Eurozone economy

A split euro is the solution for Europe's single currency

The problems with the structure of the eurozone may be insurmountable, writes Joseph Stiglitz

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That Europe, and especially the eurozone (http://www.ft.com/topics/themes/Eurozone_economy), has not been doing well since the 2008 crisis is beyond dispute. The single currency was supposed to bring prosperity and enhance European solidarity. It has done just the opposite, with depressions in some countries greater than the Great Depression.

To answer the question about what is to be done, one has to answer another: what went wrong. Some claim that policymakers made a set of mistakes — excessive austerity and poorly designed structural reforms. In other words, there is nothing wrong with the euro that could not be fixed by putting someone else in charge.

I disagree. There are more fundamental problems with the structure of the eurozone, the rules and institutions that guide and constitute it. These may well be insurmountable, raising the prospect that the time has come for a more comprehensive rethinking of the single currency, even to the point of unwinding it.

Put simply, the euro was flawed at birth. It was almost inevitable that taking away two key adjustment mechanisms, the interest and exchange rates, without putting anything else in their place, would make macro adjustment difficult. Add to that a central bank mandated to focus on inflation and with countries still further constrained by limits on their fiscal deficits, the result would be excessively high unemployment and gross domestic product consistently below potential output. With countries borrowing in a currency not under their remit, and with no easy mechanism for controlling trade deficits, crises too were predictable.

The alternative to adjusting nominal exchange rates is adjusting real ones — having Greek prices fall relative to German prices. But there are no rules in place that could force a rise in German prices and the social and economic costs of forcing Greek prices to fall enough are enormous. One might dream of Greek productivity growing faster than that of Germany as an alternative way of "adjusting," but no one has figured out how to do it. So too for Spain and Portugal. In the absence of a grand strategy, the troika of international institutions has flailed around, putting in place new rules for defining fresh milk or the size of loaves of bread. Whether these are desirable can be debated; that they are not going to achieve the desired adjustment in real exchange rates cannot.

The rule changes needed to make the euro work are in an economic sense small. A common banking union, most importantly common deposit insurance; rules to curtail trade surpluses; and eurobonds or some other similar mechanism for mutualisation of debt. Monetary policy to focus more on employment, growth and stability, not just inflation. Meanwhile, industrial and other policies should be orientated to helping the laggard countries catch up to the leaders. Most importantly: a move away from austerity towards growth-oriented fiscal policies (http://next.ft.com/content/bb4f7be8-607f-11e6-b38c-7b39cbb1138a). But these seem well beyond the politics of Europe today, with Germany still arguing that "Europe is not a transfer union".

Good currency arrangements cannot ensure prosperity; flawed ones lead to recessions and depressions. And among the kinds of currency arrangements long associated with recessions and depressions are pegs, where the value of one country's currency is fixed relative to another. A single currency is neither necessary nor sufficient for close economic and political co-operation. Europe needs to focus on what is important to achieve that goal. An end to the single currency would not be the end of the European project. The other institutions of the EU would remain: there would still be free trade and migration.

It is important that there can be a smooth transition out of the euro, with an amicable divorce, possibly moving to a "flexible-euro" system, with say a strong Northern Euro and softer southern euro. Of course, none of this will be easy. The hardest problem will be dealing with the legacy of debt. The easiest way of doing that is to redenominate all euro debts as "southern euro" debts.

As we move to a digital economy, modern technology enables a set of market-based reforms that can simultaneously achieve the triple goals of full employment, trade balance, and fiscal balance, through credit auctions and electronic trade tokens. In the current global system, we rely on central banks to set interest rates (http://next.ft.com/content/e979d096-5fe3-11e6-b38c-7b39cbb1138a), hoping somehow that the resulting trade balance, investment, and consumption will be "right." They typically aren't. The alternative approach focuses on the quantities of, say, investment and trade balance, that we need, and lets the market set the price to achieve this.

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Over time exchange rate variations could become more limited as institutions develop. The flexible euro is a strategy for incorporating the advances in economic integration already made while providing the space for reforms.

The single currency was supposed to be a means to an end. It has become an end in itself — one that undermines more fundamental aspects of the European project, as it spreads divisiveness rather than solidarity. An amicable divorce — a relatively smooth end to the euro, perhaps instituting the proposed system of the flexible euro — could restore Europe to prosperity and enable the continent to once again focus, with renewed solidarity, on the many real challenges that it faces. Europe may have to abandon the euro to save Europe and the European project.

The writer, a Nobel laureate in economics, is author of 'The Euro: How a Common Currency Threatens the Future of Europe'

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