The Eurozone crisis does not necessarily prove that a monetary union also requires fiscal/political union.

by Blog Admin

A common argument is that the Eurozone crisis necessitates greater fiscal and political integration among countries using the single currency. **Simon Wren-Lewis** *disputes this idea, arguing that we should be cautious about forming concrete conclusions from a single observation. He states that the lesson of Eurozone failure is largely about bad design, rather than disproof of concept.*

Is a monetary union without fiscal/political union doomed? This seems to be a very common view at the moment. The view that the Eurozone will have to move to fiscal union, which implies some form of political union, comes from two directions.

First, those working in the political unions that are the United States or the United Kingdom, know combined monetary and fiscal unions can work. From this perspective, the monetary only union of the Eurozone was a largely untried experiment, and it appears to be failing. (For just one example of this view, see Acemoglu and Robinson here.) Let me rephrase that: it is failing. The perpetual crisis of the markets may be over as a result of OMT [1], but the crisis that is unemployment in the periphery just gets worse. (Kevin O'Rourke puts it bluntly but accurately here.)

Second, within the Eurozone itself, there has always been a powerful lobby for further integration. It is therefore not surprising that actors like the Commission see further integration as the longer term solution to the Eurozone's problems.

Yet we should be very cautious about making generalisations from a single observation. It may be worth reminding ourselves about why the Eurozone has not been a fair test of monetary union without fiscal union:

First, the crisis of competitiveness was partly a result of a mistaken belief in the market that default risk on everyone's debt was similar to German debt, a mistake that is unlikely to occur again in decades. In the years before the recession, no attempt was made to use fiscal policy to offset overheating in periphery countries. (For more on why countercyclical policy is key, see Antonio Fatas here.)

Second, in probably only one case, Greece, was there a clear problem of underlying fiscal excess. Yet instead of recognising the need for default early on, the union made a futile attempt to avoid it by replacing private debt with intergovernmental lending, which had disastrous consequences. This major and avoidable error produced the worst moment of the crisis, when Greece was threatened with exit. It continues to impose a disastrous degree of austerity on Greece.

Third, the fiscal position of other Eurozone economies became critical because the ECB refused to act as a lender of last resort. If the ECB had introduced its OMT programme two years earlier than it did, the crisis might well have dissipated very quickly. This is hardly wisdom from hindsight, as anyone reading Paul De Grauwe (or indeed my blog) will know. Market reaction always had much more to do with the ECB than the fiscal position of the countries involved, an observation that inspired my first blog post and which research confirms.

Fourth, the current double dip recession in the Eurozone is largely about a collective failure of fiscal and monetary policy. The position of the Eurozone would look significantly better if the ECB acted more like the US Fed, and if Germany and other fiscally untroubled economies were less obsessed with austerity. Neither has much to do with the absence of fiscal union.

To use evidence from one very badly designed test case to condemn the whole concept of monetary union without political union is far too hasty. It is also potentially very dangerous. We should not forget that monetary union itself was encouraged by a belief that the fixed exchange rate regime that preceded EMU was untenable because of market pressure. (For more on the origins of the euro see Harold James here.) The lesson of Eurozone failure so far is mainly about bad design, rather than disproof of concept. If this failure leads to a fiscal and monetary union imposed from above on an unwilling electorate, by an elite that played such a big part in creating the current failure, we may go on to find out that a badly conceived political union could be even more disastrous than a badly designed monetary union.

[1] The ECB's programme to become a conditional lender of last resort

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