

# Euro zone's impossible trinity

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THE economic and monetary union of the European Union had a basic flaw: monetary integration without fiscal union. This flaw was derived from the “impossible trinity” embedded in the Mundell-Fleming equation. According to this equation, a country can have only two of the following: an open capital account, a stable exchange rate and monetary independence.

While several developing countries, including India, have at times tried – with little success – to get around this impossible trinity, countries have mostly adopted different solutions to this equation. Thus, the United States has an open capital account, independent monetary policy but a floating exchange rate (India’s solution largely resembles this model with a big BUT). China has adopted a stable exchange rate, independent monetary policy but a closed capital account. The euro zone solution to the equation was to have a fixed exchange rate, an open capital account, while it sacrificed monetary independence.

Given the solution adopted by euro zone countries, fiscal balances needed

to be kept in check because there was no lender of the last resort. This was done by setting a budget deficit limit of three per cent of the GDP for each country, and public debt limit of 60 per cent of the GDP. This was critical. Though countries are expected to keep fiscal deficits and public debt within prudent limits for sustainable growth, they can never be held hostage by the market because the central bank can always step in to buy government debt by printing money. It is for this reason that credit rating agencies assign the highest ratings to sovereigns for debt repayable in their own currencies, while they rely primarily on macro-economic fundamentals in rating external debt.

Since euro zone countries, including Germany, did not have this central bank backstop, it is intriguing that credit rating agencies assigned risk-free status to the sovereign debt of these countries, instead of basing them on macro-economic fundamentals. Economists and the International Monetary Fund (IMF) also seem to have missed this fine distinction between domestic debt and external debt: the domestic debt of euro zone countries had some features of ex-

ternal debt, as a result of which they could be held hostage by markets, as appears to be happening at present. Had such a distinction been made, the ratings assigned to the weaker euro zone countries would have been so calibrated as to make it difficult for them to run up such high levels of euro-denominated public debt.

What also seems to have been missed was the “impossibility” of the holy trinity attempted by the European Maastricht Treaty: a currency union with “no bailout, no exit and no default” in the event of the public debt of a euro zone country becoming unsustainable through a market revolt.

It is perhaps because this second, but related, impossible trinity was not highlighted by economists, the IMF and even rating agencies that markets were lulled into pricing the sovereign domestic debt of all euro zone countries on an equal footing as risk-free, despite vastly differing macro-economic fundamentals. In hindsight it is now clear that:

(a) If there was to be no bailout and no exit, a country might have to default on its debt since it could not inflate its way out through the printing press.

(b) If there was to be no bail out and

no default, a country might need to exit to regain monetary independence to enable it to honour its debt obligations through a depreciated new currency that its central bank could print at will; and finally,

(c) If there was to be no exit and no default, a country would need to be bailed out, through either budgetary support from other countries (such as through the European Financial Stability Facility) or the common central bank (the European Central Bank or ECB) acting as lender of the last resort.

The impossible trinity attempted by the Maastricht treaty now threatens to bring down not only the euro zone but also the global financial system, unless one of the three nays is abandoned. This alone would rectify the fatal flaw in the Maastricht Treaty, short of full fiscal and monetary – which effectively means political – integration for which European civil society is not quite prepared yet. And Germany would not allow the ECB to become a printing press without such integration — for good reasons.

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*Views are personal*