The True Cost of the Euro

With the ECB warrantying that it will be lender of last resort to Euro zone governments it seems that the risk of a break up of the Euro is no longer. Be that as if may, as each day passes the cost of maintaining the Euro becomes more and more apparent. The charge is not one of market turmoil, sovereign funding cost, financial sector imbalances or fiscal discipline but a more fundamental issue of price discovery and factor and goods market equilibrium. If a single currency is to persist, domestic prices of all things, goods, services and inputs, need to be flexible so that markets clear. Yet we know that for various reasons wages tend to be sticky upwards, that is, wages are easier to raise than to lower. Labour laws and unions are the main reasons for this asymmetry of wage friction. As a result, the labour market fails to clear and we have Euro zone unemployment close to 12% with youth unemployment substantially higher and Club Med countries running at double the zone's average.
Taken together the common currency and current labour market regulations fail to clear the labour market.

More generally, a common currency requires factor price flexibility to achieve market clearing efficiency. The price of capital and land are less problematic. Land prices in Spain and Italy have been correcting since 2008.

This may impoverish home owners and impair consumption through a negative wealth effect but they are less debilitating and political. And the downward adjustment is economically a good thing. If governments then try to prop up housing values or interfere in markets for capital then the inefficiencies that plague the labour market will be replicated in these other factor markets. Capital markets already face inefficiencies arising from Basel rules and the Eurozone's own efforts at financial sector regulation that they need not be exacerbated in the Euro zone. Land is already facing its own analog of unemployment. This is the true cost of maintaining the Euro.

Now we are told of all the trade barriers that would automatically materialize should the Euro be dismantled. This need not be. It is, only because we make it so. Any new impediments would be political constructs which had been enacted and not some natural behavioral phenomenon.

Today, it seems the Euro is safe from fission, saved by the ECBs backstop. How long will it be before Euro zone leaders, economists and people realize the true cost of maintaining the Euro? It may not be an instantaneous, financial market crisis type event that breaks the Euro, just too many people unemployed for too long.