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Lessons of the Euro for the Rest of the World

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It is a pleasure to be here today to give this first annual Marshall Plan Lecture on the lessons of the euro. The Marshall Planners, as you know, were great believers in European integration.[2] The U.S. State Department was firmly of the view that European integration was essential for winning the Cold War: containment of the Soviet Union would only work, State Department analysts argued, if Western Europe made peace with itself and grew stable and united, and they saw economic integration as an important means to this end. In contrast, officials of the Economic Cooperation Administration, the U.S. agency directly responsible for administration of the Marshall Plan, believed that economic integration was an important objective in and of itself. In their view, only an integrated Europe with a unified internal market would enjoy the economies of scale, feel the competitive pressures, and achieve the rational allocation of resources needed for efficiency and growth. Many ECA officials came from American business, of course, and in emphasizing the economies of scale and competition made possible by the existence of a continental market, they were simply applying to Europe their perception of what had made the United States so efficient and prosperous. They would be reassured, no doubt, to learn of the existence of the euro.

This brings me to the topic at hand. In contemplating the euro, one cannot help but be struck by how dramatically things have changed in the course of a decade. Back in 1992, when I began working on European monetary unification, most observers, American observers in particular, regarded as implausible the notion that a single European currency, complete with notes and coins and a single monetary policy managed by a European Central Bank, would exist in as few as ten years. For a long time I was one of very few North America-based scholars to take this prospect sufficiently seriously to actually devote research time to it. For even longer I was

[1]First annual Marshall Plan Lecture, delivered under the auspices of the Austrian Marshall Plan Foundation, Vienna, 4 December 2002.

[2]On this point see Romero (1996).

probably the only American economist who actually believed that European monetary unification would happen.

This made me the object of some derision among my American friends. Such was the price of being right, I am now entitled to say. But I was taken aback when, on traveling to Europe, I found that some of my colleagues here saw me as a euro-skeptic. They knew that I had written articles with titles like "Is Europe an Optimum Currency Area?" and "Shocking Aspects of European Monetary Unification," pointing out that Europe did not obviously satisfy the preconditions for a smoothly operating monetary union – symmetric shocks and a mobile labor force, for example – as well as did the United States.[3] But those who took my work as evidence that I was euro-skeptical misunderstood the point. For one thing, these articles (Bayoumi and Eichengreen 1993 in particular) contained one of the first statements of the view that the optimum currency area criteria (as these preconditions are known) are endogenous – that they can come about as a result of monetary integration and are therefore not properly viewed as exogenous preconditions. In addition, casual readers tended to overlook the second part of the argument, namely, that even if it was true that adapting to the euro might create economic difficulties, the project was still likely to go ahead for political reasons. The euro was part of a larger political project – part of the process of building a Europe that was integrated politically as well as economically. And it was the belief of European politicians and officials that the single currency was integral to this larger project that convinced me that the euro would happen.

What transpired since has more than validated this belief. The euro as a symbol has done much to bring home to the man and woman in the street the idea that, while still citizens of a nation state, they are also citizens of Europe. Every time they reach into their wallets they are reminded of this larger political entity. In addition, by reducing transactions costs and increasing price transparency, the euro has done much to further the process of market integration, heightening the perceived urgency of creating institutions at the EU level for regulating Europe's markets.[4] This is most obviously the case of financial markets, where the effects of the euro on market structure and conduct have been particularly profound. In response, we have seen the Lamfallusy Report, which recommends the creation of a powerful new committee of EU securities regulators, and the initiative of Gordon Brown, Britain's

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[3]See Bayoumi and Eichengreen (1992) and Eichengreen (1993).

[4]On the price-transparency effects of the euro, see ECB (2002).

chancellor of the exchequer, and Hans Eichel, Germany's finance minister, for similar committees to oversee the regulation of the banking and insurance industries.

Here, then, we observe the operation of "neofunctionalist spillovers" – that is, the tendency for monetary integration to quicken the pace of financial integration, and for financial integration to create pressure for political integration. As the single market is perfected, there is more pressure for EU-level regulation. As more regulatory power is centralized at the EU level, questions about the accountability of EU officials then become more pressing. This ratchets up the pressure for political reform to enhance the accountability and therefore the legitimacy of the institutions and individuals responsible for regulating Europe's integrating markets. From this point of view, it is no coincidence that the EU has convened an unprecedented constitutional convention, charged with drawing up a new blueprint for Europe's political architecture, directly following (indeed, within months of the physical manifestation of) the euro.[5] This is all by way of saying that the founding fathers of European integration were right, that economic and monetary integration can be a powerful motor for political integration.

[5]To be sure, there are other sources of political pressure for the convention, such as Ireland's failure to ratify the Nice Treaty in its first referendum and the prospect of EU enlargement to the east. My point, though, is that there would be pressure to render EU institutions more accountable and efficient even in the absence of these events.

Conversely, it is hard to imagine that Europe could have moved so rapidly to create the euro in the absence of a broader commitment to integration. Of the major continents, Europe was first to create a customs union, and it is still alone in having created a single market. Monetary integration is integral to the broader project of political integration. Exchange rate instability was long seen as reducing the efficiency and eroding political support for an integrated European market.[6] Neither is it coincidental, then, that the Maastricht Treaty followed, almost immediately, the adoption of the Single European Act and the removal of controls on capital flows as part of the process of creating a single market in factors of production as well as merchandise. Eliminating capital controls made it much more difficult to stabilize the exchange rates between national currencies, as the 1992 crisis in the European Monetary System was quick to demonstrate. The choice became whether to move backward to more freely fluctuating exchange rates, which might jeopardize the single market, or to move forward to monetary union, which would eliminate the problem of exchange rate instability by eliminating the exchange rate. Retreating to more flexible exchange rates threatened to fuel a backlash against the single market, since it would confer an arbitrary competitive advantage on producers in the country with a depreciated currency. This was not an option, given the value that European politicians and officials attached to economic integration. The only feasible alternative was to move forward to a single currency. In a sense, then, it was the 1992 EMS crisis that provided the immediate impetus

[6]The irony, of course, is that the most direct threat was not to the customs union itself but to the Common Agricultural Policy (CAP), which set domestic-currency support prices for agricultural goods that were therefore effectively exempted from the customs union. (A constellation of domestic-currency support prices that was economically viable initially could quickly become unviable if exchange rates moved significantly, since there would then be an irresistible incentive to ship agricultural products from where their prices were low to where they were now high, undermining the initial support prices. Governments responded with a special set of "green exchange rates" expressly for agricultural trade, but market participants had an obvious incentive to circumvent them.) In fact, the best way of understanding the CAP is as a side payment from Germany to France, designed to compensate France for its perceived difficulty in competing with German industry once intra-European trade was freed. Thus, there is no inconsistency in arguing that exchange rate instability which threatened the CAP might also jeopardize support for the customs union.

for monetary unification.

Some would argue that other parts of the world – East Asia, North America, South America, even Africa – are elso committed to their regional free trade arrangements and that they too need monetary unification to prevent exchange rate instability from precipitating a protectionist backlash and otherwise disrupting the development of their RTAs. There is some basis for this argument. But in none of these other regions is the commitment to regional integration as deep and abiding. The progress of regional trade liberalization remains halting in East Asia, South America and Africa. The three partners in the North American Free Trade Agreement have created a free trade area, but they do not yet have a true single market. Among other things, they continue to control their own trade policies, government procurement policies, and competition policies.[7] Trade among Canadian provinces and among U.S. states remains very much larger than trade between the two countries, even after adjusting for per capita incomes and transportation costs, indicating that the NAFTA countries have some ways to go in creating a single market.[8] While there may be pressure for exchange rate stabilization to preserve what has been achieved in terms of regional integration, in none of these other regions does the achievement and therefore the pressure approach European levels.

If monetary union was attractive in Europe because it was integral to the larger project of economic integration, then it was feasible because it was part of the larger process of political integration. In Europe there is a readiness to contemplate institutions of transnational governance like the European Central Bank, in whose decisions all the participating countries have a say. Institutions like the ECB are regarded as legitimate because they are part of a larger European construct, namely, the European Union. They are legitimate because they can be held accountable to their constituents by other EU institutions, specifically by the European Parliament to which the ECB

[7]In addition, of course, labor mobility between Mexico, Canada and the U.S. continues to be restricted.

[8]Helliwell (1999) estimates that the density of trade among provinces and states exceeds the density of trade between them by a factor of 20.

is obliged to report and before which its officials are called to testify.[9]

Could not other regions create analogous institutional frameworks within which their own regional central banks might be situated? Some will say yes, especially if we don't require them to specify the date by which they think that this will happen. But when we make the question concrete – how many years do you think it will be before the NAFTA partners or the members of ASEAN+3 create institutions with the powers of the European Commission, the European Parliament, and the European Court of Justice – one must acknowledge that we are unlikely to see this result anytime soon.

[9]To be sure, there are complaints that democratic accountability remains insufficient, but this is more likely to lead to a further strengthening of the powers of the European Parliament than to the abolition of the ECB. The constitutional convention currently underway provides a unique opportunity to address this problem.

Europe is unique because its intellectual and political history is unique. There is a long-lived strand of integrationist thought in Europe that has led politicians and their constituents to contemplate compromises of national sovereignty more readily than their counterparts in other parts of the world.[10] The Pan-European Union, founded in 1923, lobbied for a European federation, attracting the support of, among others, Konrad Adenauer and Georges Pompidou. Even earlier, in the mid-19th century, European intellectuals like Victor Hugo were advancing the case for a United States of Europe. Before him, William Penn proposed a European parliament, Jeremy Bentham a European assembly, Jean-Jacques Rosseau a European federation, Henri Saint-Simon a European monarchy. Many generations before the Maastricht Treaty and the euro, in other words, there already existed a powerful strand of European integrationist thought.

Other regions, it is clear, do not share this tradition. In North America, the problem is the size and dominance of the United States. Canadians do not want to be seen as residents of what is essentially the 51st U.S. state. Mexicans remember how the northern part of their country was taken from them by force, and they are reluctant to even privatize Pemex for fear that it will be taken over by Yankees. The members of Mercosur have little tradition of political cooperation and no desire for federation. In Asia, the problem is very different political systems. It is hard to imagine more strongly contrasting systems than those of China, Korea and Japan.

[10]This argument is drawn from Bayoumi and Eichengreen (1999).

All this leads me to conclude that other parts of the world are unlikely to follow Europe down the path to monetary unification anytime soon. The real lesson of the euro, then, is that they will have to find other solutions to the problem of exchange rate instability and other ways of reconciling monetary autonomy with economic integration. In the remainder of this lecture, I suggest what these other regions should do about this.[11]

1. East Asia

[11]A significant omission from this list is Eastern Europe. Insofar as the countries of this region, and perhaps also Turkey and parts of North Africa, will become members of the European Union, they can also solve their monetary dilemma by adopting the euro. The fact that they will be full members of the EU and therefore have a say in the decisions of the ECB makes this feasible politically. There is, of course, quite a debate over whether it would be advisable for the accession economies to adopt the euro at the first possible date, perhaps in 1996, or whether they would be wiser to defer the decision until they had made more progress in converging with the rest of the EU. Long-time students of European monetary integration will recognize this as the old debate between the so-called "monetarists" and "economists" in a modern guise (where the latter argued that exchange rates should be fixed only at the end of a long convergence process, while the former argued that fixing exchange rates could itself bring about convergence). My own view is that joining the euro at the first possible date may not be ideal for the accession economies, but it is better than the available alternative of attempting to stabilize their exchange rates within the plus-or-minus 15 per cent bands of an ERM-II, which, given the reality of open capital markets, would entail very serious crisis risk. And, as for whether the incumbents would be able to delay their admission to the euro area, the Greek, Italian, Portuguese and Spanish cases provide a clear prediction.

Let me start with East Asia, since this is there where there has been the most discussion of monetary integration. Asian countries have a tradition of pegging to the dollar, reflecting their heavy dependence on exports. Exchange rate instability – first the devaluation of the Thai baht in July 1997 and then the opportunistic depreciation of the Taiwanese dollar in October – are widely blamed for precipitating the Asian financial crisis. Restoring exchange rate stability is viewed in some circles as a necessary precondition for, or at least an essential corollary of, restoring financial stability. This has led to a proliferation of proposals for establishing common basket pegs, in which the major countries of the region would all peg to a basket comprised of the dollar, the euro and the yen, and in which they will all attach the same weights to the three components of the basket.[12] Some have gone further and suggested that this common basket peg might be a useful stepping stone to an Asian Monetary Union. European officials have actually encouraged Asian governments to follow their lead. Thus, two years ago a joint report of the French and Japanese governments recommended that Asian countries could usefully start with an exchange rate agreement, buttressed by strengthened mutual surveillance, and then contemplate a phased transition to monetary union.[13]

How seriously should we take these ideas? No question, the desire for exchange rate stability in Asia is intense, reflecting the searing experience of the 1997 crisis. And, two and a half years ago, at the time of the annual spring meetings of the Asian Development Bank, the ASEAN+3 countries (the members of ASEAN together with China, South Korea and Japan) agreed to the so-called Chiang Mai Initiative (CMI). The CMI provides $1 billion of collective support lines. Countries will be eligible to borrow up to twice their maximum contribution by swapping their domestic currencies for dollars, yen and euros. These funds will be supplemented by a network of bilateral swap agreements (BSAs) among the participating countries. Multilateral swaps can be drawn for up to six months, with one six-month extension possible. Countries can draw from the BSAs for up to 90 days, and renew their

[12]Versions of this proposal include Goto and Hamada (1994), Ito, Ogawa and Sasaki (1998), Dornbusch and Park (1999), Government of France-Government of Japan (2000), Kawai and Akiyama (2000), Kawai and Takagi (2000) and Kim, Ryou and Wang (2000).

[13]See Government of France-Government of Japan (2000).

drawings up to seven times. Up to10 percent of the drawings available to a country under the terms of the bilateral swap arrangements can be provided for a limited period without it having entered into an IMF agreement, but subsequent disbursements will be linked to an IMF program or Contingent Credit Line.

Ever since the CMI was announced, however, Asian officials have been backing away from the idea that it could be a platform for regional exchange rate stabilization. Why is not hard to see. In Asia there is little appetite for political integration. Asian countries did not conclude from the 1930s and World War II that the way to prevent a recurrence of such difficulties was by forging deeper economic and political links. This was a logical conclusion for Europeans to draw because economic interdependencies were already so extensive and their disruption in the 1930s was seen as setting the stage for political and military conflict. This is the "structural imperatives interpretation" of European integration, which argues that the process gained steam after World War II because European countries were already so interdependent economically.[14] In Asia, in contrast, intra-regional trade and intra-regional transactions generally were less important. In the 19th century, China and Japan had been closed to international transactions for extended periods, while other economies oriented their trade, for reasons not of their own volition, toward the western colonial powers. Japan's use of force to forge closer economic relations in the 1930s did nothing to lend respectability to the idea of economic ties as a bulwark against conflict. As a result of their own particular histories, Asian countries remain jealous of their sovereignty.

From the jealousy with which they guard their sovereignty flows Asia's approach of decision making. Governments are hesitant to reproach their regional partners. Surveillance shies away from criticizing the policies of neighboring countries, and even those criticisms that survive intensive vetting are rarely made public. In these respects Asian surveillance differs from its counterpart in the European Union. The implication is that initiatives for monetary and financial cooperation that require naming names and intervening in the affairs of other nations are

[14]The classic statement of this view is Milward (1984). A recent restatement of the thesis is Morvcsik (1998).

unlikely to gain traction in Asia.[15]

[15]It is hard to imagine an Asian analog of Bundesbank President Schlesinger's criticisms of British government policy in the summer of 1992, or the kind of frank discussion of German and Portuguese budget deficits by other governments that took place in the winter of 2002.

A consequence of the priority that Asian countries therefore attach to their autonomy is that regional integration tends to be organized on the basis of what some scholars refer to as "soft institutionalism" and others describe more bluntly as "weak formal institutions."[16] Their concern with sovereignty leaves Asian governments reluctant to delegate significant authority and decision-making power to a supranational body. Asian governments evince "a shared distrust... that international bureaucratic structures might become independent of their state sponsors."[17] Institutions of regional cooperation therefore tend to be inter-governmental rather than autonomous. They have little independent decision-making power.

This difference is important in the light of the "institutionalist" interpretation of European integration (which is the main rival of the "structural imperatives" interpretation described above).[18] In the institutionalist interpretation, it was the creation of strong formal institutions that lent momentum to the process of European integration.[19] Structural imperatives played a role at the initial stage, but what propelled the process forward

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[16]As Katsenstein (1996, p.125) writes, "In comparison to Europe, Asian regionalism is not well instititutionalized. Operating by consensus in regional organizations Asian states exercise effective veto power over collective actions. Indeed the history of formal regional institutions is a history of failures so conspicuous, in comparison to Europe, as to beg for an explanation."

[17]Katzenstein (1996), p.140.

[18]This is the taxonomy of scholarship on European integration laid out in Parsons (2002).

[19]The classic statement here is Haas (1958), while the definitive recent restatement is Sandholtz and Stone Sweet (1998).

subsequently was an institutional design that delegated power to"supranational agents" who in turn framed new projects and mobilized new coalitions to extend their domain. These supranational entities not only carried out an agenda-setting function but provided "centralized monitoring" and "third party enforcement" which helped to solve information and agency problems that hinder effective cooperation.[20]

In the short run, then, efforts to stabilize exchange rates in Asia are unlikely to succeed. Given the reluctance to build institutions of firm mutual surveillance, strong-currency countries will not be willing to extend unconditional commitments of support to their weak-currency counterparts, since they will have no assurance either that avoidable problems will be headed off or that the crisis countries will make the adjustments necessary to ensure that the creditors will be paid back. It is revealing that the decision to activate the swaps and credit lines of the CMI is at the discretion of the lender. If the commitment to support weak currencies is qualified in this way, the markets are unlikely to be impressed. The effort to construct a regional exchange rate stabilization agreement would only come to grief and discredit the wider project of economic integration. And, given resistence in Asia to building strong regional institutions and countries' lack of enthusiasm for political integration, a more ambitious step like a single Asian currency remains social science fiction.

2. North America

[20]See Mattli (1999). This view is not uncontroversial. But the example most relevant to this lecture -- monetary union, a project of the European Commission and political elite which had to drag a sometimes reluctant European citizenry along behind it -- is a case in point. Had the decision to create a monetary union been left to governments and their electorates, rather than having the process propelled forward by the European Commission and its independent technocrats, it is entirely possible that we would still be waiting for agreement to proceed.

On purely economic grounds, there would seem to be a strong case for monetary integration in North America.[21] More than 80 per cent of Canadian exports go to the U.S., and more than 75 per cent of the country's imports come from the U.S. The figures for Mexico are virtually identical. Labor mobility has already created immigrant networks on which future mobility can build. Cultural and linguistic obstacles here are less than in Europe. Foreign investment is substantial. U.S. banks have substantial presence in both Canada and Mexico. The single largest component of U.S.-Canada trade involves the assembly plants and subsidiaries of U.S. automobile companies north of the border, while the single most important component of Mexico-U.S. trade is in the assembly plants ("maquiladoras") owned and operated by U.S. companies south of the border.

Moreover, the U.S. dollar is an attractive basis on which to form a monetary union.[22] If Canada and Mexico adopted the dollar, their North American currency would already be the leading vehicle and invoicing currency used in transactions with and in the rest of the world. Mexico and Canada would gain greater ease of transactions not just with the United States, in other words, but also with the rest of the world. It would not be necessary to convince other central banks to add the single North American currency to their reserve portfolios, since the dollar is already the dominant component of international reserves. Assuming that an expanded Federal Reserve System remained responsible for North America's monetary policy, there would already exist an experienced central bank and no need to create a new institution or to undergo a painful teething process.

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[21]The case has been made by, inter alia, Courchene and Harris (1999), Buiter (1999), and Grubel (2002).

[22]The argument in this paragraph is *not* that Canada and Mexico are already de facto (U.S.) dollarized. Such an argument would be especially strained for Canada. Although the share of foreign currency deposits as a share of total deposits at Canadian banks nearly doubled in the second half of the 1990s, de facto use of the greenback in Canada remains limited (see Murray and Powell 2002). These authors suggest that de facto dollarization in Canada today is if anything even less than 20 years ago.

But herein lies the rub. The dominance of the United States over the North American economy means that Canada and Mexico could not go it alone. The U.S., in turn, would have effective veto power over institutional arrangements. No doubt, there would be overwhelming resistance in the U.S. to creating a new currency (like the "amero"envisaged by Grubel 2002) and a North American Central Bank to assume the responsibilities of the Federal Reserve System. The best that Canada and Mexico can hope for, looking 10 or 20 years down the road, would be seats on an expanded Federal Reserve Board, and perhaps permanent representation on an expanded Federal Open Market Committee like that enjoyed by the Federal Reserve District of New York.[23]

Not even this is certain since, as a price for giving them membership in the Federal Reserve System, the U.S. Congress might insist that Mexico become one of the "states" represented by the Dallas Fed, and that the various Canadian provinces be assigned to the San Francisco, Minneapolis and Boston reserve banks. If the Canadian and Mexican governments resisted this, their only route to monetary unification might be to adopt the dollar unilaterally, like El Salvador and Panama have done. Anyone familiar with North American politics will dismiss this as implausible.

Even if Canada and Mexico were given seats on an expanded Federal Reserve Board, there would be the question of how and to whom that institution would be accountable – and, if not from accountability, then from what else its legitimacy would derive. The Fed is held accountable by requiring its chairman to testify regularly before the U.S. Congress and its committees. If the Fed pursues policies inconsistent with the national interest, members of those committees can make life very uncomfortable for the governors; in addition to public criticism, they can hold up confirmation of new appointees to the Board. Clearly, there will be no North American Congress in our lifetimes with the power to hold the expanded Federal Reserve Board accountable. Will the chairman then be required to make periodic appearances before the Canadian Parliament and Mexican Congress in order to be held duly accountable for his actions? It seems unlikely that such appearances would be more than pro forma; objections by these bodies would be drowned out by the opinions of the U.S. Congress. Would nominees to the Board have to be confirmed by the Mexican Congress and Canadian Parliament as well as the U.S. Congress, and, if so, does one

[23]Even this assumption is heroic. Alternatively, the Bank of Mexico and Bank of Canada might have to rotate on and off the FOMC like the run-of-the-mill reserve bank.

really think that they would have the power to hold up appointments for a significant period of time if U.S. politicians felt otherwise?

There would be other economic problems to solve. The United States might demand that Canada reduce its public debt in return for representation on the Federal Reserve Board or that Mexico accept oversight of its fiscal policy. Canada and Mexico might require reassurance that the Fed would act as lender of last resort to their banking systems, despite the fact that it had no regulatory oversight of their banks. In return, the U.S. might demand new powers over Canada and Mexico's banking systems; it might require those countries to import U.S. rules on anything from ownership to lending practices.

Thus, the principal obstacles to a North American monetary union are not economic but political. The *National Post,* Canada's leading newspaper, put it well in an editorial a couple of years ago. "[T]he move to a common currency is ultimately a political issue. The euro rests on an extensive supra-national system of government that has the explicit goal of creating a united Europe. We do not seek political integration with the U.S. So there is no positive political case for a common currency."[24]

3. South America

[24] National Post (1999).

Mercosur, the free trade area made up of Argentina, Brazil, Paraguay and Uruguay (with Bolivia and Chile as associate members), has a checkered history. While trade among its members expanded rapidly, from low initial levels, in the first half of the 1990s, buffetted repeatedly by protectionist measures and financial instability. This has not prevented a few far-seeing observers from arguing that its members should begin to lay the basis for a common currency (see for example Giambiagi 1997, 1998). In large part the impetus for their proposals flows directly from the havoc that currency instability has wreaked with the development of Mercosur. The problem goes back almost to the very beginning of the FTA, which coincided with Argentina's convertibility plan. With convertibility, the peso became increasingly overvalued against the Brazilian real, and Argentina responded with anti-dumping duties and safeguarding measures against Brazilian exports of farm machinery, spark plugs, steel refrigerators, paper, textiles and chemicals. In 1994 it was Brazil's turn: with the launching of the Real Plan, the Brazilian currency became increasingly overvalued, and in 1995 the Brazilian government raised tariffs and imposed quotas on imports from Argentina.[25] In 1997 it imposed a system of discretionary import licenses on selected products. In 1998 the devaluation of the real led Argentina to impose import quotas for textiles and to impose bureaucratic restrictions on imports of Brazilian machinery and Brazil to retaliate by reintroducing subsidies for rice production and to demand limits of imports of footwear. And then, in 2001, Argentina's devaluation once more dimmed Brazil's enthusiasm for Mercosur.

These last developments have been particularly disastrous for the FTA. After expanding by 16 per cent a year on average in the 1990s, intra-Mercosur trade declined by almost 10 per cent in 2001, and 2002 looks even worse. Intra-Mercosur exports now make up only 19 per cent of the group's total exports, down from 25 per cent in 1998. The irony is that an FTA that was designed to foster better commercial relations between Argentina and Brazil has in fact seen a heightening of trade tensions between them, largely due to the instability of currency markets.

[25]Tariffs on vehicle imports were raised from 20 to 32 per cent in February 1995 and to 50 per cent in April (Bevilaqua 1997).

It has been suggested that emulating the kind of peer pressure used to encourage real and nominal convergence in Europe could be part of the solution to Mercosur's problems .[26] In response the members have adopted macroeconomic convergence targets that bear no little resemblance to the convergence criteria of the Maastricht Treaty and have established a Macroeconomic Monitoring Group (GMM) to monitor compliance and corrective measures when divergences occur.[27] Thus, on December 15th, 2000 the presidents of the member countries declared their commitment to achieve specific convergence targets. They committed to targets for inflation (a core rate not to exceed 5 per cent per annum in 2002-2005, and to fall to 4 per cent in 2006), fiscal deficits (not to exceed 3.5 per cent of GDP in 2002 and 2003 and then 3 per cent starting in 2004), and public debts (not to exceed 40 per cent of GDP by 2010). If discrepancies were detected, the government of the offending country would be required to present specific macroeconomic and structural measures sufficient to guarantee a return to target, along with a scenario for the transition path, at the next meeting of the GMM. The influence of European experience on Mercosur practice is clear.

But it is revealing that, at the time of writing, the most recent posting on the Banco Central do Brasil's website regarding the GMM is dated January 3rd, 2001 – that is, almost two years ago. First Argentina's crisis and now Brazil's unavoidably delayed the process. But the more fundamental problem is that if the governments involved fail to achieve their convergence targets, they have no one to answer to but themselves. They sacrifice nothing but their own aspirations. There is no supranational institution in the Southern Cone analogous to the European Commission to hold them accountable. There is no interlocking web of economic, financial and political bargains among the Mercosur countries, all of which would be jeopardized by their failure to adhere to their convergence targets. In contrast to the Short -Term and Very-Short-Term Financing Facilities of the pre-1999

[26]See for example Alberola, Buisan and Fernandez de Lis (200).

[27]For details, see http://gmm.mecon.gov.ar. The Treaty of Asuncion creating the FTA had provided for the coordination of macroeconomic policies and envisaged periodic meetings of Ministers of Economy and central bank governors, but no such meetings took place for several years prior to the devaluation of the real at the beginning of 1999, which can therefore be seen as having provided new impetus for efforts to encourage policy coordination.

European Monetary System, there are no credit lines to be jeopardized by bad behavior. (It is revealing in this connection that the fiscal targets that South American countries are obliged to hit are those set by the IMF, which is the source of concessionary finance.) Again, the implication is that in the absence of a broader political project, the compromises of domestic policy autonomy required for real policy convergence would be credible.

Some will say that the Mercosur countries can achieve monetary unification indirectly, by all adopting the U.S. dollar. If Mercosur is subsumed into a Free Trade Area of the Americas that extends throughout the Western Hemisphere, they argue, the case for adopting the dollar will become stronger still. But however strong the economic logic for unilateral dollarization, the political obstacles are formidable. While creative thinkers can imagine how Canada and Mexico might someday acquire seats on the Federal Reserve Board, it is impossible to imagine that the U.S. Congress would be prepared to further dilute the membership of the FOMC by giving seats to Argentina, Brazil, Paraguay, Uruguay, Bolivia, Chile and others. Dollarization would therefore mean giving up all voice in the formulation of the common monetary policy. Economists can come up with arguments for why this is desirable (see e.g. Garcia Herrero and Glockler 2000), but political scientists will recognize the political implications as unsustainable, leaving aside very small countries in very special circumstances. Even the most extreme social, political and economic crisis did not lead Argentina to dollarize this year. Is it really realistic to think that a country in more normal political circumstances would do otherwise?

4. What to Do

The unavoidable conclusion is that European monetary unification is not exportable. Europe's experience is sui generis. Its singular history has given rise to a singular political project that has made possible monetary options not feasible in other parts of the world.

What then are these other regions to do? Neglect is not really feasible, since the persistence of erratic fluctuations in the relative value of national currencies would then continue to wreak havoc with efforts to liberalize trade on a regional basis. Mercosur will not survive many more years of erratic exchange rate fluctuations. Efforts to build a true free trade area in Asia will not succeed if exchange rates again display the volatility to which they were subject in 1997-8. But holding currencies within narrow bands is not feasible in a world of high capital mobility. And monetary union, as I have argued, is not going to solve the problem anytime soon.

My preferred solution is inspired by the experience of the three NAFTA countries. All three have floating currencies anchored by a clear and coherent monetary policy operating strategy, namely inflation targeting (IT). Their exchange rates rise and fall, reflecting fluctuations in the world market prices of primary commodities versus manufactures (where the Canadian dollar and Mexican peso strengthen against the U.S. dollar when commodity prices are strong) and the relative strength of economic growth in the three countries. Importantly, however, their currency fluctuations tend to be temporary and reversible. They reverse direction when commodity prices or relative business cycle conditions reverse direction. Although exchange rates can still be volatile in the short run, and although such volatility can still have a mildly depressing impact on the volume of intra-regional trade, major disruptions due to chronic misalignments, which elicit a strong protectionist backlash, are unlikely to occur.[28]

One explanation for the relative stability of intra-NAFTA exchange rates is that when central banks have adopted a credible inflation targeting framework, inflation today is no longer perceived as augering inflation tomorrow. To the contrary, if inflation in one of the three partner countries accelerates for extraneous reasons, the expectation is that its central bank will step on the brakes even harder, bringing inflation temporarily below its equilibrium level to enable monetary policy to hit its medium-term target. Expectations will therefore tend to be stabilizing rather than extrapolative. Exchange rates should grow less volatile and therefore pose less of a threat to the integration of regional economies. The U.S., Canadian and Mexican central banks all inflation target, either de facto (in the U.S. case) or de jure (in the Canadian and Mexican cases). Their experience suggests that floating exchange rates, if anchored by a clear and coherent inflation-targeting framework, can be successfully reconciled with the desire to cultivate deeper regional links.

[28]Fernandez-Arias, Panizza and Stein (2002) show that the main impact on import levels and the principal threat of a protectionist backlash flow from persistent misalignments, not from short-term volatility.

Together with Alan Taylor, I have tested this hypothesis using data on the volatility of bilateral exchange rates for more than 100 industrial and developing countries.[29] Adopting the framework utilized in Bayoumi and Eichengreen (1997), we regress bilateral exchange rate volatility on four variables suggested by the theory of optimum currency areas: the size of the two economies, their openness, the extent of their bilateral trade, and the similarity of the commodity composition of their exports.[30] To test the hypothesis at hand, we then add dummy variables for whether countries are inflation targeters, using the tabulation of inflation targeting around the world from Mishkin and Schmidt-Hebbel (2001).[31] Since inflation targeting is an alternative to attempting to peg the exchange rate, we control for the choice of exchange rate regime when testing for the effects of this inflation-targeting variable.

[29]See Eichengreen and Taylor (2002).

[30]In extended regressions we consider a variety of additional real and nominal control variables; the results discussed below are robust to these extensions. As the dependent variable we consider both nominal and real exchange rate volatility; again, the results are robust to both specifications.

[31]Specifically, we constructed two variables: one that equals unity when one of two partner countries targets inflation, and another that equals unity when both countries have adopted this monetary regime.

The obvious problem with this approach is that the decision to inflation target may be endogenous. In particular, the literature on inflation targeting in open economies points out that countries with more volatile exchange rates may find it more difficult to inflation target because, inter alia, the domestic price level will be more difficult to forecast and exchange rate fluctuations will have disruptive output effects. In addition, countries with deeper financial markets, less short-term debt, and greater transparency are more likely to inflation target. For example, inflation targeting relies on transparency for the credibility of monetary policy; thus, countries with a culture of transparency are presumably more likely to adopt this regime.[32] In other words, while countries with these characteristics may both prefer to inflation target and enjoy more stable exchange rates, it could be that the causal connection between inflation targeting and exchange rate stability is actually weak or nonexistent.

To deal with the potential for endogeneity, we therefore instrumented our dummy variables for inflation targeting using a first-stage probit regression on the M2/GNP ratio as a measure of financial depth, the short-term debt/GNP ratio, and *Transparency International's* measure of transparency and corruption. These are some of the obvious structural and cultural characteristics of countries that choose to inflation target, and they are plausibly exogenous with respect to the choice of exchange rate regime. We find that countries that target inflation have significantly less volatile exchange rates, even after controlling for a variety of other economic and financial determinants of realized volatility and even after adjusting for the endogeneity of the regime. Volatility is still less if both countries inflation target than if only one of the two partners in the bilateral relationship does so.

One interpretation of these results is that inflation-targeting regimes are a better way of delivering low levels of exchange rate instability, ex post, than pegging the nominal rate. Pegs, no matter how hard, have historically had a tendency to collapse, unleashing a wave of pent-up volatility. These results suggest that agreement by the partners to simultaneously move to inflation targeting – and, ideally, to agree on a common inflation target –

[32]In addition, large amounts of short-term debt make it difficult to inflation target, since the interest rate adjustments needed to stabilize inflation will cause correspondingly larger spikes in debt-servicing costs. Similarly, countries with shallower financial markets will presumably experience larger disruptions to real and financial conditions as a result of the interest-rate activism that must be pursued by an inflation-targeting central bank. On these and other determinants of the choice of inflation targeting, see Mishkin and Schmidt-Hebbel (2001).

may go some way toward alleviating the tension between floating rates and regional trade liberalization.

The crux of the matter, naturally, is the word "credible." Some readers will point to cases like Argentina in 2002 and question whether inflation targeting is feasible in emerging markets. In my view, this objection reflects a misunderstanding. Under the kind of extreme instability experienced by Argentina, no stable monetary regime is feasible—neither inflation targeting, nor a currency peg, nor anything else. In countries where economic, financial and social turbulence is less, inflation targeting has been shown to work. This is the implication I draw from the experience of countries like Chile, Mexico, and even Peru. The experience of this last country suggests that the entire IT apparatus does not have to be adopted in order for countries to reap benefits from the regime. To be sure, inflation targeting in relatively open economies with high levels of liability dollarization will place a heavier weight on exchange rate movements as a leading indicator of future inflation (and future output movements) than is the case in, say, the United States. But this is a point about the conduct of inflation targeting under such circumstances, not a challenge to its viability.

Conclusion

Let me conclude. One traditional way of characterizing the history of European integration is that European officials used the route of "low politics" to further the process of regional integration. Thus, following the failure of the French Parliament to agree to the European Defense Community in 1954, they pursued economic integration – first the customs union, then the single market, and now to the euro – to promote their ultimate objective of political integration. I have suggested that this traditional characterization is too simple. Important elements of that agenda, including the single market but epitomized by the single currency, would not have been feasible had there not already existed a predisposition toward and progress in deepening political integration. Economic integration encouraged political integration, but the converse was also true.

European observers will find the implications both comforting and disturbing. They are comforting in that they suggest that Europe is a special place. Because of the continent's distinctive history, with its distinctive historical legacy, Europe can avail itself of distinctive economic and monetary options, whose most dramatic manifestations are the euro and the ECB. The implications are disturbing in that they suggest that other regions, whose political histories and legacies are different, will find it much harder to avail themselves of these strategies.

They suggest, in other words, that European monetary unification is not exportable.

Does this mean that other regions, which are unlikely to follow Europe down the path to a single currency anytime soon, will never succeed in building serious regional free trade areas? I have suggested that such a pessimistic conclusion is unwarranted. There are more modest steps, such as harmonized inflation targeting, that would minimize the kind of chronic misalignments that have undermined regional arrangements in the past. With time, deeper trade links could lay the basis for political collaboration, and with political collaboration other monetary options would become possible. But that is the challenge for another generation and therefore the subject of another lecture.

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