

# The Washington Times

## GOKHALE: Beginning of the end for the euro?

### Greece's fate might signal destiny of Europe's common currency

By Jagadeesh Gokhale, 06/06/2012

The euro was introduced as part of the Stability and Growth Pact of 1999, which also prescribed clear fiscal guidelines for member nations to limit public debts and deficits, and ensure the economic stability needed for the European Central Bank's conduct of a common European monetary policy. It is now clear that this was an impossible dream for such disparate economies as Greece and Germany. But are Spain, Italy and France also too far from being able to repair to those guidelines? That will depend on fiscal policy stewardship during the next few months - and on whether the euro survives.

Rising debt in southern European countries threatens the euro's dissolution just 13 years after it was introduced. Opinion is now divided about whether the euro can survive Greece's exit, or Grexit, as wags have dubbed it. The outcome hinges on upcoming elections in Greece. There may be some hope if Greek voters decisively restore power to pro-bailout parties, but none if they strengthen extremist, anti-bailout parties or if the election result remains inconclusive. Under the latter two scenarios, Greece will run out of time and money too quickly to prevent institutional chaos in the short term. If Greece does exit the euro and reintroduces the drachma, it will regain economic competitiveness over time but only after undergoing a large devaluation, inflation and significant austerity for current generations.

What is the correct policy course that the stronger countries - led by Germany - should follow to prevent Grexit and restore the preconditions of stability and growth? Should they offer Greece more stimulus funds and relaxed austerity conditions? Or should they insist on implementing the current bailout agreement regardless of the election outcome in Greece? Both strategies involve insurmountable hurdles.

Offering better bailout terms to Greece makes sense if it would effectively end the recession and restore economic stability, if not kindle positive growth. That would not mean the end of austerity, which might even be prolonged as a result of past government overspending, and benefits would remain curbed for a longer period to restore an acceptable debt level. Unfortunately, Greek elections will occur first, with voters unsure of what, if anything, Germany might offer under a revised bailout deal. Symmetrically, the Germans remain unsure of the impact of any pre-election offer on the election outcome. Such a "pseudo negotiation under blinders" is unlikely to yield a positive result.

Were Germany to make a pre-election offer of better bailout terms to Greek voters or agree to an indirect bailout of weaker countries through the introduction of eurobonds, what effect would it have on the French, Spanish and Italians? Germany's policymakers must worry about whether these countries would conclude that their own austerity policies could be relaxed and, indeed, that stronger debt-financed stimulus policies should be introduced. But such policies could cause higher short-term deficits without much impact on economic growth in those countries. After all, the recent record of fiscal stimulus policies has been far from stellar among developed economies. If deficits surge but growth stalls, will German taxpayers be forced to carry even larger bailout burdens? And the option of issuing eurobonds - to enable the European Central Bank to conduct EU-wide monetary policy more freely - would constitute just another German bailout and lead to a reduction in weaker countries' borrowing costs at the expense of higher borrowing costs for Germany.

On the other hand, denying better bailout conditions is likely to further harden the attitudes of Greeks, who now perceive little difference between strong German-imposed austerity and the chaos likely to follow Grexit. This outcome is also dangerous as a Greek default on foreign debt contracts will weaken banks throughout the EU and induce additional debt-financed sovereign bank bailouts. Investors are already wondering whether the recently announced bailout of Bankia by Spanish authorities is just the tip of the iceberg. Spanish interest rates already have climbed beyond levels that triggered the first Greek bailout deal, but there is no possibility of a similar deal for Spain - the money is just not there.

Even if European policymakers emerge from the crisis and are successful in saving the euro, its fundamental disadvantages are clear: At the cost of giving up control over national monetary policies, the common currency system was to provide greater price transparency and promote economic efficiency by exploiting regional differences in competitiveness across economic sectors. In reality, the euro succeeded only in delivering the exact opposite.

The path toward European political union is not through a common currency system, which is proving to be increasingly divisive. It may be time for policymakers in Brussels to collectively plan for the dissolution of the euro and revert to a system of individual currencies, free trade and floating exchange rates to restore the pre-1999 status quo.

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