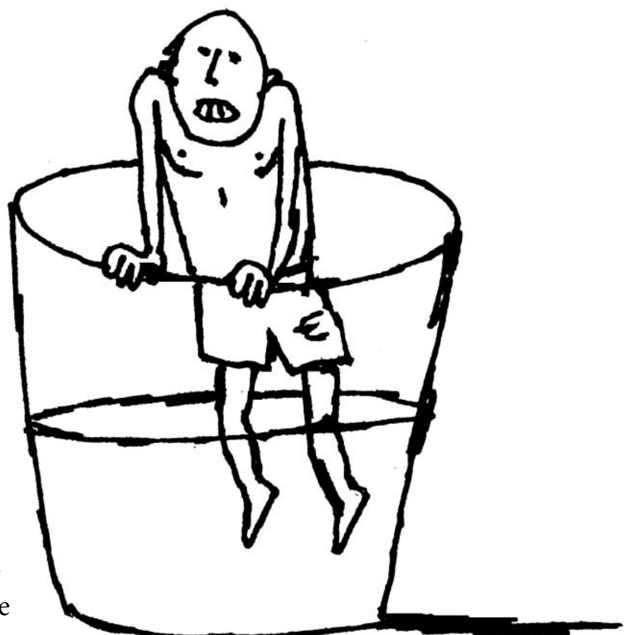
THE Euro

Filling the Half-Full Water Glass



In January, Europe's monetary union will mark its fifth anniversary. However, the congratulations are not exactly pouring in. For there is seemingly little to celebrate: growth in the countries of the euro area has been significantly slower than in the United States in recent years, while unemployment over much of the continent remains stubbornly, disturbingly high. Indeed, in the view of many, the euro has only compounded Europe's myriad economic problems.

SCOTT MENCHIN (ALL)

By Barry Eichengreen

If anything, the volume of grumbles is rising. In the first few years of the monetary union, Europe's growth was sustained by booming stock markets (which were almost as irrationally exuberant as their American counterparts), and then by the depressed exchange value of the euro (which gave the continent's exports an artificial boost). But now that the both the stock markets and the value of the euro have returned to realistic levels, Europe's problems are mounting. And even some erstwhile champions of the single currency are having second thoughts.

THE PROMISE

Almost everyone would agree that the euro has, in part, delivered on its promise. One tangible benefit has been the deepening and widening of Europe's financial markets. By eliminating exchange rate fluctuations within the union, the euro eliminated the currency risk that previously segmented Europe into a dozen or more separate corporate bond and commercial paper markets. Indeed, with monetary unification, the German "bund" (the Federal Republic's 10-year government bond) became the benchmark on which corporate debt could be priced throughout the euro area. No longer worried about the risk of currency fluctuations within the member nations, investors began searching out the most attractive corporate debt securities regardless of the national market in which they were issued. The result has been a more liquid continent-wide market.

Almost immediately, then, the euro began narrowing the competitive disadvantage created by Europe's lack of U.S.-quality bond markets. Funding costs for European corporations declined as the rate of issuance of new securities exploded. In the first year of the monetary union, the value of euro-denominated corporate bond issues more than tripled, compared to the amounts that had been denominated in the old, "legacy" currencies. And the share of new corporate bonds in the high yield, sub-investment-grade category rose from 4 percent to 15 percent.

The extraordinary growth rates of the markets have since tailed off, but the issuance of corporate debt continues to outpace the growth of their other sources of capital. Note an indirect benefit: easier access to debt markets has helped to finance a wave of mergers and acquisitions, which promises to strengthen Europe's corporate sector.

As with many economic adjustments, there have been losers as well as winners. Europe's banks, confronted with fiercer competition from the bond market, have seen their profits squeezed. Indeed, banking has gone from top dog to dog house in a few short years. It's worth pointing out, though, that the decline was overdue; Europe was overbanked, and U.S. corporations enjoyed a cost advantage as a result of America's more efficient capital markets. The end-product will undoubtedly be a better balanced European financial system, and a more competitive private sector.

A second benefit of the euro is stimulus to price competition. Europeans may have reservations about cutthroat competition *à la Amérique*, but it is hard to deny that more competition was needed to spur the productivity of European retailers and their suppliers. In fact, with just this goal in mind, policymakers have been pursuing what's called the Single Market Program for nearly two decades.

But a true single market is easier to declare

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than to establish. And the existence of a dozen different currencies plainly complicated cross-border price comparisons and reduced the intensity of competition. With the euro, residents of different European countries can finally compare apples with apples. They can more easily determine where prices are lowest, and vote with their feet (or Web browsers). Europe is still far from the competitive ideal of textbook economics, but it is closer than it was five years ago.

It is also worth pondering the counterfactual – that is, how events would have transpired had the members of the euro area retained their national currencies. Europe's history is replete with instances in which economic and political shocks led to sharp changes in currency exchange values, undermining economic stability. A classic example is Germany's reunification after the fall of the Berlin Wall, which was a major factor in the currency crisis of 1992.

REAL GDP GROWTH SINCE THE START OF 2002

PERCENTAGE CHANGES, 1Q 2002–2Q 2003

	EURO AREA	U.S.
GDP	0.8%	2.7%
Consumption	0.9	2.8
Government Spending	2.2	3.8
Investment	-1.9	1.6
Exports	1.4	2.3

NOTE: The 2nd quarter 2003 figure for the euro area is an estimate based on Germany and France.

SOURCE: JP Morgan Global Data Watch (August 29, 2003, p.7).

Now imagine a shock like the recent military action against Iraq, which raised diplomatic tensions between the U.S. and France. In this riskier political environment, investors might have fled the French franc for, say, the German mark, forcing a devaluation of the franc and perhaps other currencies as well.

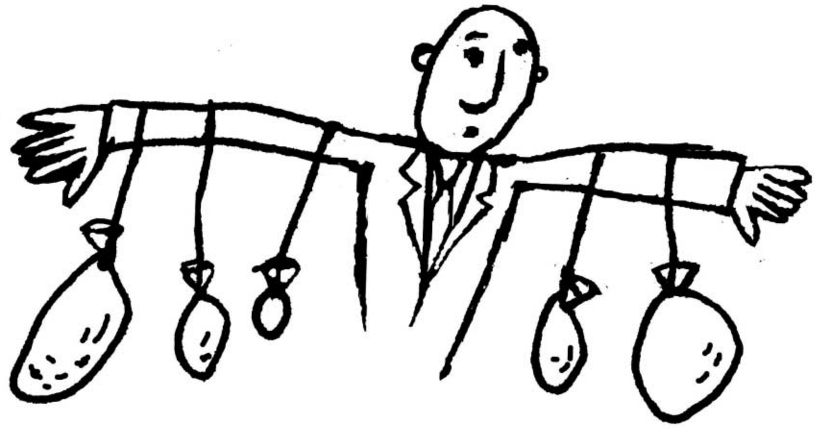
One of the goals of the euro's creators was to establish a zone of currency stability in which exchange rate crises could no longer occur. Events like the high-tech stock bubble, Al Qaeda's attack on the World Trade Center, and war in the Middle East all could have (and likely would have) produced currency chaos in pre-euro days. The residents of Euroland can at least take heart that this specter has been vanquished.

THE COST

But "what-ifs" rarely sway public opinion when the costs of the policy in place are palpable. The most fundamental constraint of monetary union is that the central bank must set uniform interest rates for the entire zone. And the effect on Europe has been to accentuate the boom-and-bust cycles experienced by individual national economies. In Ireland, growth more rapid than the European average also meant inflation above the European average. But since the level of market interest rates was necessarily the same throughout Euroland, the real interest rate (the market rate minus the rate of inflation) was lower in Ireland than elsewhere.

The perverse result was that firms in Europe's fastest growing country effectively had the lowest cost of borrowing, further stimulating Ireland's already overheated economy. The opposite was true in Germany, where slow growth meant low inflation and hence high real interest rates. But the European Central Bank, which set monetary policy with average European inflation and growth in mind, could do little to address these divergent national trends.

Ireland's boom was mainly the result of the fact that the country is home to so many electronics firms. Similarly, the fact that growth there has now decelerated mainly reflects the slowdown in the high-tech sector worldwide. California went through a very similar cycle over the last five years and, like Ireland, is now attempting to come to grips



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with the consequences. But it is far from clear that California – or, for that matter, the United States – would have been better off had the Federal Reserve pursued a significantly tighter policy during the technology boom and stock market bubble. Many economists would argue, to the contrary, that the central bank should simply keep its eye on the ball – which in this case means focusing on economy-wide inflation.

This is just what the European Central Bank did for the last five years. In fact, its policies have conformed quite closely – even closer, by some estimates, than the Fed's – to the Taylor Rule, the simple rule of thumb relating short-term interest rates to inflation and the output gap that is the internationally recognized benchmark for monetary policy.

What California needed during the boom, we now know, was greater fiscal discipline. It should have resisted the temptation to raise public spending along with tax revenues, instead building a rainy day fund for bad times. The same logic applies to members of Europe's monetary union: since the common monetary policy cannot be tailored to the needs of any single nation, members should adjust their fiscal stances to counter local shocks. And this is just what Ireland did, running substantial surpluses in the late stages of its boom.

FISCAL FOLLIES

Fiscal policy is, in fact, at the center of the current debate over monetary union. Europe's Stability and Growth Pact aims to compel national governments to keep their budgets in surplus – or at least close to balance – in normal times, so they can move safely into deficit when recession looms. But by failing at the first task, the pact has frustrated rather than facilitated the second.

A number of European governments were especially lax during the recent expansion. Having gone on crash diets in the 1990s to qualify for membership in the monetary union, they succumbed to a loss of fiscal discipline thereafter. Consequently their deficits were already close to the Stability Pact's putative ceiling of 3 percent of GDP when the current slowdown struck.

They then came under pressure to prevent their deficits from widening further. As a result, their ability to use fiscal policy as what economists call an "automatic stabilizer" – injecting stimulus in lean times, reducing total demand in fat times – was inhibited. With no safe place to turn politically, these same governments have been inclined to let their automatic stabilizers operate in the current economic downturn. And in the process, they have eroded the credibility of the fiscal rules on which the monetary union is built.

European governments have never been particularly effective in employing fiscal policy. But this impotence has become even more of a problem with the advent of the euro. Now that a single currency and a single monetary policy prevail throughout Euroland, fiscal policy is all that's left to buffer national (or local) shocks.

The unspoken question is why the Stability Pact exists in the first place. On what grounds does creating a monetary union justify interfering with national fiscal policies? Most of the arguments made to this point are fallacious. The only one that holds a drop of water is that chronic budget deficits might eventually render a country's debt unsustainable, precipitating a financial crisis and forcing the European Central Bank to intervene.

Imagine – to pick a country not entirely at random – that Italy runs chronic deficits. Eventually the debt burden grows so heavy that voters rebel against the exorbitant taxes needed to service it. Rome would then be unable to service the debt, leading to panic selling of Italian bonds. The panic might spill over to other markets, as big institutional investors dumped assets in a scramble to sustain liquidity. Questions might then arise about the solvency of banks – mainly, but perhaps not exclusively, Italian banks – that hold large quantities of bonds.

The European Central Bank presumably would not stand by idly. It would intervene by buying up Italian bonds and providing emergency liquidity to distressed financial institutions. A national debt crisis could thus undermine the European Central Bank's resolve to maintain price stability through a consistent anti-inflationary policy.

Fiscal prudence is a prerequisite for debt sustainability – it is necessary whether a country belongs to a monetary union or not. But monetary union alters the incentives of governments in unfavorable ways. So long as the Bank of Italy still printed the lira, Italians alone would bear the consequences of their government's fecklessness. If there was a debt crisis in Italy, it would be the Bank of Italy that had to respond in the first instance. If responding produced inflation, that meant Italian inflation. And knowing this, there would be domestic pressure for the Italian government to limit its fiscal excesses.

But now that the European Central Bank is Europe's lender of last resort, any consequence of central bank intervention would diffuse throughout Euroland. If the ECB purchases bonds to support Italian financial markets or cuts interest rates to relieve distressed financial institutions, the result is additional inflation throughout the euro area.

This creates a classic free-rider problem in which Italians know that if their government's undisciplined policies go awry they will bear only a fraction of the costs. The likely consequence is less public pressure for a government to avoid fiscal excesses. The Stability Pact limiting the right of national governments to run deficits can thus be seen as a mechanism for internalizing this consequence and disabling what would otherwise become an engine of inflation.

BUDGET BALANCES IN EU MEMBER STATES, 2001–2004 (% OF GDP)

	BUDGET BALANCE				CYCLICALLY-ADJUSTED BUDGET BALANCE			
	2001	2002	2003	2004	2001	2002	2003	2004
Belgium	0.3	0.1	-0.2	-0.1	-0.4	0.1	0.2	0.0
Germany	-2.8	-3.6	-3.4	-2.9	-3.0	-3.3	-2.6	-2.4
Greece	-1.9	-1.2	-1.1	-1.0	-2.3	-1.8	-1.8	-1.9
Spain	-0.1	-0.1	-0.4	-0.1	-0.8	-0.4	-0.4	-0.1
France	-1.6	-3.1	-3.7	-3.5	-2.2	-3.3	-3.5	-3.3
Ireland	1.2	-0.3	-0.6	-0.9	0.0	-0.9	-0.3	0.1
Italy	-2.6	-2.3	-2.3	-3.1	-3.1	-2.1	-1.8	-2.7
Luxemburg	6.4	2.6	-0.2	-1.2	4.1	2.0	0.5	-0.3
Netherlands	0.1	-1.1	-1.6	-2.4	-1.0	-1.0	-0.4	-1.1
Austria	0.3	-0.6	-1.1	-0.4	0.0	-0.6	-1.0	-0.4
Portugal	-4.2	-2.7	-3.5	-3.2	-4.6	-2.5	-2.6	-2.1
Finland	5.1	4.7	3.3	3.0	4.2	4.8	3.7	3.3
EUR-12	-1.6	-2.2	-2.5	-2.4	-2.1	-2.2	-2.0	-2.0
Denmark	2.8	2.0	1.8	2.1	2.3	1.9	2.0	2.2
Sweden	4.5	1.3	0.8	1.2	3.6	0.9	1.1	1.5
UK	0.8	-1.3	-2.5	-2.5	0.7	-1.0	-2.0	-2.0
EU-15	-0.9	-1.9	-2.3	-2.2	-1.4	-1.8	-1.8	-1.8

NOTE: Cyclically-adjusted figures are computed with the Production Function Method, except for Germany, Spain, Luxembourg and Austria, where the Hodrick-Prescott filter method has been used.

SOURCE: Commission of the European Communities, *Communication from the Commission to the Council and the European Parliament, Public Finances in EMU - 2003*, p. 5.

Indeed, Europe is not the only place that takes this problem seriously. Most U.S. states limit their governments' own flexibility to run deficits and to borrow – and the Federal Reserve would not have it any other way.

But unlike Europe, restraints on the freedom of U.S. states to run deficits do not prevent automatic fiscal stabilization since the federal government can still run deficits during recessions. At the federal level, the free-rider problem undermining incentives for prudence does not exist; the domains of the Federal Reserve and the federal fiscal authorities are one and the same.

Once this rationale for the Stability Pact is made explicit, it becomes clear how many questionable assumptions must be made to justify the rule. Given the weight the ECB attaches to price stability, would the bank really be likely to respond to a national debt crisis with a significantly more inflationary policy? Would it really worry that a financial crisis in one country would infect neighboring markets? Or would it stand aside – as the Fed did when the government of Orange County in California defaulted on its bond obligations in the 1980s? Even if the ECB injected significant amounts of liquidity in response to a financial crisis, couldn't it simply reverse the process once the crisis subsided – neutralizing any inflationary effects in the way the Fed neutralized its expansionary operations in the aftermath of the Long-Term Capital Management crisis in 1998?

WHAT TO DO WITH THE PACT

Skeptics thus suggest that the Stability Pact should be abandoned. After all, it is not part of the Maastricht Treaty that authorized the establishment of the European Central Bank. It is an afterthought – and an ill-advised one at that.

Majority opinion in Europe has not yet reached this point. Most opinion leaders continue to take the free-rider problem seriously, worrying that, if unfettered, national governments would run reckless fiscal policies that become engines of inflation. Rather than abandoning the Stability Pact, they recommend revising it to allow budgets more flexibility to respond to the business cycle while maintaining the long-term commitment to fiscal discipline.

There is now a cottage industry cranking out proposals for reforming the pact. One popular scheme would use cyclically adjusted budget balance – the deficit that would exist if the economy were at full employment – rather than actual budgets in Stability Pact calculations. Others include exempting public investment from the 3 percent deficit ceiling, and more readily giving governments exemptions from that limit.

All these proposals would make it easier for deficit spending to rise when growth slows, freeing Europe from its fiscal straitjacket. But unless these reforms are accompanied by measures that significantly strengthen incentives to run surpluses in good times, they will also heighten worries about unsustainable debts and inflation down the road. However compelling the case for greater flexibility, EU leaders will remain reluctant to allow governments more freedom to run deficits in bad times unless they find a way of ensuring that they will run surpluses in good times.

Exempting public investment or focusing on cyclically adjusted budgets would do nothing to ratchet up the pressure to run surpluses in good times. Increasing the transparency of the European Commission's reviews of national fiscal policies in the hope of shaming profligate governments into compliance underestimates the capacity of national authorities to ignore criticism from those who can't vote them out of office. And, while popular among academics, the idea of assigning control of national fiscal policies to a committee of independent experts is social-science fiction.

The best hope is to encourage governments to reform their budgetary institutions. There is now extensive research linking the nature of fiscal institutions to fiscal outcomes. We know that countries in which the prime minister or finance minister has agenda-setting power in fiscal policy are less prone to chronic deficits. Countries in which states and provinces are not permitted to spend now and ask for bailouts later are similarly less deficit-prone. Moreover, countries that minimize the reach of publicly owned enterprises are less likely to find deficit-inducing fiscal skeletons in the closet.

If European economies changed their institutions to generate surpluses during booms, it would be practical to give them more freedom to run deficits in hard times. Such reforms are the responsibility of member states, not the European Union. But the EU could help by altering the focus of surveillance under the Stability Pact, giving less weight to numerical ceilings for deficits and more to the strength and design of policy-making institutions. The Stability Pact would then become an asset rather than an obstacle in the effort to enhance both fiscal discipline and fiscal flexibility.

MAKING MONETARY UNION WORK BETTER

Happily, there is evidence that reform of the pact is finally in the works. And there is hope from other directions as well. Following a garbled start, the European Central Bank has improved its communications strategy. It is getting better at preparing the securities markets for its actions and providing a convincing justification for them after the fact. The bank's executive board is learning the importance of having one individual – the president – speak for the institution. The bank is moving away from an incoherent "two pillar" strategy where it is supposed to simultaneously hit two moving targets – price increases and money supply increases – in favor of a simpler, more transparent and more credible inflation target. As its policies acquire credibility, it is showing an ability to respond faster to events.

To be sure, the ECB is still criticized for not reacting as quickly or communicating as clearly as the U.S. Federal Reserve. But the comparison is not entirely fair. At the age of five, the ECB is still feeling its way. When the Fed was five years old (in 1919) it still had not established that policy authority resided with the Federal Reserve Board in Washington rather than with the regional reserve banks. It had not even discovered "open market" operations in which the Fed buys and sells government securities to change private bank reserves and alter interest rates.

By this standard, the ECB is a quick learner. Moreover, there are grounds for thinking that the ECB will continue to grow more adept. A new bank president is likely to command more respect from the markets, while a rotation system for membership on the policymaking council will streamline the decision process.

The European economy also seems to be adapting to the fact of monetary union in ways that should make the single monetary policy work more smoothly. The previously divergent business cycles of the individual Euroland economies are beginning to converge. Labor mobility is rising, making it easier to adjust to shocks with localized impact on employment.

Faster structural reform of the European economy would also help, of course. The continent desperately needs more flexible labor markets and less government regulation. But the need for reform would be equally urgent if Europe had not adopted a single currency and single central bank. An economy suffering from structural rigidities and high labor costs will have high unemployment, whatever its monetary arrangement.

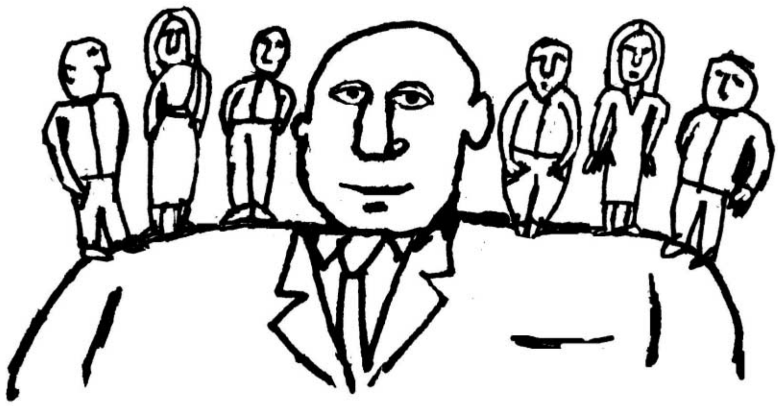
Europe's structural rigidities were not created by the central bank, and the central bank can do little to mitigate their consequences. Separate national monetary policies would do no better at restoring full employment and promoting faster growth so long as wages are not responsive to supply and demand, and regulation remains oppressive.

Some observers suggest that Europe's labor unions will become more flexible when they realize that there are no longer national central banks to bail them out with inflationary policies to offset wage increases in excess of productivity gains. But I wouldn't bet on it; exactly these arguments were offered when Argentina gave up its monetary autonomy in favor of pegging its currency to the U.S. dollar. The resulting increases in wage and price flexibility were much too slow to prevent the disastrous currency collapse in 2001.

The lesson is that structural reform must begin at home. It cannot be artificially stimulated by one monetary regime or another. More flexible markets would make life with monetary union significantly easier. But the euro is neither the cause nor the solution to Europe's inflexibilities.

THE CAMEL'S NOSE

Eventually, more liquid securities markets and more competitive product markets should make both European firms and the European economy more efficient. But even in the most optimistic scenario, the changes will take time to work their effects. In contrast, the euro's costs, in the form of a one-size-fits-all monetary policy and a rigid fiscal policy, are immediate and clear to see. In other words, while the costs of monetary union are immediately apparent, the benefits will accrue later.



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This, in turn, points to an enduring conundrum. Politicians have little incentive to practice delayed gratification on behalf of their constituents. A costly policy that promises benefits in the distant future rarely appeals, in part because there is no guarantee that the politicians will still be in office when the time comes to claim the credit.

This contradiction suggests that the decision to create the euro involved more than strictly economic calculations. Some of the euro's architects, notably Chancellor Helmut Kohl of Germany, clearly had in mind the political effects. For them, European economic and financial integration was a step toward political integration. Create a single market overseen by the European Commission and a single currency overseen by the European Central Bank, and there would be pressure to expand the powers of the European Parliament in order to create a political entity capable of holding the EC and ECB accountable for their actions.

The desirability of a more integrated European polity can reasonably be questioned – a wide majority of Swedish voters clearly questioned it by voting "no" on the country's recent referendum on the euro. Nonetheless, the advent of the euro and the ECB breathed new life to the arguments of those seeking a more integrated political architecture for Europe. In particular, it is hard to imagine that the European Union would have convened an unprecedented constitutional convention like the one that met in 2002-03 – much less taken the results seriously – in the absence of a monetary union that created a demand for new political structures to hold the European Central Bank accountable.

Americans like to spin tales of the coming collapse of Europe's five-year-old monetary union. But the fact that monetary union is part of a larger European project means that the euro is not going away. The euro union will not be jettisoned simply if it produces uncomfortable economic results, because it is not going to be judged by its members on narrow economic grounds. That said, anything the participants can do to make their new monetary arrangement operate more smoothly would be welcome. They should get to work.