

EMU 2.0: Building a Durable Monetary Union in the Eurozone.

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Summary

The Eurozone is a limited construct, essentially a currency union, lacking the structures for crisis prevention and resolution required in a full monetary union.

Europe's financial crisis has arisen in the context of a worldwide liquidity bubble which has afflicted banking systems inside and outside the Eurozone. The intensity and persistence of the crisis in Europe and the protracted policy response have revealed serious weaknesses in the design of the Eurosystem. The policy response has focussed on short-term measures only—liquidity provision to banks and the correction of budget deficits—and on the prevention of future fiscal excess rather than on reforming the monetary system. Four years after its onset the crisis remains unresolved. This paper argues that recurring crises are likely unless a more fundamental re-design is undertaken.

In a currency union financial imbalances can arise in either the government or private sectors. It is clear that private rather than public imbalances were more significant, with the sole exception of Greece, in the genesis of the Eurozone crisis. The design limitations of the Eurozone inhibited both the recognition and the resolution of the problems arising from these private sector imbalances. Moreover, European policymakers have yet to recognise the fundamental trade-offs involved in creating a monetary union and have lurched from one partial solution to another instead of instituting centralised bank supervision, centralised bank resolution and a centralised system of liability insurance for banks. As a result, the fortunes of banks and sovereigns have become excessively intertwined. And bank resolution at national level has been inhibited by European policy, further exacerbating the sovereign debt crisis.

Until the task of building a full monetary union is accomplished the Eurozone will remain no more than a currency union prone to sovereign debt crises and to regional banking bubbles. It will also remain unattractive to potential new entrants because they will be deprived of the capacity to identify or control problems arising outside the government sector, even as they will be required to strengthen their system of central budgetary oversight. The paper concludes with a consideration of the steps necessary to contain and resolve the current crisis and to create the structure of an EMU 2.0 which would be more robust in the face of a recurrence.

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