All that matters is the political will

Author:

Dr. Gertrud Traud
Chief Economist/Head
of Research
phone: 0 69/91 32-20 24
research@helaba.de

Editor:

Dr. Stefan Mitropoulos

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Landesbank Hessen-Thüringen
MAIN TOWER
Neue Mainzer Str. 52-58
60311 Frankfurt am Main
phone: 0 69/91 32-20 24
fax: 0 69/91 32-22 44

Is the current nervousness in the markets attributable solely to the Greek tragedy, or is it instead the expression of a general risk aversion vis-à-vis countries that are deeply in debt? Accepting the dissolution of the European Currency Union is not a meaningful approach to finding a solution.

Still no calm in the markets

I was wrong: a couple of days ago I still assumed that a swift loan guarantee to Greece in combination with a tough austerity program would calm the markets. That has not happened, at least not yet.

Generally rising risk aversion

Is the current nervousness in the markets attributable solely to the Greek tragedy, or is it instead the expression of a general risk aversion vis-à-vis countries that are deeply in debt? Accepting the dissolution of the European Currency Union is not a meaningful approach to finding a solution.

Theory of optimal currency areas

The question of which countries should join into a currency union already preoccupied me as a young academic – in the mid-90s in the lead-up to the European Currency Union. My doctoral dissertation examined the question which countries in Europe should join on the basis of the theory of optimal currency areas. Unfortunately there is no single approach to determining an optimal currency area, which means that depending on the criteria that are used, different European countries can be brought together to form an optimal currency area. Back then this led me to the conclusion that the actual composition of the European Currency Union would in the end always be also a political decision.

Economic factors alone not decisive

We now know that this is exactly what happened: the program was from the beginning the creative interpretation of the convergence criteria. One should recall Belgium, for example, whose participation in the European Currency Union was never questioned in spite of a debt level that was well over one hundred percent of its GDP. Even the Stability Pact was not able to put a stop to the violation of the Maastricht criteria.

Deficit limits can be traced back to criteria of homogeneous preferences

Even if the deficit limits of the Maastricht Treaty cannot be derived directly from the theory of optimal currency areas, the criterion of homogeneous preferences can still be invoked. This theory posits that the greater the differences in preferences, the greater the danger of instability to the currency union. If we look at the current debt situation of the Euro countries, we can certainly observe differences, for example, in the current deficit for 2010, which ranges from just under 4 % in Luxembourg and Finland to more than 10 % in Greece and Ireland – but all exceed the 3 % limit of the Maastricht Treaty. One could thus almost argue that the preferences of all Euro countries have shifted toward higher levels of debt and are thus relatively homogeneous.

Deficit limit makes stability easier to achieve

The decisive reason for a deficit limit in the lead-up to and within a currency union lies in the fact that accession to a currency union makes debt management practically impossible for a joining country. Relinquishing a separate, national monetary policy should therefore occur only when a country has substantially reduced its debt and is able to finance its expenditures. But what happens when a country has already joined the currency union?

Start of the currency union in favorable times

Fortunately enough, the first ten years of the European Monetary Union coincided with a phase of declining rates of inflation worldwide and waning risk aversion. The convergence of yields at a low level made it easy for the ECB to fulfill its task. The acid test is taking place only now, after the expansionary fiscal policy in recent years led to excessive levels of debt in many countries. The various countries, having lost the exchange rate instrument, must now bring down their deficits increasingly through austerity measures. In addition, there is growing pressure on the ECB to support the expansionary fiscal policy in monetary ways.

ECB under pressure

It would therefore be premature to strike up a swan song to the European Currency Union. In opting for monetary tools, the ECB now is merely choosing the path that the Fed or the Bank of England also chose. Thus, my studies fifteen years ago showed that the durability of a currency union is not determined by either economic or institutional factors. Only political factors provided a clear result. What is needed now are unambiguous political signals that the European Currency Union is not merely a fair weather phenomenon.

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