The Euro: No Economic Rationale for a Common Currency

There is no economic rationale for Europe having a common currency. The USD works in the US because there is a common treasury on top of the state governments and Federal taxes and benefits unite the US. Also, labor mobility is high, and the national identity is at least as strong as the state or regional identity.

Any economist of basic competence would have struggled to find an economic rationale for the Euro. Yet it went ahead 12 years ago as a work in progress with a weak or incipient form of fiscal alignment if not union in the form of the Maastricht criteria. It was recognized by the European leaders of the day that Maastricht was but a first step towards a closer fiscal union which would be necessary if the Euro were to survive. As it turned Maastricht was breached by every member including Germany and was allowed to lapse in 2010, probably when it was clear to all that fiscal union was a bridge too far.

While the Euro makes no economic sense, we have to realize that it was the product of political and not economic will. When Euro notes and coins were initially introduced, those who lived in Europe will recall the rise in inflation which was foreseen by many economists in the day, but who unfortunately were shouted down by the politicians. Beware the politicians and the loud. Human beings are susceptible to decibels and smart suits, and less accepting of logic unless it is suitably embellished by a silver or a forked tongue.

Pity the Germans. Since they were locked out of the embryonic European Union immediately following World War II they have paid dearly to be part of the Europe they once tried to conquer. And so with the implementation of the Euro sovereignty over monetary policy was transferred from the Bundesbank to the ECB. This came as a second blow to Germany which was only a few years into absorbing the East German economy and in need of a weaker currency and lower interest rates. Instead the Germans got chronic unemployment and higher inflation. This was the bargain for inclusion into the Euro club.

More than memories of the Great War, the Weimar Republic, World War II, more than a Teutonic tendency to eschew indebtedness and to require its repayment all else be damned, more than all this is the more recent memory of the price of Euro membership to Germany some twenty years ago, a price which Southern Europe seeks now not to pay. This is hard for the German to understand or bear. Germany is being asked again to pay.

More immediately and more topically, France and Germany are working desperately to avert a crisis in the Eurozone. Each has paid a price to have the Euro and are now likely to throw good money after bad to save a currency union which has no economic underpinnings. If it did, the world would have a single currency. Europe needs the Euro as much as Asia needs a common currency. While the risks to a Euro break up are high, the immediate damage in its wake to the banking system is too much to contemplate and so it is expected that some compromise solution will be hammered out which will allow the ECB to begin monetizing sovereign debt. The Germans will only allow this if there is a binding framework for centralized fiscal management of the Union and its members. A partial union has not worked, perhaps a more complete one might. This is misguided.

Fiscal union is only necessary to maintain monetary union. It is predicated on the logic of monetary union which is flawed. Be that as it may, fiscal union will indeed allow the Euro to survive. But years hence as countries look back to their subjugation to both a European Central Bank and possibly a European Central Treasury, how will they judge their investment? A central fiscal planner suffers from the same illogic as a central monetary planner. Countries in Europe will at different times require different fiscal policy. What is profligate for one may be thrifty for another. We give up efficiency for no good reason.

The sum of outcomes of separate individual optimizations is greater than or equal to the optimization of a sum of outcomes. This is a mathematical truism that is clearly overlooked by anyone seeking monetary or fiscal union.