

Euro: Why The Euro Should Be Broken Up

Forget about fiscal union. If you cannot get convergence in the productivity of all factors of production, that includes not just labour but land and capital as well, you will not have convergence in the reward to factors, and thus convergence in factor prices.

Under a common currency, efficiency would require that factor prices were sufficiently flexible to clear markets. Without factor productivity convergence, this implies domestic price volatility across the common currency zone. Europe is an interesting live example of this failure.

The theory tells us that it must accumulate imbalances over time. In Europe, these imbalances have reached crisis levels. The failure to recognize the fundamental causality leads the EuroZone to pursue misguided policies.

The failure to understand this causality also leads to misguided trading strategies in the face of European asset volatility.

On the policy front, attempts to maintain currency union are misguided. The Eurozone should be dismantled and domestic currencies introduced to provide the additional degree of freedom in price discovery.

The process of breaking up will be painful and there will always be some chaos. The alternative is analogous to attempting to stretch a rubber band indefinitely.