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The Downside of a Single Currency

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Greece has been causing a major headache for the world's economists during the past two months. That country's debt totals 113 percent of its gross domestic product (not a world record, but very high), and it has at least a 13 percent budget deficit.

There are three ways to finance such a deficit: increase budget income (the government doesn't know how to do this), significantly reduce spending (which is politically impossible) or borrow money on the market (where there are few interested parties, even among those European Union partners who promised to help bail out the country). Unfortunately, most of the talk by states and economists focuses more on criticizing the irresponsibility and poor decision making of the Greek government than on how to improve the situation.

Interestingly, renowned Princeton University economist and Nobel laureate Paul Krugman points out that Spain is a better illustration of Europe's economic ills than is Greece. At a comparatively low 55 percent of gross domestic product, Spain's debt is not high enough to accuse the government of spending too freely during its boom years. But Spain has a 12 percent budget deficit because of high labor costs.

Ordinarily, a country in that situation would devalue its currency to reduce its labor expenses. But because all of Europe uses a unified currency, Spain does not have that option. Salaries in Spain rose rapidly in the decade prior to the economic crisis. This was caused by an influx of capital — primarily from Germany — that expanded the real estate market bubble, which in turn stimulated an even greater inflow of capital.

When the bubble burst and demand for goods fell, Spanish firms became highly uncompetitive because of the high salaries that employers could not easily lower. Spanish firms were left with no other choice than to start laying off workers.

If Spain had its own currency, the government would have devalued it relative to the German and French currencies, thereby reducing Spanish firms' labor costs and allowing them to retain a greater number of workers. With a unified currency, however, that is not possible and the government was forced to increase government spending to keep employment at current levels, causing the budget deficit to soar.

The major countries of Europe will solve the problem of Greece's debt one way or another. After all, Greece is a small country. To get some perspective, Spain's economy is twice as large as the economies of Greece, Ireland and Portugal combined. Germany and France have been slow to help because they do not want to in any way condone Greece's irresponsible fiscal policies. But in this case, it was impossible to avoid.

Nonetheless, Spain's example shows that irresponsible government is not the worst problem. In addition to a common currency and the free flow of capital, European countries need to achieve substantial integration of their fiscal policies for tax collection and expenditures.

In other words, they need to achieve complete political integration. To place all tax income into a single coffer and determine how that money will be spent, Europe would need to have a single representative government.

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