How the euro went from unifying force to divisive one

by Sabri Ben-Achour (/people/sabri-ben-achour)
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The euro hit the streets of Europe in 2002 with much fanfare. It was seen at the time by many as a tangible, unifying force.

Then things changed.

“The euro has been much more of a divisive force since the crisis,” says Carmen Reinhart, professor of international finance at Harvard, referring to the global financial crisis.

The euro became divisive because the different economies of different countries needed the currency to do different things.

“Periphery Europe really needed a cheaper euro, a depreciation, whereas the creditor countries like Germany did not,” Reinhart says.

The strain sent Europe’s economies in different directions and revealed the fissures between them. But this wasn’t because the euro had pulled them apart; rather it was that the currency wasn’t enough to hold them together. Currency unions need much more than currency to be successful.

“The idea was that monetary union would only work if it led to banking union, fiscal union, and political union,”
says Barry Eichengreen, professor of finance at University of California, Berkeley. “The belief was that those other good things would follow.” But they didn’t.

Campbell Harvey, professor of finance at Duke, says the motivation to do so wasn’t there. “Given that economies were growing, people didn’t think it was urgent to implement the next step.”

The banking systems are not fully integrated. At different times, fearful Europeans have taken deposits out of banks not only in Greece but also in Ireland, Spain, Portugal and Italy, says Harvard’s Reinhart, out of fear that individual national banking systems might fail.

Nor are there sufficient ways to cope with the fact that individual countries don’t have recourse to individualize monetary policy. An instructive comparison can be made with the United States. Fifty different states with different economic needs could theoretically benefit from having individual currencies and interest rates. Yet they all share the dollar without incident.

“The key difference is that the U.S. also has a banking union and a fiscal union,” Reinhart says.

“In the U.S. we have the Fed,” says Harvey. “They set the monetary policy, whereas in the eurozone, you have all these individual central banks to get agreement from. The European Central Bank is really shackled by a decentralized system.”

The federal government in the U.S. also reallocates resources between different parts of the country to create a buffer for economies suffering during a downturn.

“Certain areas of the U.S. are at certain times net payers to other parts of the U.S.,” says Stephan Siegel, who teaches finance at the University of Washington in Seattle. Income taxes collected in one region may be used to support federal benefits somewhere else.

In Europe, those "certain areas” are Germany and Greece, for example. That creates political tensions when it comes to moving resources.

In the U.S., “we’ve created a lot of these [resource reallocating] institutions before it was clear which way the transfer and funds would go,” says Eichengreen. “So we have the FDIC to step in to use federal taxpayers' money to resolve a bad bank when there is a banking problem in Nevada or Florida. But when we set that fund up it wasn’t clear whether the transfers would go from Florida to Nevada or Nevada to Florida. Now in Europe everyone knows the transfers will go from Germany to Greece.” And that’s where things can get nasty.

“In Europe you don’t have this, where by default a German taxpayer would help out Greek or Spanish or Italian citizens hit by economic shocks,” says Siegel. “And you don’t have at least any type of European institution that could step into the market to raise funds to offer support. This is all left to the individual country in Europe, whereas in the U.S., it’s happening at the federal level. That federal level is absent in Europe.”

Europe, despite its open borders, also lacks a degree of labor mobility, according to Duke’s Campbell. “So when you don’t have the mobility to relocate,” he says, “then it’s much more difficult to have a common currency.”
If you can’t move to a different economy, you want to change your own – which is exactly what European countries can’t do under the euro. In short, says Campbell, European unity requires much more than a currency.

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