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The Future of the Eurozone Does Not Lie with Enlargement

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It has become a cliché that the survival of the European Union (EU) depends on its ability to reform, either through enlargement—greater economic and fiscal coordination in the direction of some sort of federal state—or by getting smaller, with the eurozone becoming a true optimum currency area.

Surprisingly enough, most analysts, including leading EU officials, have sided unequivocally with the former proposition. In addition to being insensitive to history, which punishes large-scale utopian undertakings with a vengeance, they are clearly oblivious to the fact that the rush to strengthen and expand the Union is what led to the current crisis—a crisis that now threatens not only the eurozone but also the entire foundation of the European project.

With Italy already engulfed in the flames of the eurozone debt crisis—a wildfire that's quickly spreading in the direction of France and Belgium—it is almost a sure bet that Euroland will not look the same a year from now, or maybe even sooner. In this context, there are really only three possible scenarios: (1) the exit of problematic Greece from the eurozone, followed soon thereafter by Portugal and Italy, and the subsequent formation of a southern euro bloc under the aegis of France, with a new, weaker euro in place; (2) the exit of Greece and possibly Portugal from the eurozone, which could immediately restore markets' trust; and (3) the complete dissolution of the eurozone.

Scenario 2 is the most likely outcome. Scenario 1 is unlikely to materialize because France has neither the desire nor the capacity to lead a "Latin" Europe that would be in constant competition with "Teutonic" Europe to its north and east. Scenario 3, the dissolution of the eurozone, is something that Germany would resist by whatever means necessary, even if in the end this meant institutional changes in the way the European Central Bank (ECB) operates. But under no circumstances would Germany allow the ECB to play a more interventionist role, or accept the eurobond scheme, as long as nations like Greece (especially now that they have become a burden!) remained in the eurozone.

Economies operating at fundamentally different levels of growth and competitiveness do not fit within a single monetary union. Robert Mundell's pathbreaking work in monetary dynamics and optimum currency areas should have been a good guide for EU policymakers from the start: allowing countries from the south to join when they did was a highly risky proposition, particularly since the economic architecture of the eurozone was itself deeply flawed. Many economists had warned about a eurozone catastrophe, though not Mundell himself (in fact, he was optimistic at the start that Greece would soon exit its debt crisis!), which goes to show you how wide the gap between theory and policy—or, more precisely, between economic reality and political wishful thinking—can be.

Germany has clearly benefitted from the inclusion of the weak peripheral nations in the eurozone. However, Greece and Portugal have been badly hurt precisely because of their inclusion in a union with a hard currency. Since joining the eurozone, both countries have seen their competitiveness decline and domestic and interregional inequalities rise. The surrender of national control over monetary policy has deprived the weak European economies of that most essential tool of economic policy, the ability to issue money. We know by now that a responsible monetary policy does not result in inflation, although it is also true that the globalization of financial markets has put constraints on the devaluation of currencies as an economic policy tool.

If Greece, in particular, were to stay in the eurozone under the conditions currently imposed by the German/EU leadership, it would not only face a decade of economic recession (as German Finance Minister Wolfgang Schäuble recently acknowledged) but also experience a long-term maldevelopment trajectory, and its status in the EU would remain that of a colony.

In sum, the probable outcome of the eurozone debt crisis will be either the split of the eurozone into two Europes (the least likely scenario), or a move along the path to a true optimum currency area. In this new economic setup, weak and problematic economies like those of Greece and Portugal would have no place, but they could be allowed to join years down the road, once they were fit for membership in a hard-currency union.

As for those who insist on the enlargement of the eurozone, suffice it to say that converting Europe into some type of federal state would be a task of immense political, economic, social, and cultural proportions, and one of almost unimaginable complexity. And as history has shown, humanity is ill prepared for such large-scale utopian projects.

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