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“The Fatal Flaw in the Design of the Euro”

Abstract. It is now well recognized that there is something wrong with the euro. A variety of explanations for the current crisis has been offered. Some have argued that the nations that have been allowed to join the eurozone are too heterogeneous; from the perspective of Mundell’s optimal currency area thesis, these countries did not constitute an optimal area for a currency. Others have blamed profligate Mediterraneans on the periphery of Europe—that their governments spent too much and brought on the inevitable Reinhart-Rogoff debt crisis. Some point (more correctly, in my view) to bankers run amuck—in other words, the crisis was caused by the same sort of dynamics seen in the United States, with unregulated and unsupervised bankers taking on excessive risk. Finally, many blame current account deficits—again, on the periphery—that led to excessive external debt. While conceding that there is at least some truth in most of these arguments, I will argue that the real problem is in the design of the euro system: the separation of fiscal policy from sovereign currency.