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Whither the Euro?

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After a decade of relatively benign existence, Europe's 17-country euro area has finally come under the kind of serious strain that was foreseen by some economists many years ago. It was precipitated by the revelation in late 2009 that Greece's budget deficit was very much larger than previously reported and that Greece needed assistance in continuing to finance it. Europeans represented that they could solve this European problem without outside help, and then dithered for three months before sending Greece to the International Monetary Fund for a corrective program with financial assistance, to which Europe would contribute. If this had been done earlier, there was at least some possibility that Greece's problem could have been isolated. But the months of irresolution served as a wake-up call to financial markets that all might not be well in the eurozone, and doubts gradually spread about Ireland, Portugal, Spain, Italy, and even Belgium and France – despite significant differences among these countries in fiscal policy, outstanding public debt, and international payments. By late 2011 euro-denominated bond spreads over ten-year German bonds, which had been negligible until late 2007, had risen to 155 basis points for France, 290 for Belgium, 466 for Spain, 480 for Italy, 650 for Ireland, 945 for Portugal, and an extraordinary 2550 (25.5 percentage points) for Greece, thus raising greatly, but differentially, the cost of new borrowing, both to finance continuing deficits and to roll over maturing debt.

By then Greece, Ireland, and Portugal had official sources of funding and did not need to pay these rates in the market-place. But other countries did, and were judged to have requirements so large that they could not plausibly be met by official lending, except from the European Central Bank (ECB). Italy's public debt, for instance, was six times that of Greece.

Most of the focus of official and public attention has been on budgets and outstanding sovereign debt. But this crisis exposed an even more serious problem, which should have been evident earlier: some eurozone countries, again especially Greece at over 9 percent of GDP in 2011, were running large current account deficits, meaning that they were importing much more than they were exporting and had to borrow abroad to cover the difference. There is nothing wrong with this in principle – drawing in foreign saving permits larger investment than could take place based on domestic saving alone. In Spain, however, foreign saving was largely financing an unsustainable construction boom; and in Greece (and to a lesser extent Portugal and Italy) it was largely financing public consumption, which was not being covered by adequate tax collections. The counterpart surpluses were largely within the eurozone itself, especially in Germany and the Netherlands.

Loss of competitiveness in many countries has been rectified by depreciating the currency, resulting in a decline in wages and other local costs when measured in foreign currency. That course is not available for the countries of the eurozone, since they do not have their own currencies. Thus it would seem that apart from cutting public expenditures to reduce public borrowing requirements (they seem unwilling to pay taxes), Greeks need to cut wages and rents to improve competitiveness, and/or emigrate and send remittances home to families. If outsiders are unwilling to lend, this adjustment is like that required under the gold standard, but without gold.

Leaving the eurozone, possibly desirable in principle, cannot in practice be done. Liquid assets will leave the country in anticipation, and liabilities in euros will lead to widespread bankruptcy, thus producing the severe austerity it was hoped to avoid. Greece faces a bleak decade under all circumstances. But what can be done to mitigate it and make it politically tolerable? I suggest the following courses of action.

Greece and Portugal could simulate a currency devaluation for trade by imposing a special tariff on all imports, matched by a corresponding subsidy to all exports. This course would not be permitted within the European Union. But they could increase their valued-added taxes, which would be levied on imports and rebated on exports. With the increased revenues they could provide an employment subsidy to firms, thus approximating a currency depreciation by lowering effective wages. By stimulating net exports, this would mitigate the austerity which Greece and Portugal must inevitably undertake.

To bring borrowing costs for Spain and Italy within manageability, Europe could adopt the scheme proposed by George Soros, whereby the ECB would purchase sufficient bonds to hold market rates below, say, five percent; and the ECB would be guaranteed against potential losses on such purchases by the European Financial Stability Fund (EFSF), which at 250 billion euros is not large enough to persuasively purchase enough Spanish and Italian bonds on its own. Just the promise of such purchases should be sufficient to stabilize the markets, obviating the need for heavy exposure. Neither Spain nor Italy would be relieved of improving their public finances; but the new governments in both countries could do so in a measured way, without constantly being worried about short-term market reactions, which would distract them from the longer term adjustments required.

These actions would be made much more effective in a buoyant economic environment, which Europe, verging on recession, is not at the moment. Germany needs to back more stimulative fiscal and monetary policies, the latter by the ECB. Germans seem to have low tolerance for both, even though they inconsistently strongly welcome economic stimulus coming from the export sector. But in the environment they are helping to create, one in which all its eurozone neighbors pursue austerity measures, Germany will also slip into recession, with or without a financial crisis.

Over the longer term, and in the context of an effective EU mechanism for assuring fiscal discipline (which emphatically does not mean balanced budgets at all times), Europe should create true Eurobonds, guaranteed by all eurozone members but serviced by each country originating the bond.

Contrary to the initial European claim that Greece was a European problem to be solved by Europeans, financial turbulence in the eurozone has become an issue of global concern, capable of destabilizing global financial markets and even driving the world into another recession. For this reason the G20, led by the USA, China, Japan, and Britain, should stand ready to provide financial support if it proves to be necessary, i.e. if Germany remains obstinately doctrinaire and fails to act in the interests of Europe, and indeed in its own long-run interest.