The global fallout of a eurozone collapse

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By Kenneth Rogoff
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A s many commentators have rightly observed, **the euro experiment is at a crossroads**. Either the eurozone will deepen into a fiscal union, or the weak members will be forced to break off. But the euro experiment has also brought us to a crossroads in the whole international monetary system. Will our grandchildren inherit a world with a huge number of national currencies, or a very small number of multi-country currencies?

If the euro survives and goes on to assume co-reserve currency status with the dollar, surely there will eventually be a strong trend towards consolidation elsewhere. Other blocs will form to mimic the euro's success. They will aim to enjoy lower interest rates, and greater resilience to financial crises. Perhaps, for example, Canada and Mexico will eventually form a North American currency bloc with the US, possibly extending to include a significant part of Latin America. **China and Japan could put aside their differences** and form the heart of a third major trading bloc in Asia. Indeed, until the recent financial crisis, it was hard for most researchers to imagine things any other way, save perhaps for idealists who believed the world should adopt a single world currency. (I doubt this would be a desirable outcome, as some currency competition is important as a constraint on the effects of inflation.)

Yet if the euro is torn by centrifugal force, perhaps because European leaders are constitutionally incapable of making tough decisions on how to radically trim periphery debt burdens, it could take a great many decades before any other region attempts a similarly ambitious programme. The 1980s and 1990s taught us that for countries with open capital markets, fixed exchange rates are a mirage that cannot be indefinitely sustained. If the euro goes the way of the Argentine currency peg, the noughts and tens – the first decades of the 21st century – will be viewed as teaching the same lesson about more radical currency marriages. Sovereignty and currency co-habitation do not mix.

Oddly, the euro was not at the heart of the recent financial crisis. Only Spain can really be described as an epicentre country, and of course the US and the UK had far greater systemic importance. Rather, the sovereign debt crises that Europe is experiencing today are a typical aftershock of a deep financial crisis. Nevertheless, even if the euro system was not at the heart of the crisis, it needs to be able to withstand two standard deviation shocks.

Unfortunately, as currently construed, the euro is looking very much like a system that amplifies shocks rather than absorbs them. The UK, which of course did not adopt the euro, has benefited from a sharp sustained depreciation of the pound. The peripheral countries of Europe are meanwhile stuck with woefully weak competitive positions and no easy adjustment mechanism. European leaders' plans to achieve effective devaluation through major wage adjustment seem far-fetched. The only clean rescue for Europe would be if growth far outstripped expectations. Unfortunately, post-financial crisis growth is likely to continue to be hampered by huge debt burdens.

It is ironic that the euro, forged to eliminate speculative exchange rate movements within Europe, is suffering from having an overly strong exchange rate, particularly against the dollar, and at precisely the moment when a huge depreciation would be most helpful. European leaders may mistakenly view this as a sign of confidence in the euro. I think it would be more accurate to say that rightly or wrongly, markets are more worried about the US's lack of a plan A than Europe's lack of plan B. Of course, having researched flexible exchange rates for more than three decades, I am all too aware that they can be extremely difficult to explain, much less predict. (Such was the finding of my 1980s work with Richard Meese when we were junior researchers at the Federal Reserve Board.)

Difficult as exchange rates are to predict and explain, perhaps the lesson of the euro crisis will be that it is easier to live with sharp market exchange rate swings than with unpredictable politics. The political leaders who formed the euro billed the transition as a sacrifice for the sake of their grandchildren. Right now, it is far from clear what system would be better for future generations to inherit. It is sometimes said that the euro is a creature of politics that would never be justified by economics. The present episode could well turn this statement on its head.

Having a smaller number of currencies is a phenomenon that makes a lot of sense economically, economising on transactions' costs and leveraging economies of scale. The real question is whether common currency is sustainable politically. My guess is that if the current slow patch in global growth does not quickly subside, we will not have to wait long for an answer.

The writer is professor of economics at Harvard University and co-author with Carmen Reinhart of This Time is Different