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Book Review

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Book review

Stiglitz, Joseph E. (2016): *The Euro: How a Common Currency Threatens the Future of Europe*, New York, NY, USA and London, UK (416 pages, W.W. Norton, hardcover, ISBN 978-0-393-25402-0)

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There are a number of books on the eurozone crisis but Stiglitz's book is special. Like many others, he argues that the euro was flawed at birth, not only due to the fact that a common currency abandons national monetary and exchange-rate policy, but also because of the set of institutions that came with and after the Maastricht Treaty of 1992. This design of the euro is seen as a toxic mix of ideology and misguided economics that can at best survive by muddling through with high costs. Reforms are possible, despite the birth defect, but they are difficult and unlikely, so he recommends the second-best alternative of an 'amicable divorce' or 'a flexible euro', both breaking up the eurozone into parts.

The book comprises four parts. Part I describes 'Europe in crisis'; part II analyses why the euro is 'Flawed from the start'; part III criticizes 'Misconceived policies'; and part IV searches for 'A way forward?'. The eurozone crisis is not only a crisis of dismal performance over the long haul since the zone's inception in 1999, with poor growth, immense unemployment, and a trend towards divergence rather than convergent integration. It is a threefold systemic crisis of the euro as a common currency, the main institutions embroiled in the Maastricht and later treaties (for example, the Stability and Growth Pact and subsequent fiscal regulations and the provisions for the European Central Bank (ECB)) and the policies enacted within the institutional setting. The underlying ideology of the founding fathers was predominantly market fundamentalism, in which there was a belief in the capacity of goods, labour and financial markets to generate and sustain full employment and to enable catching-up growth in less advanced countries, as long as an independent central bank with a hard currency and strict monetary policy, targeted at a single goal, is established. Such a monetary union can be enlarged to include diverse economies, as long as the convergence criteria are fulfilled.

The initial consensus among the fathers of the euro included the absence of a federal state, no political union with a full fiscal union entitled to issue bonds (apart from a minuscule budget relative to GDP), national fiscal policies constrained by straitjacket rules leaving little fiscal space, no unified banking regulation, no concepts for centralized or coordinated national expansionary fiscal policy in recessions, a strict no-bail-out prescription regarding over-indebted members, and a disregard or even a prohibition of national industrial policies. Stiglitz's main criticisms of this consensus can be summarized as follows: the currency system is as rigid as the gold standard, providing no substitute for nominal exchange-rate realignments but coupled with free trade and cross-border capital mobility; failure of internal devaluations as a potential replacement since they would function in a deflationary manner, prone to depression and financial crisis; the system tends to

low growth and depression, and has built-in pro-cyclicality mechanisms with asset-bubble-driven growth episodes; the system tends to divergence among member nations with current-account imbalances and a divide between surplus and deficit countries without policies for rebalancing, and an especially high vulnerability of countries exposed to asymmetric shocks, which are mainly the weaker deficit countries.

At first sight, much of what Stiglitz offers looks convincing, even though there is a strong overlap with mainstreamer Martin Feldstein's (1992) early critique of the Maastricht Treaty, in which Feldstein alluded to the first generation of the theory of optimal currency areas (OCA) from Robert Mundell (1961), as does Stiglitz. Stiglitz, however, adds the critical role of pro-cyclical fiscal policy. But there are a number of points which both authors overlooked.

First, they disregard the second generation of OCA theories to which Mundell (1973) turned in the early 1970s, joined by Ronald McKinnon (2002) and others. Monetary advantages of currency unions were now brought to the fore, resulting in a call for larger unions despite a lack of factor mobility and despite exposure to asymmetric shocks and the absence of fiscal federalism. Under a common hard currency, country risk premiums would melt down, in parallel with high inflation rates, to the level of the best performers, leading to lower interest rates. This could induce more investment and growth in countries with formerly higher inflation and reduce the costs of public debt. Strengthening the role of all functions of money with network advantages adds to monetary advantages. Furthermore, doubts about the capacity of flexible exchange rates to adjust current accounts were grounded in foreign currency debt which increases the burden of debt when depreciating the currency, apart from widespread experience of the pass-through of costs for imported goods and elasticity pessimism. Despite the valuable ideas of the second OCA generation, both generations suffer severe shortcomings, such as underrating the role of a common state, necessary (at least to some extent) for a common currency, and the potentially hazardous role of liberalized finance under segmented and deregulated national financial systems.

Second, Stiglitz seems to see the root of the eurozone malaise as being within the euro itself, that is, the abandoning of adjustable nominal exchange rates. If this shortcoming could not be corrected, the euro would indeed be doomed to fail. However, Stiglitz adds in the same breath that Maastricht lacks 'complementary institutions', meaning that a common currency could work if institutions were reformed. This ambiguity permeates all chapters of the book. Interestingly, in the chapter on euro reforms he shows that in principle the problem could be solved by internal revaluation of the surplus countries or Keynes's proposal for taxing surpluses. He adds a novel proposal from Warren Buffet calling for a system of tradeable import licenses ('chits') for deficit countries (and/or export chits for surplus countries). A quasi exchange rate would be reintroduced via a variable tax (or fee) on imports (or exports). The proposal is interesting but not elaborated in detail.

What is less heeded by Stiglitz is the fact that imbalances in the eurozone are largely due to growth differentials and to divergent specialization of member economies. Germany's export structure overlaps only a little with most of the other eurozone members, and its imports come less and less from the eurozone and more often from production networks in Eastern Europe and elsewhere. This creates a deep technological divide within the eurozone and the European Union and makes realignments of the real exchange rate, say by internal de- or revaluation, less effective.

Third, too little attention is paid to the no-bail-out clause in the European Treaties, combined with the very strict prohibition of monetary financing of the ECB and reinforced by the even stricter interpretation of some national courts and by the European

Court of Justice. This undermines the capacity of the ECB to purchase the sovereign bonds of all its members and to use them as collateral for providing liquidity, irrespective of their sovereign debt. It opens the door to risks of state bankruptcy and self-fulfilling speculative attacks on bonds from indebted governments. Such risks did not (and do not) exist in advanced countries with their own currencies after the Second World War, except in Iceland. The background for this jurisdiction is the fear of moral hazard toward tolerance for fiscal profligacy, undermining 'sound finance', harming the balance sheet of the ECB and forcing neighbour states to bail out debtors. It is especially the German obsessive fear of risk-sharing that leads to a *de facto* transfer union and a fiscal federation, thereby risking the break-up of the monetary union. Yet Stiglitz seems to be aware of the problem, and proposes a system of eurobonds which could indeed heal the flaw, if eurobonds abide by existing European and national laws.

Regarding policies in the eurozone, enacted mainly by the European Council, the informal Euro Group, the IMF and the infamous 'Troika', are rightly criticized by Stiglitz. He emphasizes the flaws of austerity and the underlying concept of expansionary fiscal contraction, and so-called 'structural reforms' which target the long run and often have no positive effect on growth in the short and medium run. Many of his arguments are focused on Greece, the most extreme case.

The reform agenda proposed for creating a eurozone that works is long, ambitious and Keynesian in its nature. Most proposals are not new but have been rejected time and again or are still in the making. To mention some: a uniform banking union, including mutual deposit insurance across states; new fiscal policies with an array of proposals (change of the fiscal convergence criteria; inclusion of a 'golden rule' for debt-financed public investment; a solidarity fund for distressed members; automatic stabilizers); convergence policy (including real revaluation in Germany by wage increases and expansionary fiscal policy); coordination of tax policy to avoid races to the bottom; a European tax on high income; debt restructuring; rules for state insolvency; and a new mix of monetary and fiscal policy in the face of limitations of monetary policy. Some proposals would apply to many countries. None of the proposals is explained in detail.

Much of the reform agenda requires changes in the treaties, that is, unanimity among members. It is argued that the main barrier to reforms is Germany's stance, as the hegemon in the eurozone. The main reasons why Germany is such a stubborn opponent are not really analysed, although an inkling may be gleaned between the lines. Apart from deep-rooted ideology among the leading groups of politicians and economists, it is the fear of establishing a European federal state to which nation states would have to succumb; Germany might lose its hegemonic position and become the paymaster for its neighbours since majority rule would be instituted. Behind these fears is the missing institutional blueprint about how the 'halfway house' (as Stiglitz christens it) can be transformed into a workable and democratic currency union which incorporates some important functions of a common state, though not a full federation as in the US or within Germany.

Stiglitz concludes that since his reform proposal or other similar ones are unlikely to find consensus, different options for the orderly dissolution of the eurozone should be envisioned. The first option proposed is an 'amicable divorce' of some member states which would exit the euro in a bloc, starting with a new bloc currency, devaluing and restructuring collaboratively their external debt. The second option, of a 'flexible euro', would entail the breaking-up of the eurosystem into several country groupings (perhaps three), which would return to floating or managed exchange rates as under the erstwhile European Exchange Rate Mechanism (the ERM, 1979–1998). At a later stage, a new attempt to start a common currency might come, once the institutional preconditions are given. Both options seem very similar.

Only some 30 pages are devoted to the two exit proposals. A discussion of the literature that estimates the costs of dissolving the euro as being extremely high is missing. The main economic problem is the restructuring of euro-denominated assets and liabilities, especially if one takes gross assets and liabilities into account. Managing such a restructuring would most likely lead to a full-blown financial crisis. If it could be done in an orderly manner, the political power of governments and European institutions would be strong enough to reform the euro, since it is the concomitant institutions rather than the common currency that are flawed. A return to the ERM, which was dominated by German hegemony and disliked by almost all participants, would mean turning the clock back. The reviewer wonders at the sanguinity of an author with so much international experience in this subject.

The overall message of the book is this: the euro was *not* really flawed at birth and could in principle be reformed, but due to the many roadblocks and for the sake of avoiding kicking the can endlessly down the road, exits seem unavoidable. Stiglitz asserts, nonetheless, that he is in favour of the reform option. The book provides many good insights, written by and large in non-professional language for a broader readership, and should be read as a wake-up call for reform, rather than for exit.

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