

**ECONOMICS:** SPECIAL COMMENTARY—DECEMBER 16, 2011

# Europe's Imperfect Union

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As Europe struggles to deal with deep challenges, the course of the unified euro currency—and possible fiscal union—has drifted away from its original promise. Where did the wrong turn occur?

Europe's widely anticipated summits and far-reaching emergency measures have been front and center in media headlines, as policymakers grasp for financial stability. Their actions represent an urgent response to the region's deep malaise. But where did the malaise originate? How did everything seem to go so well for so long with the Economic and Monetary Union (EMU), only to suddenly become a major risk and source of disruption for both the region and the broader global economy?

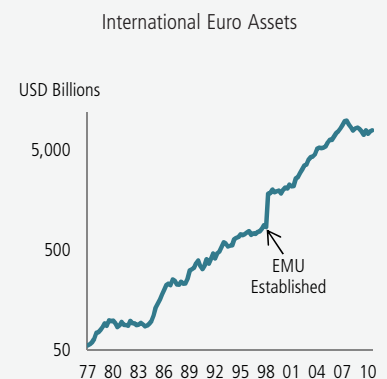
## The Original Idea

To assess the course of the EMU, we turn to the views of someone whose thinking was central in the campaign to form a euro currency—Canadian economist Robert Mundell. Mundell, who would go on to receive the Nobel Prize in Economics, helped advance the euro debate by describing the advantages and disadvantages of a potential monetary union in Europe. How has the reality of the euro lived up to—or failed to live up to—Mundell's expectations?

Mundell viewed inflation and unemployment as twin evils that monetary and fiscal policy should seek to control. Around this central idea, the euro debate would focus on how to design a suitable economic region, in which either inflation or unemployment would likely prevail uniformly at any one time. With the proper framework in place, policies within the union would be able to work effectively for all of its members.

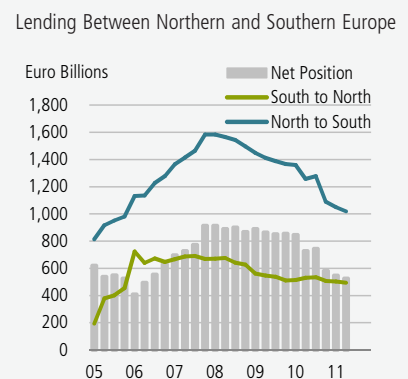
In Mundell's opinion, a badly formed monetary union would be defined by strong differences among its nations. A policy that was best suited for one area might be the opposite of a policy needed elsewhere. Mundell feared that strict measures to control inflation in high-demand areas would prevent accommodative policies from being deployed in low-demand areas suffering from high unemployment. The inefficiency of a monetary union, according to Mundell, could be measured in periodic peaks in unemployment.

Display 1  
An Explosion in Post-Union Financing



Through December 15, 2011  
Source: Bank for International Settlements

Display 2  
Banks Pull Back on Cross-Border Lending



Through December 15, 2011  
North includes Austria, Belgium, Netherlands, Finland, France and Germany; South includes Greece, Ireland, Portugal, Spain and Italy  
Source: Bank for International Settlements

Today, we can compare the reality of Europe's great experiment in monetary union with Mundell's early ideas. One surprising difference was the explosion in financing in post-union Europe, as well as a steady decline in euro-area unemployment rates, cycle by cycle, through 2008. Some of this growth in finance has flowed from lower interest rates globally. The union also caused a surge in cross-border credit denominated in euros (including credit between EMU nations), particularly after 2002 (**Display 1, previous page**).

### Papering over Unemployment Risk

Europe may have been selected for monetary union less for rational reasons than for political convenience. In keeping with Mundell's views, the economist expected that the cost of this political choice would be higher unemployment.

But higher jobless rates didn't happen. Instead, the problem was apparently papered over with easy credit in a Europe-wide expansion of bank lending. Burgeoning financial markets found eager buyers of private credit in some countries. In other nations, government debt was issued to finance public spending in an effort to avoid the expected increase in unemployment. Mundell wasn't wrong, he just underestimated the role of explosive financial growth in a big monetary union.

Many developments over the past year and a half—starting with the unexpected financing difficulties in Greece—have stemmed from the recognition that something was fundamentally wrong with the paths of both national-sovereign and private-sector debt across Europe. In fact, some governments were compounding their debts at rates that could only accelerate into insolvency.

Other countries witnessed private-sector credit booms, the costs of which would eventually be faced by governments in the form of massive bailouts. As debts continued to compound and veer far from

the path of stability, investors grew increasingly concerned—until they eventually shied away altogether from providing Greece with financing at any reasonable price.

### An Attempt to Create a Useful Crisis

To reform the vast expansion of credit, particularly public credit, some European policymakers—partially for political reasons—engineered a near-default by Greece. This "Private Sector Initiative" called on international private creditors to voluntarily reduce their claims on Greece's government. That shock led to a wave of disruptions across Europe, as other nations with high current deficits or heavy debt burdens also came under pressure.

Those who triggered the crisis intended to push European politicians to devise a fiscal union that would accompany its monetary union. The only alternative would have been to socialize Greece's debt, which would set a logically impossible precedent: never permitting a public debt failure, while setting no limit to the amount one country could tap from a common borrowing pool. Sensing the risks of that choice, officials instead opted to create the shock of a loss on what was once assumed to be safe euro-area public debt.

In trying to force a fiscal union, the engineers of the crisis sought to hold public borrowing by individual nations to a near-zero-deficit level. With such limits on fiscal policy, private-sector participants in each nation would be forced to become more flexible—either adapting to lower their costs or resigning themselves to long periods of unemployment. Unfortunately, they would have to adapt not to some average cost structure across nations, but to the cost of the country with the lowest inflation—Germany.

As we've seen, engineering crises is a dangerous game. It's become painfully clear that markets don't do well at panicking just enough to frighten politicians into action, but not enough to

cause major disruptions.

### Two Worrisome Possibilities

We're particularly concerned about two possible outcomes in Europe. One is that politicians will fail to create a convincing zero-deficit framework. The other is that they'll try to demonstrate fast success with shock fiscal-austerity adjustments.

Of course, the democratic process in each country might reject the delayed, oversize adjustments now called for. But that could create disorder, including demands for debt relief and—in the extreme—individual floating currencies.

These risks ought to be small: The politicians who initiated the crisis should have the ability to defuse it. But there's no guarantee that they'll get the job done, and the explosion of cross-border lending that allowed Europe's great imbalances to develop now stands ready to flee from even a minor risk of loss.

Greece's unpleasant surprise has already caused a precautionary wave to wash over the great sums of capital at risk across the European monetary system today. The sheer size of the capital at play magnifies the impact of each new development on financial markets. When money starts to shift away from risk, the impaired liquidity caused by the flight can create a self-perpetuating cycle.

### Playing Defense

Defensive moves by investors to contain risk on very large amounts of funds can amplify the crisis faster than politicians are able to respond. The absence of investor demand for sovereign debt can lead to the highly visible and alarmingly high sovereign-bond yields we're seeing. These high yields increase the risk of unsustainable debts; at the same time, they increase the pressure on governments to take harsh fiscal measures, raising the specter of political risk.

In another self-reinforcing move to contain

risk, some banks in Europe seem to be falling back to banking markets within their own national borders (**Display 2, page 1**). This makes sense to guard against the unlikely—but highly disruptive—possibility of a move to floating currencies. However, it also tends to increase the pressure exerted on Europe’s weaker banking systems.

Clearly, there are sizable forces at play in Europe—the ultimate outcome remains uncertain, and more volatility is likely ahead. But one thing is for sure: the script in Europe has already deviated from the one originally authored by Mundell. ■

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