Foundations of the Euro Crisis

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Contradictions in the Euro

1. The 17 member countries are not an optimal currency area – too many countries too unlike each other.

2. The euro has a severe governance problem: it is a monetary union without a political union.

3. The European Central Bank increasingly holds the debt of stressed governments and banks.
Optimal Currency Areas (OCAs)

- The theory is well worked out:
  - Mundell (1961), McKinnon (1963), Kenen (1969)

<table>
<thead>
<tr>
<th>Elements of an OCA</th>
<th>The Euro-Zone</th>
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<tbody>
<tr>
<td>Similar inflation rates</td>
<td>Max Greece 4.7%, Min Ireland -1.6%</td>
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<tr>
<td>Fiscal and political integration</td>
<td>Poor</td>
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<tr>
<td>Price and wage flexibility</td>
<td>Good in north, Poor in south</td>
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<tr>
<td>Labor mobility</td>
<td>Moderate</td>
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<td>Economic openness</td>
<td>Trade/capita €34.4k Ireland, €24.4 Greece</td>
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<tr>
<td>Financial market integration</td>
<td>Good</td>
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Source: Eurostat
Country Differences

• Germany has substantially improved productivity in the past ten years.
  – Wage restraint
  – Liberalization of regulations
  – Openness to global competition

• Greece, Portugal and other southern countries have lagged in productivity.
  – Competition restricted by regulations
  – Local monopolies
  – Restrictive labor practices
Greek / German Price Level

Source: Eurostat
Pre-Euro Currency Divergence

Source: Eurostat
Euro-zone Current Accounts (€ b)

Source: Eurostat
Exchange Rates Matter

Industrial production gap began with the Euro Index, 12/31/1998 = 100, sa

Source: OECD.