

## A two-speed Europe

As French President Sarkozy suggested the subject of a “two-speed Europe” had been discussed at last month’s EU summit, there has been an attention to the idea of preserving the EUR by dividing the countries into two groups. Given the large disparities in economic conditions among the EMU nations, which has serious implications for an optimal currency area, a case could be made for the formation of a group with convergent economic conditions.

This would not be a magic formula, however; the EMU framework has been in place for a decade, and its splitting would entail a variety of problems. I examine this issue from the perspective of countries in each group—those with fewer problems and those with tougher challenges.

### Perspectives: Group 1

If the EMU were divided into two groups, the biggest benefit for those in the fiscally sound group would be the restoration of confidence in their debt. In fact, discussion on a partial forgiveness of some countries’ debt or an increased risk of “disorderly” default led to fears about a spread of the problems to other countries. That put upward pressure on the bond yields of countries with relatively sound finances. By drawing a clear line between the two groups, it is argued, such a negative externality could be avoided.

However, without fiscal union, even Group 1 countries can only gain the market’s trust by cleaning up their own finances. In that sense, the policy issues are the same for all countries regardless of whether they are grouped together.

From longer-term point of view, group 1 countries might be able to enhance confidence in their debt by implementing even stronger governance over fiscal consolidation than in the current framework. In that sense, it might be possible to make a case for dividing the EMU countries into two groups.

But given the difficulties over the last decade in providing effective governance, it would hardly be expected to improve the situation suddenly. There is also the risk that confidence in the bonds of countries in Group 2 would take a further hit as soon as it was declared that only countries with strong fiscal discipline will be allowed into Group 1. (Core nation leaders have made comments to the effect that they would form a currency zone consisting solely of “countries that can keep their promises.”)

If dividing the EMU is intended to ensure that Group 1 has no obligation to look after Group 2, but that would hardly lead to a favorable outcome for Group 1 countries if the EMU are to play an independent role in addressing the crisis.

### Perspectives: Group 2

Those in favor of dividing EMU countries in two groups argue that the key benefit for Group 2 countries would be increased economic policy flexibility. Given the extremely low policy rate and the extremely little room for fiscal policy, currency devaluation would be the only macroeconomic policy tool available. In other words, a new exchange rate might be applied to countries in Group 2, with the new ‘SUR’ being exchanged at a rate of, say, 1.3 to the euro.

Inasmuch as there would be disparities in fiscal health even within Group 2, one would ideally like to establish separate exchange rates for each country, but that would be no different from decomposing the EMU effectively. We should

also keep in mind that the de facto devaluation resulting from the adoption of the ‘SUR’ would be a trump card that could only be played once. Its continued devaluations versus the euro would jeopardize confidence in bonds issued by Group 2 countries and could actually exacerbate the fiscal crisis.

Even if these caveats are properly taken care of, there are a number of issues for a de facto devaluation to succeed. First, it is essential to prevent the two-tiered union from becoming the normal state of affairs. Otherwise, when doubts arise about the sustainability of outside assistance, Group 2 bond yields would be vulnerable to upward pressure inasmuch as there were questions about their commitment to fiscal discipline to begin with. As such, even countries relegated to Group 2 need to persist with efforts to clean up their finances and bolster their growth potential.

Situations in which a Group 2 country was promoted to Group 1 but subsequently sent back to Group 2 should also be avoided in order to maintain confidence in government debt. It may be necessary to demand stronger fiscal austerity measures from Group 2 countries to prevent such backsliding.

On top of these tough challenges, the most difficult problem is how to prevent the instabilities of the financial system. If a given country will certainly be placed in Group 2, businesses and households would try to keep their assets denominated in EUR. The authorities could possibly force an exchange to SURs at a given rate in the case of most financial assets. But nothing could be done about withdrawals of EUR banknotes. If bank runs became common, it would be difficult from a practical standpoint to stop the slide into financial crisis.

The concern is that the greater the scale of the economy and financial markets in Group 2 countries, the more serious the threat to the European financial system. That, needless to say, is because the destabilization of the nation’s financial system could easily spill over into other EMU economies via inter-connectivity of financial transactions.

### Using the farm team to get back in shape

Then, what does the idea of dividing EMU countries into distinct groups offer in return? The primary benefit would be to give Group 2 countries time to address their problems.

Providing time could make sense, if we could put the difficult question of maintaining financial system stability aside. It is clear that the distressed nations need to make efforts to clean up public finances and enhance growth prospects. But at the same time, it is difficult to envision a policy response that would have a substantial impact in the near term.

Even if such strategy is successful, however, that will not resolve the pending policy issues. At times, a key player on your favorite club may need to spend time on the farm team to prepare for a comeback. But a successful return requires that he use that opportunity to get back in shape.

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