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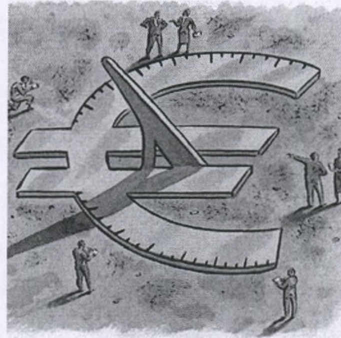
The Future of the Euro: A Symposium
Where does the single currency go from here?

This week, Europe's leaders will convene in Brussels to debate the future of the common currency. Five eminent economists -- Barry Eichengreen, Hans-Werner Sinn, Martin Feldstein Pedro Solbes and Steve H. Hanke -- weigh in on where the euro goes from here.



Fix the Banks, Fix the Currency
By Barry Eichengreen

For the euro to grow into a happy and healthy adult, many things must happen. Most importantly, Europe needs to fix its banking system. Many European banks, starting with Germany's, are dangerously over-leveraged, undercapitalized, and exposed to Greek, Irish and Portuguese debt. Rigorous stress tests followed by capital injections are the most important step that governments can take to secure the euro's place.

Since European leaders seem fixated on what to do after Greece's rescue package runs out in 2013—often, it appears, to the neglect of more immediate problems—they should also contemplate transferring responsibility for supervising their banks from the national level to the newly created European Banking Authority. The mistaken belief that a single currency is compatible with separate national bank regulators is, at the most basic level, why Europe is in the fix it's in.

Indeed, Europe's budget deficits are largely a result of the continent's festering banking crisis. Greece may be an exception, but it's clearly of a kind. The whole euro area would benefit from stronger discipline on borrowers and lenders. However, it is fantastical to think that this can be achieved by imposing Germanic debt ceilings Continent-wide. Germany's fiscal rules work because of Germany's history. The idea that they can be mechanically transplanted to other countries is a historical thinking at its worst.

The only discipline guaranteed to prevent fiscal excesses is market discipline. Reckless borrowers and lenders must be made to pay for their actions. Governments with unsustainable debts should be forced to restructure them, damage to their sovereign creditworthiness or not. The banks that lent to them

should similarly suffer consequences, as should the bondholders who provided those banks with funds.

But whether Europe can afford to let market discipline work comes back to the condition of its banks. Only if banks are adequately capitalized can they take losses without collapsing the financial system. Only if they are adequately capitalized can the European Central Bank refuse to buy more Greek, Irish and Portuguese bonds, and only then will the EU be able to say "no more bailouts."

And once this experience with market discipline is burned into Europe's collective consciousness, it will be correspondingly less likely that borrowers and lenders will again succumb to similar excesses.

In other words, European governments need to "put the risk back where it belongs, namely in the hands of the bondholders." Those are not my words. They are from the mouth of Bundesbank President Axel Weber speaking in Dusseldorf on Feb. 21. But while President Weber is right about the principle, he is wrong to think this can wait until 2013.

Mr. Eichengreen is a professor at the University of California, Berkeley. His book, "Exorbitant Privilege: The Rise and Fall of the Dollar," (Oxford University Press) was published in the U.K. last month.

Survival Isn't Guaranteed

By Hans-Werner Sinn

In my opinion the euro should survive. Though its members are too many and too disparate, the monetary union must be maintained, largely with its current number of states, for the benefit of political stability. The euro also offers measurable economic benefits, among them substantial reductions in transaction costs and exchange risks, which are prerequisites for exploiting the benefits of free trade.

Whether the euro will survive is another matter. This very much depends on whether European countries implement political and private debt constraints that effectively limit capital flows. The trade imbalances from which the euro zone is currently suffering have resulted from excessive capital flows brought about by interest-rate convergence and the apparent elimination of investment risks after the currency conversion was announced some 15 years ago. While huge capital exports brought a slump to Germany, the countries at the euro zone's southern and western peripheries overheated, with the bust and boom resulting in current-account surpluses and deficits respectively.

Automatic sanctions for excessive public borrowing, and a reform of the Basel system that forces banks to hold equity capital if they invest in government bonds, are among the political constraints necessary for the euro to survive. But much more important are private constraints.

After years of negligence, private markets have recently started to impose more rigid debt constraints on overheated euro economies. So the brakes kicked in eventually, but much too abruptly, triggering Europe's sovereign debt crisis. What

Europe needs is a crisis mechanism that is able to activate markets earlier and allow for a fine-tuning of the brakes they impose on capital flows; in sum, a crisis mechanism that helps to prevent a crisis in the first place and mitigates it when it occurs.

Such a system has recently been proposed by the European Economic Advisory Group at the Center for Economic Studies and the Ifo Institute for Economic Research (CESifo). The plan's essential feature is a three-stage rescue mechanism that distinguishes between a liquidity crisis, impending insolvency, and full insolvency, and offers specific measures in each of these stages. The system places the most emphasis on a piecemeal debt-conversion procedure that contemplates haircuts in the second of these stages, which could help to avoid full insolvency by acting as an early warning signal for investors and debtors alike.

The system would allow Germany to gradually appreciate in real terms by living through a boom that generates higher wages and prices and thus reduces the country's competitiveness, while cooling down the overheated economies of the south such that the resulting wage and price moderation would improve their competitiveness. European trade imbalances would gradually reduce.

If Europe, on the other hand, moves to a system of community bonds, where national debts are jointly guaranteed by all countries, then excessive capital flows would persist, and so would trade imbalances. The countries at Europe's southern and western peripheries would abstain from necessary real depreciation, and Germany would not appreciate, with the result that trade imbalances would continue with ever-increasing foreign debt and asset positions respectively. In the end, Germans would own half of Europe. I do not dare to imagine the political tensions that would bring about. The death of the euro would be the least of our worries.

Mr. Sinn is president of Germany's Ifo Institute for Economic Research and the CESifo Group.

Still an Economic Mistake
By Martin Feldstein

I continue to believe that the creation of the euro was an economic mistake. It was clear from the start that imposing a single monetary policy and a fixed exchange rate on a heterogeneous group of countries would cause higher unemployment and persistent trade imbalances. In addition, the combination of a single currency and independent national budgets inevitably produced the massive fiscal deficits that occurred in Greece and other countries. And the sharp drop in interest rates in several countries when the euro was launched caused the excessive private and public borrowing that eventually created the current banking and sovereign-debt crises in Spain, Ireland and elsewhere.

But history cannot be reversed. Despite these problems, the euro will continue to exist for the foreseeable future. It will continue even though that will require large

fiscal transfers from Germany and other core nations to those euro-zone countries with large debts and chronic trade deficits.

One reason for the euro's likely survival is purely political. The political elites who support the euro believe it gives the euro zone a prominent role in international affairs that the individual member countries would otherwise not have. Many of those supporters also hope that the euro zone will evolve into a federal state with greater political power.

There is also an economic reason that the euro will survive. While hard-working German voters may resent the transfer of their tax money to other countries that enjoy earlier retirement and shorter workweeks, the German business community supports paying taxes to preserve the euro because it recognizes that German businesses benefit from the fixed exchange rate that prevents other euro-zone countries from competing with Germany by devaluing their currencies.

The euro will not only survive but will likely continue to increase in value relative to the dollar as sovereign-wealth funds and other major investors shift an increasing share of their portfolios to euros from dollars.

Those investors had been quietly diversifying their investment funds to euros before the crisis began in Greece. They stopped temporarily because of uncertainty about the future of the currency. But they eventually came to recognize that the problems of the peripheral countries were not a problem for the euro and should be reflected in country-specific interest rates rather than in the euro's value. The result was a rising euro and a renewed shift of portfolio balances to euros from dollars. As that process continues, the relative value of the euro will continue to rise.

Mr. Feldstein, chairman of the U.S. Council of Economic Advisers under President Reagan, is a professor of economics at Harvard University.

A Decade of Success
By Pedro Solbes

After 10 years with the euro, the economic crisis and its consequences in some countries of the euro zone have reopened the debate about the suitability of a single currency in the absence of a high level of political integration.

But the euro has been a great joint success, which has allowed for a long period of growth and price stability in Europe. It has had a different impact in each country, but its benefits have been seen across the board. The euro has permitted more coordinated action in Europe and has prevented competitive devaluations. This has been key not only for the euro zone, but also for the rest of Europe and even for the global economy. Without the euro, we would have witnessed an increase in protectionism, which would in turn have aggravated the impact of the crisis in Europe and elsewhere.

Would it have been easier to reach consensus in the G-20 without the euro zone? Would it have been easier to respond to the challenges and difficulties faced by the international financial system? Would there have been greater cash-flow access? The answer to all these questions is no. It could be argued that a fluctuating exchange rate could have limited the impact of the crisis in some countries. However, would the crisis have been avoided without correcting the fundamental problems in each country and subsequent generalized competitive devaluations? The absence of an exchange rate may have aggravated the problems that existed before the crisis. But have these been better tackled outside the euro? Some observers have affirmed that behavior outside the euro zone has not been any better.

Quite a few countries of the euro zone already faced significant risks before the crisis, both real (real-estate bubble, public and/or private debt) and financial (inadequate risk management or excessive dependence on external funding). In addition, in some cases, uncoordinated fiscal and monetary policies in the euro zone could have helped generate the problem. Experience shows that the Maastricht architecture designed to manage the euro zone has been lacking. Focusing economic-policy coordination in the fiscal arena, coupled with a somewhat lax implementation of norms, has not been enough. Leaving the task of correcting imbalances in the hands of euro member states has not worked. The crisis has brought to the fore the lack of a mechanism to help troubled countries before their problems end up affecting the entire euro zone.

As is often the case with the European construction process, the problem resides not only in diagnosing the problem. There is an urgent need for clear and quick solutions, backed by the political will to comply with what has been agreed, something not always easy to achieve when dealing with 27 different countries.

Even though it has not been adopted by all EU member states, the euro is today, as German chancellor Angela Merkel has recently expressed, an inherent element of the European integration process. The euro is here to stay and the real challenge is how to make it more efficient.

Mr. Solbes is chairman of the Executive Committee of FRIDE and former Spanish minister of economy.

A Political Currency

By Steve H. Hanke

A grand European project has percolated since Napoleon. After World War I, the project took on some ideological color. In the name of Continental peace, the containment of Germany via a "union" was deemed to be desirable, particularly by French governments. The staging of the euro during the last decade-and-a-half and the playbills presenting the dramatis personae—such as former French President François Mitterrand—signal that the agenda is as robust as ever. The modalities are familiar: the French will provide the direction and the Germans will foot the bill.

Since its inception in June 1998, the European Central Bank (ECB) has been error prone. An initial and significant flaw appeared in 1998, when the ECB's first chief economist and member of its Executive Board, Otmar Issing, was forced to produce a monetary policy strategy in a matter of weeks. Despite lip service about a "monetary pillar," the so-called Issing Committee latched onto the fashion of the day: inflation targeting. In consequence, the ECB has displayed a propensity to either tighten or loosen monetary policy at precisely the wrong moments.

One of those inauspicious episodes occurred during the summer of 2008, when the ECB pushed interest rates upwards. By blindly embracing inflation targeting, the ECB ramped-up interest rates, even though Europe had been in the grip of a recession for two quarters. More ominously, the biggest financial crisis since the Great Depression was brewing—a fact that had bubbled to the surface in the summer of 2007, when Europe's interbank markets seized up.

Rather than correctly diagnosing Europe's interbank malfunctions as a symptom of sovereign and bank insolvencies, the ECB and Europe's political elites instead pushed the button marked "liquidity deficiency." This placed the euro on center stage and took the public's eye off the source of the problem: too much debt and associated insolvencies. The heart of the problem is simply too much borrowing that can never be paid back on the terms promised—not a euro problem per se.

The best antidote for over-indebtedness is a good haircut. But haircuts are not in the political cards. Instead, the ECB has morphed into the euro zone's "bad bank," taking on enough questionable credits to sink a battleship. As if that's not bad enough, the European Union's "no-bail-out" principle has mutated into the European Financial Stability Facility—an institution that is specifically designed to bail out governments that have never learned the Victorian virtues.

The euro remains a creature of politics, not economics and finance. Indeed, most of the economic arguments—both pro and con—have been, and continue to be, either wrong or irrelevant. The hallmarks of this project have been more politicization, more centralization and more "harmonization." What does the future hold? Everything will depend on Europe's avatars. There are good reasons for the skeptics to remain, well, skeptical.

Mr. Hanke is a professor of applied economics at the Johns Hopkins University in Baltimore.