The Crisis of the Euro

Barry Eichengreen

Berkeley – The financial crisis has breathed new life into hoary arguments about the demise of the euro. They invoke Milton Friedman, who warned in 1998 that Europe's commitment to the euro would be tested in the first serious economic downturn. That serious downturn is upon us. Yet the results have been precisely the opposite of what Professor Friedman predicted.

Unemployment is now rising and with it populist posturing. In countries like Italy, already suffering from Chinese competition, and Spain, which is experiencing a massive housing bust, the pain will be excruciating. Yet these countries have shown no inclination to abandon the euro.

They understand that even whispering the possibility would panic excitable investors. They see how countries like Denmark with their own currencies have been forced to raise interest rates to defend their exchange rates when the Fed and ECB are cutting rates. They see how, if there was still a lira or a peseta, they would be experiencing capital flight. They understand that they would have to fend off an old-fashioned currency crisis at the worst possible time. They appreciate that there is stability and security in numbers.

And the euro-collapse scenario where such countries successfully pressure the ECB to inflate, compelling Germany to abandon the euro, has similarly shown no signs of developing. The ECB, protected by statutory independence and a price-stability mandate, has shown no inclination to let it rip whether in response to pressure from Mr. Sarkozy or anyone else.

One can argue that the worst is yet to come – that there will be more inflation and unemployment down the road – and that, when they come, the euro area will collapse. Euro skeptics always make this argument. But, given recent events, it is now they who bear the burden of proof.

What neither Professor Friedman nor anyone else anticipated in 1998 was that the first serious downturn following the advent of the euro would coincide with the mother of all financial crises. Runs by panicked investors have required central banks to undertake unprecedented lender-of-last operations. Extensive loan losses have required expensive bank recapitalization operations. There have been predictions that governments stretched to the limit by the financial crisis might respond by abandoning the euro. They might resort to the inflation tax to recapitalize their banks. They might inject the national currency to in the desperate effort to reliquify their banking systems and financial markets.

In fact, the response has been precisely the opposite. The ECB has provided essentially unlimited amounts of liquidity to euro area financial systems. And the Stability and Growth Pact has been relaxed to free up the borrowing capacity for governments to recapitalize their banks.

It is European countries outside the euro area, still with their own currencies, that have suffered the gravest difficulties. Because their currencies are not widely used internationally, many of their bank liabilities are in euros. They can't print the euro liquidity that the banks desperately need. This renders them dependent on interest rate hikes to attract that euro liquidity via the market and on swap lines from the ECB. So far, those swaps have been forthcoming, but with delay and political baggage attached.

The implication is clear. National banking systems need a lender of last resort. In small countries, where a significant share of bank liabilities is in someone else's currency, the national central bank lacks this capacity. The only options are then to slap draconian controls on the banking system or join the euro area.

Given the difficulty of rolling back the financial clock and the constraints of the Single Market, it is clear which way European countries will move. One already sees a shift in public opinion toward euro adoption in Denmark and Sweden. Poland has reiterated its commitment to adopting the euro. Hungary, given the trauma of an IMF program, is certain to do likewise.

Obviously, the crisis will be economically and financial challenging for Eastern Europe. It will heighten the difficulty of meeting the convergence criteria for euro adoption. But it will also heighten the will to succeed.

The implication, then, is a larger euro area, not a smaller one, as more countries see the writing on the wall. Indeed, there are already signs of countries not even in the EU, notably Iceland and Switzerland, contemplating EU accession as a step toward adopting the euro and resolving their financial dilemma.

The one exception is probably Britain, whose currency is used internationally as a legacy of its history. In any case, Britain has always had one foot in Europe and one foot out. It is conceivable therefore that Europe will have two currencies, the euro and sterling, in the long run. But three, much less three dozen, are out of the question.

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