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The Euro Through a Glass Darkly

by

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Abstract

On January 1st, Europe's monetary union will celebrate its fifth anniversary. Congratulations are not exactly pouring in. For going on two years, growth in the countries of the Euro Area has been significantly slower than in the United States. Unemployment over much of the continent remains disturbingly high. The single currency has not been a tonic for Europe's stagnant economy. To the contrary, numerous critics complain, the advent of the euro has only compounded Europe's economic problems.

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On January 1st, Europe's monetary union will celebrate its fifth anniversary. Congratulations are not exactly pouring in. For going on two years, growth in the countries of the Euro Area has been significantly slower than in the United States. [See Table 1.] Unemployment over much of the continent remains disturbingly high. The single currency has not been a tonic for Europe's stagnant economy. To the contrary, numerous critics complain, the advent of the euro has only compounded Europe's economic problems.

If anything, their complaints are growing in number and intensity. For the last five years, Europe's growth was sustained first by booming stock markets, which soared nearly as high as in the United States, and then by the low level of the euro, which gave the continent's exports an artificial boost. But now that the stock market bubble has burst and the dollar has fallen, Europe's problems are mounting. Although reluctant to admit it, at least some advocates of the single currency may be having second thoughts.

The Promise

It is difficult to believe that policy makers would have undertaken this unprecedented monetary experiment unless it promised significant benefits. A first benefit is the stimulus that the euro has lent to

the growth of European financial markets. By eliminating exchange rate fluctuations within the Euro Area, the euro eliminated the currency risk that previously segmented Europe into a dozen and more separate corporate bond and commercial paper markets. With monetary unification, the German "bund" (the Federal Republic's ten year government bond) became the benchmark off of which corporate credits were priced throughout the Euro Area. Investors, no longer deterred by currency risk, 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 market continent wide.

Almost immediately, then, the euro began erasing the competitive disadvantage suffered by European economies from their lack of U.S.-style bond markets. Funding costs for European corporations declined as the rate of issuance of new corporate credits exploded. In the first year of the euro, the value of euro-denominated corporate bond issues more than tripled, and the share of corporate bond issues accounted for by speculative (sub-investment-grade) issues rose from 4 per cent to 15 per cent. Corporations were able to place unpredecentedly large issues on European markets. These extraordinary early growth rates have now tailed off a bit, but the rate of growth of issuance of debt securities by nonfinancial corporations continues to outrun the growth of their other sources of finance. This enhanced access of euro-denominated corporate debt markets helped to finance a wave of mergers and acquisitions which in turn promises to strengthen Europe's corporate sector.

As with many economic adjustments, there have been losers as well as winners. In this case, Europe's banks, confronted with fiercer competition from the bond market, have seen their profits squeezed.

Banking has gone from one of Europe's crown jewels to one of its sick industries. The starting point, however, was one in which Europe was over-banked and U.S. corporations enjoyed a cost advantage as a result of America's better-developed bond markets. The end product will undoubtedly be a better balanced European financial system and a more competitive corporate sector.

A second benefit of the euro is the stimulus it has given to price competition. Europeans may have reservations about cut-throat competition *a la Amerique*, but their economic leaders do not doubt that more intense competition is needed to prod efficiency gains out of European retailers and their suppliers. For nearly two decades officials have been pursuing the Single Market Program with this goal in mind. But a true single market is easier to declare in principle than to establish in practice. In Europe the fact that prices were denominated in so many different currencies complicated cross-border price comparisons and limited the intensity of competition. With the advent of the euro, residents of different European countries can finally compare apples with apples. They can more easily determine where the prices are lowest and through their actions place more pressure on high-cost suppliers. Europe is still very far from the perfectly competitive marketplace of textbook economics. But any step in the direction of a more competitive environment is a step in the right direction.

It is also important to ask what monetary and financial life would have been like for the last five years had the members of the euro area retained their separate national currencies. Europe's history is replete with instances where economic and political shocks led to sharp changes in currency valuations, wreaking havoc with economic stability. A classic example is Germany reunification, which was a major

factor in the currency crisis of 1992. Now imagine a shock like the recent military action against Iraq giving rise to diplomatic tensions between the U.S. and France. Presented with this riskier political environment, investors might have fled the French franc for, say, the German mark, causing volatile fluctuations in European currencies. All this is hypothetical, of course. But in pondering the effects of the euro, it is essential to consider hypotheticals – to ask how events would have played out in the single currency's absence. 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 collapse of high-tech stocks, Al Queda's attack on the World Trade Center, and war in the Middle East all could and likely would have produced currency chaos in pre-euro days. The residents of the Euro Area can at least take heart that this specter has been vanquished.

The Cost

"What if's" rarely sway public opinion when the costs of a policy are palpable. In the case of the euro, the most obvious cost has been a one-size-fits-all-monetary policy. Fast-growing Ireland, until recently known as the Celtic Tiger, would have preferred a tighter monetary policy for much of the last five years. Slumping Germany, for much of 2003 at risk of falling prey to deflation, clearly would have preferred a looser policy.

But the most fundamental fact of monetary union is that the central bank must set a single level of interest rates for the entire monetary zone. The effect over the euro's first five years has been to accentuate the boom-and-bust cycles experienced by different 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.

To be sure, 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 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 period of the technology boom and NASDAQ bubble. Monetary medicine can treat a variety of ills. But there are serious questions about whether monetary tightening is an appropriate response to an asset price 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 keeping its eye on economy-wide inflation. And 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 policies of the Fed – to the prescriptions of 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 could have used in the boom period, we now know, was greater fiscal discipline. It should have resisted the temptation to raise public spending along with tax revenues and instead run surpluses, building up a rainy day fund for bad times. In other words, since the common monetary policy cannot be tailored to the idiosyncratic needs of one member of a monetary union, that member should adjust its budget to counter local shocks. Actually, this is just what Ireland did. Unlike California, it ran substantial surpluses in the late stages of its high-tech boom, although this failed to prevent its economy from overheating because the high-tech mania was so pronounced and Ireland is such a small part of the global electronics industry. That the Irish economy overheated anyway is one way of understanding why this fiscally responsible country was criticized by the European Commission, the Euro Area's fiscal overseer, for not running even larger budget surpluses.

Fiscal Follies

This reference to fiscal policy brings us finally to Europe's notorious Stability and Growth Pact, the rules whereby the Commission, working in harness with national finance ministers, is supposed to encourage the pursuit of prudent (Irish-style, if you will) fiscal policies. The Stability Pact and associated procedures are intended to compel governments to keep their budgets in surplus or at least close to balance in normal times so that they can move safely into deficit when activity slows.

But by failing at the first task, the pact has frustrated rather than facilitating the second. A number of European governments were lax during the recent expansion. Having gone on crash diets in the 1990s to qualify for participation 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 per cent of GDP when the current slowdown struck. [See Table 2.] They then came under pressure from the Commission to prevent their deficits from widening further. As a result, their ability to use fiscal policy as an automatic stabilizer was inhibited. Alternatively, to the extent that governments resisted the pressure from Brussels to keep their deficits from widening further in the recession and instead opted to allow their automatic stabilizers to operate, the credibility of Europe's fiscal rules has been tarnished.

Failure to make sensible use of fiscal policy has long been a European problem. [Figure 1 shows that European fiscal policy has been perversely procyclical for most of the last five years.] But it is 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 the only instrument that can be tailored to national conditions. This makes the automatic stabilization function of national budgets even more important. Now that the monetary hand is tied down, in other words, it is all the more critical that the budgetary hand be left free, giving governments the leeway needed to tailor fiscal policy to local conditions

The unspoken question is thus 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 in this context are fallacious. The only one that holds a drop of water is that a string of budget deficits

might eventually render a country's debt unsustainable, precipitating a financial crisis and forcing the ECB to intervene. Imagine – to pick a country not entirely at random – that Italy runs deficits year in and year out. Eventually its debt burden would grow so heavy that residents might rebel against the exorbitant taxes needed to service it. The government would then have to announce that it could not pay, leading to panic selling of Italian bonds. The panic could spill over to other markets as hedge funds and other highly-leveraged investors dumped assets in a desperate scramble to raise liquidity. Questions might then arise about the solvency of banks – mainly but perhaps not exclusively Italian banks – with large investments in bonds.

The ECB, being responsible for the stability of Europe's financial and payments systems, could not stand by in the face of these events. It would feel compelled to intervene by buying up the distressed assets and providing emergency liquidity to the distressed financial institutions. The consequence of the debt crisis would then be to undermine the central bank's anti-inflationary resolve.

Fiscal prudence is the sine qua non of 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, in the first instance, that had to respond. If responding produced inflation, that meant Italian inflation. Thus, if Italy had a debt problem, Italians alone would suffer the inflationary consequences. And knowing this, there would be domestic pressure for the Italian government to limit its fiscal excesses.

But now that the ECB is Europe's lender of last resort, any inflation resulting from central bank intervention will be borne by Europeans as a whole. 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 risky policies go awry they will bear only a fraction of the costs. The likely result is less public pressure for a government to avoid fiscal excesses. The Stability Pact can be seen as a mechanism for internalizing this externality and disabling what would otherwise become an engine of inflation.

Indeed, it is not only Europe that takes this problem seriously. This logic is one way of understanding why U.S. states have restrictions on their freedom to run deficits and borrow. The Fed, in other words, would not have it any other way.

But in the U.S., unlike Europe, restraints on the freedom of 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 same free-rider problem does not prevail; the domain of the Federal Reserve and the federal fiscal authorities is one and the same.

Once this rationale for the Stability Pact is made explicit, it becomes clear how many tendentious assumptions must be made along the way. Would the ECB really respond to a debt crisis with a

significantly more inflationary policy, given the weight it attaches to price stability? Would it really worry that a financial crisis in one country would infect neighboring markets, or would it adopt a more skeptical view and stand aside as the Fed did when Orange County defaulted in the 1980s? Even if the ECB injected significant amounts of liquidity, couldn't it simply reverse out those operations once the crisis subsided, neutralizing any inflationary effects as the Fed did in the aftermath of the Long-Term Capital Management crisis in 1998?

What to Do with the Pact

Skeptics of this logic thus suggest that the Stability Pact should be abandoned. After all, the pact 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. They worry that national governments, if left to their own devices, will 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 cycle while at the same time maintaining the commitment to fiscal discipline.

There is now a large industry of academics and officials producing proposals for reforming the pact. Popular schemes include using cyclically-adjusted budget balance rather than actual budgets in its calculations, exempting public investment spending from the 3 per cent ceiling, and more readily giving

governments exemptions from that limit. The proposals have in common that they 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 the incentive to run surpluses in good times, they will also heighten worries about unsustainable debts, crises and inflation down the road. However compelling is the case for greater flexibility, until this additional shortcoming of the Stability Pact is addressed EU leaders will remain reluctant to allow governments more freedom to run deficits in hard times.

Here is where popular reform proposals fall short. 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 foreign criticism. And the even more radical idea of giving over control of national fiscal policies to a committee of independent experts, while popular among some academics, is social-science fiction.

The best way of solving the problem would be to encourage governments to reform their budgetary institutions. There is now an extensive empirical literature on the connections between fiscal institutions and fiscal outcomes. We know that countries where the prime minister or finance minister has agenda setting power in fiscal policy making are less prone to chronic deficits. Countries where states and provinces are not permitted to spend now and ask for revenue transfers from the federal authorities later

are similarly less deficit prone. Countries that privatize public enterprises are less likely to find deficit-inducing fiscal skeletons in the closet.

If European economies implement these reforms, they would be less likely to run deficits in good times. It would then be feasible to give them more freedom to run deficits when times were bad. Institutional reform at the national level is fundamentally the responsibility of member states, not the European Union. But the EU could help if it altered the focus of surveillance under the Stability Pact, giving less weight to arbitrary numerical ceilings for deficits and more to the strength and design of policy making institutions. The Stability Pact would then become a asset rather than an obstacle in the effort to enhance both fiscal discipline and fiscal flexibility.

Making Monetary Union Work Better

Reforming the Stability Pact is necessary to make Europe's monetary union work better, and there is mounting evidence that reform of the pact is in the works. There are other positive signs as well. Following a garbled start, the ECB has improved its communications strategy. It is getting better at preparing the markets for its actions and providing a convincing justification after the fact. Its 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.

The ECB is still criticized, to be sure, for not reacting as quickly or communicating as clearly as the Federal Reserve. This is not an entirely fair comparison. The ECB, at the not yet ripe old age of five, is still feeling its way. When the Fed was five years old, in 1919, it still had not established that decision making authority resided with the Federal Reserve Board rather than the regional reserve banks. It had not even discovered open market operations. By this standard, the ECB is a quick learner. The prospect of a new president who will command more respect from the markets and of rotation system for the decision-making council, which will help to limit its unwieldy size, are additional grounds for thinking that the ECB will continue to grow more adept.

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 different Euroland countries are beginning to converge. Labor mobility is rising, making it easier to adjust to shocks that hit parts of the Euro Area but not others.

Faster structural reform would also help, of course. Europe desperately needs more flexible labor markets and less government regulation. But the need for structural reform would be equally urgent even if the euro had never come about. When an economy suffers from structural rigidities and high labor costs, it will have high unemployment whatever its monetary arrangement. Labor market rigidities were not created by the central bank, and the central bank can do little to avoid their consequences. A

separate national monetary policy would do no better at restoring full employment and promoting faster growth so long as real wages are rigid and regulation remains oppressive.

In practice, there is no evidence that structural reform is faster when a country retains its own independent national monetary policy than when gives it up. Nor is there convincing evidence of the opposite. Some observers suggest that Europe's labor unions will become more moderate and flexible when they realize that there is no longer a national central bank to bail them out with a more inflationary policy if in negotiations with employers they set the level of wages too high. But it is important to recall that exactly these arguments were mooted when Argentina gave up its monetary autonomy in the 1990s in favor of a dollar peg and a quasi currency board. Increases in economic flexibility there were, but at much too slow a pace to put off the disastrous collapse in 2001.

The lesson is that structural reform must begin at home. It cannot be artificially stimulated by one monetary regime or another. Greater economic flexibility 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

All these factors – the ECB's learning by doing, sentiment to reform the Stability Pact, rising labor mobility, and the beginning of structural reform – are reasons to think that Europe's monetary union will work more smoothly in the next five years than the last. Such improvement would go some way toward

reassuring the critics. But it still would not suggest a solution to the most fundamental mystery about Europe's monetary union, which is this.

The euro's benefits, though potentially substantial, may be a long time in coming. 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, they 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 still rigid fiscal policy, are immediate and clear to see. While the costs are front-loaded, in other words, the benefits will accrue only down the road. Politicians, of course, do not believe in delayed gratification. A costly policy that promises benefits only in the distant future rarely appeals, since there is no guarantee that they will still be in office when the time comes for someone to claim the credit.

This paradox suggests that the decision to create the euro involved more than strictly economic calculation. What some of the euro's architects clearly had in mind were the political effects. For at least some of them, the ultimate goal of European economic and financial integration is political union or at least significant steps in the direction of political integration. They saw monetary union as the thin end of the wedge. 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 federal Europe can reasonably be questioned – that's another discussion. But there is no doubt that the advent of the euro and the ECB breathed new

life to the arguments of those who desire 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 that which met through much of 2002 and 2003 – 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.

The fact that monetary union is part of a larger European project is one way of understanding why the euro is not going away. Americans like to spin tales of "the coming collapse of the monetary union." But the monetary union is not going to collapse even if it produces uncomfortable economic results because it is not going to be judged by its members on narrowly economic grounds. That said, anything that the participants can do to make their new monetary arrangement operate more smoothly would be welcome. They should get working.

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Table 1

Real GDP Growth since the Start of 2002

%q/q saar, averages 02Q1-03Q2

	Euro area	US
GDP	0.8	2.7
Consumption	0.9	2.8
Government	2.2	3.8
Investment	-1.9	1.6
Exports	1.4	2.3
Dom. Final sales contribution	0.6	2.8
Inventories contribution	0.4	0.5
Net trade contribution	-0.2	-0.5

Note: The 03Q2 reading for the Euro area is an estimate based on Germany and France.

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

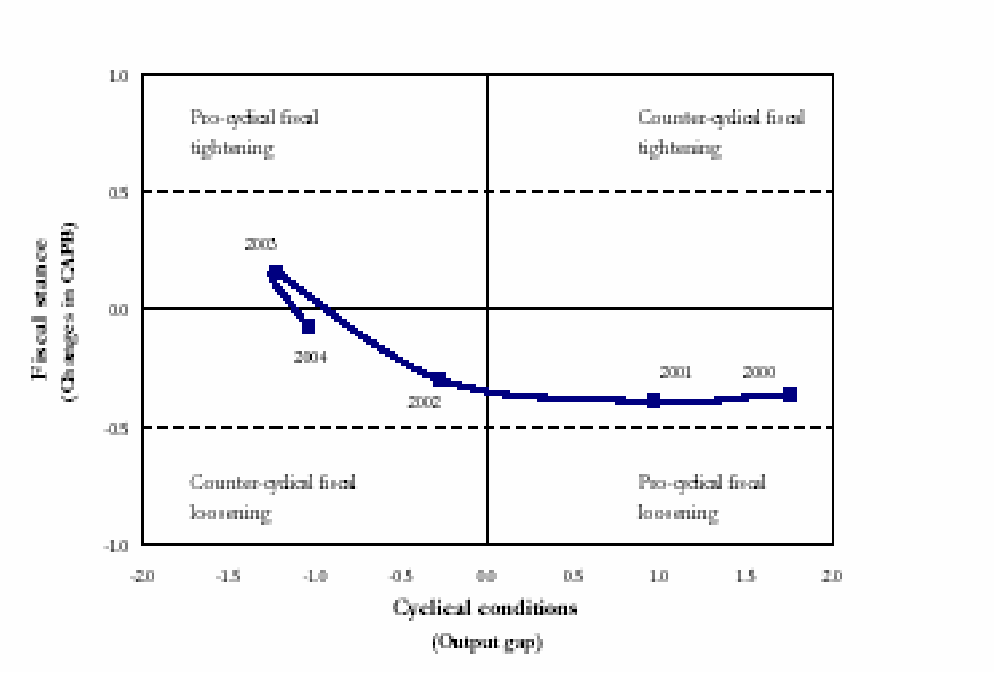
Table 2
Budget Balances in EU Member States, 2001-2004 (% of GDP)

	Budget balance				Cyclically-adjusted budget balance			
	2001	2002	2003	2004	2001	2002	2003	2004
BE	0.3	0.1	-0.2	-0.1	-0.4	0.1	0.2	0.0
DE	-2.8	-3.6	-3.4	-2.9	-3.0	-3.3	-2.6	-2.4
EL	-1.9	-1.2	-1.1	-1.0	-2.3	-1.8	-1.8	-1.9
ES	-0.1	-0.1	-0.4	-0.1	-0.8	-0.4	-0.4	-0.1
FR	-1.6	-3.1	-3.7	-3.5	-2.2	-3.3	-3.5	-3.3
IE	1.2	-0.3	-0.6	-0.9	0.0	-0.9	-0.3	0.1
IT	-2.6	-2.3	-2.3	-3.1	-3.1	-2.1	-1.8	-2.7
LU	6.4	2.6	-0.2	-1.2	4.1	2.0	0.5	-0.3
NL	0.1	-1.1	-1.6	-2.4	-1.0	-1.0	-0.4	-1.1
AT	0.3	-0.6	-1.1	-0.4	0.0	-0.6	-1.0	-0.4
PT	-4.2	-2.7	-3.5	-3.2	-4.6	-2.5	-2.6	-2.1
FI	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
DK	2.8	2.0	1.8	2.1	2.3	1.9	2.0	2.2
SE	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.

Figure 1

Euro Area Fiscal Stance and Cyclical Conditions, 2000-2004



Source: Source: Commission of the European Communities, Communication from the Commission to the Council and the European Parliament, Public Finances in EMU - 2003, p. 8.