidate attacked the Fed for keeping interest rates too low. Hopefully the Fed’s independence will hold. [↑](#footnote-ref-3)