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SNAPSHOT

The Future of the Euro

Why the Greek Crisis Will Not Ruin Europe's Monetary Union

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When the euro was conceived two decades ago, few people expected it to have to weather a storm as great as the recent global economic and financial crisis. And many observers now think the entire European construct -- its institutions and currency -- has been so damaged by the crisis that it might not survive. A careful analysis of the problems within individual eurozone economies, particularly Greece's, and in the architecture of the monetary union among them reveals what went wrong, how the EU has responded, and what the prospects of the euro really are.

Between 2008 and 2010, several things went wrong in Europe, the biggest of which was Greece's financial crisis. For years, Greek fiscal policy had been unsound. Although private debt had been rising, the country's overall debt-to-GDP ratio had not ballooned, because the Greek economy was growing. But that growth turned out to be unsustainable. When the global economic crisis hit, Greece's deficit more than doubled. The problem was compounded by revelations that the government had grossly falsified and padded its budget in the run up to the 2009 parliamentary elections.

Unlike countries with national currencies, Greece could not address its problems through monetary policy. It can neither print money to inflate its debt away nor depreciate its currency to recover the international competitiveness of Greek goods and grow the economy out of debt. And unlike a subnational federal region in trouble, Greece, as a sovereign unit itself, could not have its falling revenues and rising social expenditures offset through simple fiscal transfers from the rest of Europe. Its labor force, moreover, is not mobile enough for excess to be exported elsewhere in the eurozone.

As far as the euro's architects were concerned, this kind of problem should never have arisen. European financial markets should have put pressure on countries with excessive debt-to-GDP ratios, such as Greece, by charging them higher interest rates for loans. The European Central Bank (ECB) prohibits loaning money to service national debts, and its no-bail-out clause should similarly have discouraged overspending. Additionally, the eurozone's Stability and Growth Pact, which was meant to enforce fiscal discipline in member countries through rules against running high deficits and debts, should have constrained Greek politicians. Finally, the Lisbon process, a 2000 development plan for the eurozone, should have increased Greece's economic competitiveness and spurred real growth.

Unexpectedly, however, European financial markets accommodated Greece's public and private spending with relatively low interest rates. It was only when the global financial crisis gained momentum that the markets reacted and capital flows suddenly stopped. The Stability and Growth Pact was ineffective as well; member states proved unwilling to enforce restrictions against others for fear of being subject to restrictions themselves. Finally, the Lisbon process underestimated the true differences in the member countries' economies and failed to adequately address them.

Once the Greek financial crisis was under way, there were two options for tackling it. The first was for Greece to implement fiscal and structural reform that would bring its debt and deficit under control. Greece, the International Monetary Fund (IMF), the European Commission (EC), and the ECB negotiated just such a plan in June, with the goal of turning Greece's primary deficit of nine percent of GDP into a surplus of six percent by 2015. It rests on fairly standard IMF reforms: substantial expenditure cuts, increases in revenue creation, and improvements in tax collection. It also includes important structural reforms, such as pension reform and privatization, which are aimed at improving long-run debt sustainability and the performance of Greece's labor and manufacturing sectors.

The plan was accompanied by financing from the IMF and loans from the rest of the eurozone worth €110 billion -- or 46 percent of Greece's 2010 GDP. Because the Greek crisis spread to other countries -- Portugal and Spain, in particular -- member states agreed to create a special European Financial Stability Fund to support any eurozone country that decides to undertake economic reform.

Yet there is already widespread skepticism about the IMF plan among some academics, investors, and speculators. Many fear that it is too harsh, imposes too many restrictions, and would ultimately be politically unsustainable. Their alternatives, however, are no better. Some have called for Greece to undertake an "orderly" debt restructuring, including devaluing bonds to alleviate the country's debt burden. In its extreme form, this proposal also calls for the reinstatement of the drachma, because moving to the less valuable currency could restore Greece's economic competitiveness.

In truth, however, these measures would not work and would be much harsher for the people of Greece than the IMF plan. Debt restructuring is never orderly. Undertaken now, it would hammer Greece's domestic financial system and have serious repercussions for the rest of its economy. Greek access to eurozone capital markets would be impaired for years, stalling the public and private sectors. And if Greece did not fully repay the loans from other eurozone countries, it would suffer a major loss of political credibility.

In such an economically integrated area as the eurozone, leaving the currency union would not solve Greece's economic problems either. After Italy left the European Exchange Rate Mechanism (ERM) and devalued its currency in 1992, for example, it suffered from volatile swings in interest rates due to a lack of investor confidence. Inflation rapidly reappeared, and Italy had to tighten its monetary policy further than would have been necessary if it had stayed in the ERM.

The return to a national currency would also involve renegotiating business contracts, both within Greece and between Greeks and others. In the event of legal disputes, EU courts would likely be inclined to rule against Greece, the country that changed its currency. Greek citizens would probably try to maintain the euro as a unit of account and means of exchange, leading to parallel circulation of the drachma and the euro. And, having accepted billions in euro-denominated loans, the Greek debt burden would immediately increase if Greece reinstated the less valuable drachma.

The costs of restructuring debt or abandoning the euro would be too high for Greece to bear. The IMF plan is therefore Greece's best option. That said, it is ultimately quite tough and carries with it two types of risk. The first is if the reforms are not economically sustainable, they might create a debt spiral. The second is that if they are not politically sustainable, the government may adopt the other plan anyway.

A restrictive fiscal policy might well have a negative impact on Greece's growth in the short term, but many of the arguments about its recessionary effects are flawed. They use a baseline model that assumes a given growth rate and an unsustainable fiscal policy. When a restrictive budget is added, growth does indeed decrease at first, due to standard Keynesian principles. But financial markets are completely excluded from this model. It does not account for the fact that unsustainable fiscal policies inevitably provoke financial markets, which tend to react abruptly and generate terrible economic crises. At that point, much harsher measures are required to restore debt sustainability. A well-designed baseline model should include these effects and would show that over the long run uncontrolled fiscal policy is much more recessionary than timely budgetary adjustments.

Greece is a case in point. Due to fears about hindering future economic growth, for many months the Greek government refused to regain control of its budget. Now, even after emergency bailouts last spring, Greece is projected to lose four percent of its GDP in 2010. Had it taken action earlier and avoided the financial crisis, its economy probably would have shrunk more than what was projected before the crisis (in the fall of 2009, the EC projected a 0.3 percent loss for 2010), but it certainly would have fared better than it has now. The fiscal adjustment needed would have been milder, and the loss of political credibility would have been less devastating. Even now, a plan that does not include fiscal retrenchment will be much worse for long-term economic growth.

Beyond economic sustainability, critics cast doubt on the IMF plan's political feasibility, arguing that it is impossible for Greece to retrench if it means that the country must do away with entitlements that the population has come to view as fundamental rights, such as generous unemployment and retirement pensions. Such retrenchment would stir public unrest, they say, and leaders would have no option but to default to devaluation.

It is true that, as is often noted, there is no constituency for budget discipline. And Greece's ruling political class may not have had the ability, or will, to convince Greek citizens of the need for restrictive fiscal measures in advance of the crisis. The current economic situation has shown, however, that politicians can build consensus for unpleasant fiscal action during a crisis. Governments in the eurozone used the threat that the Greek problem could spread to build support for an expensive rescue package, for example. And the governments of Portugal, Spain, Ireland, and others used the dire state of European financial markets to justify budgetary restraint and major reforms to labor and financial markets.

Citizens do not take fiscal reform lightly, but they are more easily convinced of its necessity if persuaded that something even worse looms as the alternative. This is why public support should coalesce around IMF-style economic reform, not debt restructuring or devaluation. Citizens of countries where those occurred remember their devastating effects. In countries where there is no recent memory of financial crisis, some may harbor the illusion that the current one will pass easily. But in today's world of densely networked economic systems, that is indeed an illusion.

Just as the economic crisis exposed problems in the Greek economy, it also exposed weaknesses in the euro's institutional framework. Restoring confidence will require strengthening that framework. A task force headed by EU President Herman Van Rompuy is scheduled to offer concrete proposals to do so by the end of this year. And in June, the ECB released its own recommendations: stronger independent surveillance of the budgetary policies of the member states with more automatic implementation of sanctions; improved surveillance of country competitiveness to ensure that member states continue to converge economically; and a crisis management structure with strong conditionality to support countries that implement adjustment programs. We acknowledge that it will not be possible to expel member states that fail to comply with EU budgetary guidelines, so such a threat would ultimately not be credible.

The EC and the European Parliament have also called for the creation of three financial supervisory authorities (the European Banking Authority, the European Insurance and Occupational Pensions Authority, and the European Securities and Markets Authority) and a regulatory authority (the European Systemic Risk Board). Because the economies of the eurozone are so interconnected, eurozone-wide supervisory and regulatory authorities are necessary. They would have the discretion to press national governments to remedy problems and would be independent enough to act preemptively, without having to wait for a crisis to galvanize politicians to action. Some may dislike the idea of giving international bodies the power to constrain national economic policy. But financial contagion spreads too quickly, and European taxpayers have had to pay for the failures of other countries too often, for the current system to remain.

Forecasting the euro's demise was premature. The EU and eurozone countries were able to respond to the financial crisis with appropriate corrective measures: many countries adopted strong fiscal adjustment packages; eurozone countries have announced, and in some cases already implemented, unprecedented structural reforms, not least of which was their joint decision to coordinate and publish the results of their bank stress tests; the new European Financial Stability Fund has been established and can be used to support other eurozone countries in distress, and a task force on reform will offer and approve concrete proposals to strengthen eurozone governance by the end of the year.

One might criticize these measures for having been taken only after a crisis was eminent, but this is ultimately how democracies work in the face of difficulties. Problems in the economies of eurozone countries and in the framework of the monetary union will need to be addressed, but all the constituent countries will emerge stronger if they continue to pursue the right adjustment policies. Europe will need to find the right mix of cooperation, in defending its common interests at the global level, and competition in incentivizing growth. It will need to rely both on the center, which must ensure strong fiscal policy, and on the member states, which control much of the rest of economic policy. But one should take inspiration from the EU's history. Finding these balances has historically been one of Europe's key strengths.