Summary for non-specialists
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Finance at Center Stage: Some Lessons of the Euro Crisis

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Finance and financial markets were at the heart of the global economic crisis that began in August 2007. Despite having subsided elsewhere by 2010, the global crisis left an ongoing legacy of turbulence in the euro zone. I argue that the euro zone's continuing turmoil, like that of the world economy in 2007-09, is rooted in financial vulnerabilities that EMU's architects did not envision when they set up its defenses. If the euro is to survive, EMU's institutions must evolve to overcome these vulnerabilities. The necessary changes will have profound effects on the future shape of EMU, effects significant enough to require changes in EU political arrangements alongside more technical financial reforms.

In the postwar period up until the global crisis, financial fragility played a limited role in the theory and practice of industrial-country macroeconomic policy. Recognition of that shortcoming has spurred a profound reassessment of the place of finance in macroeconomics generally, and specifically in our understanding of the macroeconomic dynamics of EMU. The financial dimension was arguably a secondary one in concerns about the initial architecture of EMU. Mirroring mainstream macroeconomic theory, most of the attention focused on monetary policy, fiscal policy, and structural reform in nonfinancial markets (especially labor markets). Commentary on EMU's performance during its first decade generally paid much less attention to financial factors than now seems warranted

Because of rapid growth in financial markets, several distinctive features of EMU have had consequences that were largely unforeseen before the single currency's launch, or that turned out to be even more damaging than could have been predicted then. As I document below, the 2000s saw remarkable worldwide growth in capital flows and banking, both domestically and across borders, but it was especially strong within Europe, in part due to the increasing (and policy-driven) integration of euro zone financial markets. That development, however, undermined the ability of some member states credibly to backstop their national banking systems through purely fiscal means. I propose a new policy *trilemma* for currency unions like the euro zone: Once financial deepening reaches a certain level within the union, one cannot simultaneously maintain all three of (1) cross-border financial integration, (2) financial stability, and (3) national fiscal independence. This financial/fiscal trilemma lies at the heart of the euro zone crisis that began in 2009, and it provides a useful organizational structure for understanding the unexpected consequences of rapid financial market growth, as well as the reforms needed to preserve financial stability while also preserving a unified euro area financial market.

In this essay, I first document the buildup of financial vulnerabilities in the euro zone after 1999, with an emphasis on the evolution of banking-sector and national balance sheets. The essay then discusses the safeguard systems put in place before the launch of EMU and their inadequacy in the face of rapidly evolving global and euro zone financial markets. I next assess initiatives to remedy the safeguard system that failed after the euro's first ten years, stressing the close interdependence of financial-market, fiscal, and monetary reforms. New ideas, including ideas that the European Commission has already implemented or placed on the agenda for consideration, are considered.