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The Euro: It Happened, It's Not Reversible, So… Make It Work

Rejoinder to the comments on: "It Can't Happen, It's a Bad Idea, It Won't Last. U.S. Economists on the EMU and the Euro, 1989—2002." Link

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Abstract

According to Paul Krugman (2010c), our paper—critically assessing the analysis of the U.S. economists in the 1990s and appearing in January 2010—was "spectacularly ill-timed." We do not concur. The publication of our survey is spectacularly well-timed, as the arguments of the 1990s have been given new life by the present crisis in the euro area. Some U.S. economists commenting in the 1990s on the single currency such as Barry Eichengreen, Martin Feldstein and Paul Krugman are back in the current debate, refreshing their analysis and arguments of yesterday.

We are grateful for the responses to our paper. Our rejoinder consists of two parts. First we comment on our nine distinguished commentators. Next, we consider current events in the euro area from the perspective of the views presented in the 1990s by U.S. economists on the EMU.

Looking back…

The nine commentators on our paper are in basic agreement with our survey—with some minor exceptions. In this rejoinder we cannot do justice to the wide variety of views. Still, we dare conclude that there is one theme that permeates

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the comments. It is also a theme where the opinions of the commentators are converging. They stress the political dimension of the euro project, in this way being skeptical of the abstract economic approach attached to the theory of the optimum currency area (OCA). Fred Bergsten (2010) explains that the U.S. analysis of European monetary unification during our survey period was focused almost entirely on economics with only general references to political forces. According to him, his political economy approach made him a "euro enthusiast," different from most U.S. economists during this time.

Jeffrey Frieden (2010), as a political scientist, Charles Goodhart (2010), Steve Hanke (2010) and Otmar Issing (2010), a former member of the executive board of the ECB, all emphasize the political dimension underpinning the euro. The same holds for Selgin (2010) and Vaubel (2010). Vaubel strongly argues that politics drove the creation of the euro by referring to his own research into the German acceptance of the single currency as a part of a bargaining between France and Germany during the German reunification.

Peter Kenen (2010) defends the use in the 1990s of the OCA model, in spite of it being ahistorical and apolitical, with the argument that it was the only analytical framework available for economists. We agree with his view. Indeed, an analytical approach is necessary for understanding the economic implications of a monetary union. The OCA approach gave the economics profession such a tool in the 1990s, although, as McKinnon (2010) shows, Robert Mundell, the founder of the traditional OCA theory—moved away from this framework already in the early 1970s. In our view, U.S. economists pushed its use too far, however, ignoring elements *not* included in the OCA paradigm.

The commentators' emphasis on the political dimension is consistent with our original argument that the adoption of the OCA paradigm by US economists as their analytical framework "was the main source of U.S. pessimism towards the single currency in the 1990s "(Jonung and Drea 2010, 37). We stressed that the OCA view was a static one, preventing the Americans from appreciating the evolutionary and political nature of the process of monetary unification in Europe: "Monetary unions have not been established according to the optimum currency area criteria. The approach ignores the political and historical factors driving integration "(36).

Regarding the performance of the euro during the past 10 years, the commentators diverge. Some of them view the euro as a success—such as Bergsten and Issing. To improve euro area performance, they propose economic reforms and recommend steps fostering fiscal discipline. Others like Hanke and Vaubel are critical. Hanke fears that the European Union will hinder "much-needed European economic liberalization" and points to his own preferred solution for Europe: a currency board arrangement where the German currency is the key currency.

Vaubel believes that the euro started to underperform once the Germans lost full control of the ECB. Concerning the future, Vaubel is pessimistic. Germany has lost its strong currency and has received the euro as a weak replacement.

Looking forward…

Our survey covers the debate among U.S. economists on the single currency starting from the publication of the Delors Report in 1989 and ending with the introduction of euro notes and coins in January 2002. Now the euro has existed for more than a decade.

The publication of our survey coincides with the deepest crisis that so far has emerged within the euro area, developing in the shadow of the global depression. The current fiscal and financial difficulties facing euro area members like Greece and Ireland have resulted in a lively debate on the sustainability of the single currency, breathing new life into the *It's a bad idea* camp of euro observers following the taxonomy developed by Rudiger Dornbusch (2001). Some of the members of this group in the 1990s like Martin Feldstein and Paul Krugman have returned to their initial objections.

Feldstein (2010), active as a leading—if not the leading—euro-sceptic in the 1990s has recently concluded that "The European economic and monetary union is doubly flawed. First, it forces diverse countries to live with a single interest rate and exchange rate that cannot be appropriate for all members. Second, combining a single currency with independent national budget policies encourages fiscal profligacy."Paul Krugman (2010b) views the "Making of a Euromess" as being directly attributable to "the arrogance of elites—specifically, the policy elites who pushed Europe into adopting a single currency well before the continent was ready for such an experiment."

The euro crisis has also awoken the *It won't last* camp, although no leading U.S. economist at this stage has openly announced imminent collapse. Rather, the current financial turbulence has actually increased the demand for euro membership among EU members outside of the euro area.

Concerning the future of the euro, U.S. commentators on the euro like Eichengreen (2010) and Krugman (2010a and b) suggest further political integration in the EU as a likely response to the crisis. Eichengreen (2010) views the current economic downturn as providing the impetus for deeper integration and highlights that this requires "not just closer economic ties, but also closer political ties. Those running a strong emergency financing mechanism will have to be strongly accountable. They will have to answer to a strong European Parliament." Krugman (2010b) expects several years of political and economic uncertainty characterized by "bailouts accompanied by demands for savage austerity, all against a background of very high unemployment."

Today we see a strong awareness among U.S. economists of the political will in shaping the euro project. For all the faults of the euro—and the majority of U.S. economists commenting on the euro, now as well as in the 1990s, are convinced there are many—the current attitude may be summed up by Krugman's (2010a) characterisation of the euro as "it happened, it's not reversible, so Europe now has to find a way to make it work."

It is fair to say that this is what Europe is doing presently. As in earlier crises, Europe is trying to learn from the past to improve upon its policies and institutions. A number of steps have already been taken like new institutions to strengthen financial supervision. More is in the pipeline. This process of learning and adaptation to new challenges is vital for the success of the euro.[3] It will determine its future.

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3. This point is stressed by Jonung (2002). Learning from the present crisis is a theme among many commentators of the euro today. See for example Regling et al (2010).

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