OPINION Contributor

Does the eurozone need its own monetary fund?

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Eurozone countries should strive for a stronger and independent ECB and the creation of a European Monetary Fund for a solution to Greek economic woes.

Six months after the troubles with the Greek debt were unveiled by the newly elected Greek government, German Federal Minister of Finance Wolfgang Schäuble suggested that the countries of the eurozone should consider creating a European Monetary Fund, or EMF – in contrast to the International Monetary Fund.

Daniel Gros of the Center for European Policy Studies and Thomas Mayer of Deutsche Bank argued for an EMF a month ago in The Economist. Greek Prime Minister George Papandreou urged the EU to pursue this institutional change and the European Commission has taken up the challenge. European leaders reached a consensus last month following a drawn-out Franco-German compromise with provisions for bilateral loans by eurozone members (2/3 participation) and IMF involvement (1/3 participation) should Greece face any refinancing problems of their debt in the future. The Greek troubles might be coming to a close but the question remains: Does the Eurozone need its own monetary fund?

As we consider the usefulness of a regional monetary fund, it is useful to ask: Why did we ever need an IMF in the first place? It was summer, 1944, and the world was emerging from the Great Depression and World War II. Many believed that the economic turmoil of the previous decade had spurned beggar-thy-neighbor policies to maintain fixed exchange rates. To address trade deficits and debt, governments either had to tighten the belts of their own countries, or pass the buck on to others, through protectionism and competitive devaluations. In the late 19th century when monarchs ruled Europe, the austerity measures were politically palatable, but with the rise of democracy and the growing strength of labor unions, governments tended toward passing the buck. This beggar-thy-neighbor approach reached a crescendo in the 1930s when world markets collapsed.

An international monetary fund was proposed as a solution. Member governments would all contribute to a pool of resources from which deficit countries could borrow temporarily. The loan would allow the process of tightening the belt to be more gradual; the IMF loan would "soften the blow" of adjustment. Yet, the prospect of lending to deficit countries exacerbated a different horrible menace to global finance: moral hazard. The IMF loan might not just soften the blow of adjustment – it might forestall the need for adjustment at all, allowing deficits to widen until they were beyond the ability of even the IMF to bail out. The solution to this problem developed by the IMF was "conditionality:" in return for continued loan disbursements, governments had to follow policy conditions. If they failed to comply, the loan would be cut off. This solution directly impinged on national sovereignty, and the governments of Europe did not like it.

During the Bretton Woods era, from 1944 until 1971, many Western European governments borrowed from the IMF, but there were clashes over the degree of adjustment policies required by conditionality. On occasion, governments even went outside of the IMF, and simply devalued their currencies without IMF approval. Then, in the midst of growing social spending and the Vietnam War, deficits began mounting in the United States. The dollar was pegged to gold (the so-called gold standard). Yet, even the mighty dollar was not beyond speculation as deficits mounted. With an

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election on the horizon, President Richard Nixon was faced with the prospect of tightening the American belt, or forging a different path. In 1971, he suspended dollar convertibility to gold, and introduced a floating exchange rate. Within three years, every major industrialized country followed suit.

Under floating exchange rates, developed countries did not need the IMF. Trade deficits could take care of themselves as currencies gradually adjusted to changing circumstances. Prices of imports and exports fluctuated regularly, but wages and unemployment were safe from the day-to-day rigors of an open economy. This is at least the way it worked for most countries.

The United States was special, however, as the dollar was used throughout the world as the international reserve currency. No matter the size of deficits or the weight of debt, the dollar remained in demand, to the point that the current international monetary system is undergirded by an $800 billion US debt to China. This is not sustainable, and the externalities of imbalances can spill over to other countries around the globe. The meltdowns from Iceland to Greece are only the tip of the iceberg if serious adjustments are not forthcoming.

So bailouts of even the advanced economies of Europe are presently needed and may be needed again in the future. Is the eurozone ready to return to the IMF for help? They have gone back and forth on this issue. The European Union did not have any problem with Hungary or Latvia going to the IMF, but they have their own currencies. When mere rumors floated that Ireland might turn to the IMF, the euro tanked and officials from Ireland to Berlin were quick to quash the rumors. With Greece, the IMF seemed unthinkable at first, but then Greece and Germany started to dance. Germany hedged on bailing Greece out, and Greece suggested an IMF solution, perhaps as an act of brinkmanship: alarm Germany with the IMF-intrusion threat. This seemed to work, as Germany then seemed ready to come to the rescue. But then Germany softened on an IMF package. The outcome of the Franco-German compromise was somewhere in the middle.

Ultimately, however, this is a European problem. Economic integration has made the world a smaller place, but the most intimate connections are within regions. The crux of any bailout is the balance of how much liquidity versus how much adjustment. When we address this balance at a global level, through an institution like the IMF, there will be outside actors involved who are less impacted by the crisis and argue for more adjustment, less liquidity. Yet it is the countries within the same region who have the most at stake. A regional monetary fund is the solution.

The main difference between Greece and other states in the eurozone with high deficits is that the former is borrowing at higher interest rates. Beyond the recent plan, a more long-term intervention is appropriate, and it should be made at the regional level through a European Monetary Fund. First of all, an EMF will strengthen EU solidarity and will prevent speculators from profiting off of the troubles of the various members of the eurozone. Second, an EMF would preclude a more direct IMF intervention in the future which—at least symbolically—would undermine euro's credibility and the EU project as a whole. Third, an EMF would further strengthen a "Political Europe." Fourth, an EMF would prevent systemic risk in the union at large –if not a global one.

We believe that the countries of the eurozone should strive for a stronger and independent European Central Bank and the creation of a European Monetary Fund that would make a "European solution" to the troubles of Greece a reality.

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