Three new lessons of the euro crisis

By Arvind Subramanian
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While some observers argue that the key lesson of the eurozone's baptism by fire is that greater fiscal and banking integration are needed to sustain the currency union, many economists pointed this out even before the euro's introduction in 1999. The real lessons of the euro crisis lie elsewhere – and they are genuinely new and surprising.

The received wisdom about currency unions was that their optimality could be assessed on two grounds. First, were the regions to be united similar or dissimilar in terms of their economies' vulnerability to external shocks? The more similar the regions, the more optimal the resulting currency area, because policy responses could be applied uniformly across its entire territory.

If economic structures were dissimilar, then the second criterion became critical: Were arrangements in place to adjust to asymmetric shocks? The two key arrangements that most economists emphasized were fiscal transfers, which could cushion shocks in badly affected regions, and labor mobility, which would allow workers from such regions to move to less affected ones.

The irony here is that the impetus toward currency union was partly a result of the recognition of asymmetries. Thus, in the aftermath of the sterling and lira devaluations of the early 1990's, with their resulting adverse trade shocks to France and Germany, the lesson that was drawn was that a single currency was needed to prevent such disparate shocks from recurring.

But this overlooked a crucial feature of monetary unions: free capital mobility and elimination of currency risk – indispensable attributes of a currency area – could be (and were) the source of asymmetric shocks. Currency unions, in other words, must worry about endogenous as much as exogenous shocks.

Free capital mobility allowed surpluses from large savers such as Germany to flow to capital importers such as Spain, while the perceived elimination of currency risk served to aggravate such flows. To investors, Spanish housing assets seemed a great investment, because the forces of economic convergence unleashed by the euro would surely push up their prices – and because there was no peseta that could lose value.

These capital flows created a boom – and a loss of long-term competitiveness – in some regions, which was followed by an all-too-predictable bust. To the extent that monetary and fiscal arrangements fail to reduce or eliminate moral hazard, the risk that capital flows create these endogenous asymmetric shocks will remain commensurately high.

A second insight from the case of the eurozone, advanced by the economist Paul de Grauwe, is that currency unions can be prone to self-reinforcing liquidity crises, because some vulnerable parts (Greece, Spain, Portugal, and Italy at various points) lack their own currencies. Until the European Central Bank stepped in last August to become the central bank not just of Germany and France, but also of the distressed peripheral countries, the latter were like emerging-market economies that had borrowed in foreign currency and faced abrupt capital outflows. These "sudden stops," as the economists Guillermo Calvo and Carmen Reinhart call them, raised risk premiums and weakened the affected countries' fiscal positions, which in turn increased risk, and so on, creating the vicious downward spiral that characterizes self-reinforcing crises.

The most appropriate analogy is with a country like South Korea. In the aftermath of the Lehman Brothers collapse in 2008, South Korea needed dollars, because its firms had borrowed in dollars that domestic savers could not fully supply. Thus, it entered into a swap arrangement with the Federal Reserve to guarantee that South Korea's demand for foreign currency would be met.

Of course, the euro crisis was not just a liquidity crisis. Several countries in the periphery (Greece, Spain, and Portugal) were responsible for the circumstances that led to and precipitated the crisis, and there may be fundamental solvency issues that need to be addressed even if the liquidity shortfall is addressed.

Finally, a less well-recognized insight from the euro-crisis concerns the role and impact of a currency union's dominant members. It is often argued that the United States, as the major reserve-currency issuer, enjoys what then French Finance Minister Valéry Giscard d'Estaing famously called in the 1960's an "exorbitant privilege," in the form of lower borrowing costs (a benefit estimated to be worth as much as 80 basis points).

There was always a downside – previously ignored but now highly salient in our mercantilist era – to this supposed privilege. If investors flock to "safe" US financial assets, these capital flows must keep the dollar significantly stronger that it would be otherwise, which is an unambiguous cost, especially at a time of idle resources and unutilized capacity.

But, in the case of Germany, exorbitant privilege has come without this cost, owing solely to the currency union. Weakness in the periphery has led to capital flowing back to Germany as a regional safe haven, lowering German borrowing costs. But, yoked to weak economies such as Greece, Spain, and Portugal, the euro has also been much weaker than the Deutschemark would have been. In effect, Germany has had the double exorbitant privilege of lower borrowing costs and a weaker currency – a feat that a non-monetary-union currency like the US dollar cannot accomplish.

The future of the eurozone will be determined, above all, by politics. But its development so far has forever changed and improved our understanding of currency unions. And that will be true regardless of whether the eurozone achieves the closer fiscal and banking arrangements that remain necessary to sustain it.

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