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Greater Europe and the Euro
A Window of Opportunity

Joseph E. Bigio [1]

In September 1998, at the ECSA Conference in Brussels, and again in mid-October, in Paris, at the Cicero Foundation debate on the Euro, I put forward the hypothesis that there could be a different outcome to the one the Euro's main protagonists were expecting. I suggested that it might well start out as a weaker currency than was hoped for. And I postulated that, over time, this alternative scenario might well prove to be more beneficial for both the Euro, the dollar and global markets in general. The two scenarios were set out in a paper entitled *Euroimplications*.

My postulation appears to have been largely correct. The second scenario is the one that we are watching, even if the reason for the Euro's weakness is attributed more to the unexpected continuity of the strength of the U.S. economy than it is to the underlying weaknesses of the economies of several of the economies within the Eurobloc.

I think that the issue — that of the stability of the Euro *and* its consequent potential as a harmonic factor for international economic development — bears reiterating, because of its significance to the global community of the XXIst century.

The background to the 'rosy glow' scenario put forward by the Euro's principal advocates was that the European economy as a whole had been pulling steadily, if slowly, ahead. The growth rate was averaging around 2.75 per cent and might even be found to average 3 percent in 1999.[2] Germany and even, to some extent, France

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[1] Professor, Universidade Autónoma de Lisboa.

[2] Source: *The Economist*, Economic Indicators, August 22nd, 1998, p. 82.

had had upticks from the nadirs of their unemployment figures. Exchange rates were relatively stable. Central banks had held real interest rates steady at low levels and had managed to contain cost-push inflation inside very acceptable limits.

Against this background the ECB was committed to maintaining price stability, which meant that its monetary policy had to prevent any upsurge of inflation. To help in this process, the anticipated greater levels of productivity were to ensure that growing competition left companies little or no room to increase prices. In addition, the Amsterdam Stability Pact required the EMU countries to pursue the goal of fiscal consolidation on a steady and enduring basis. This was to keep interest rates at the low level necessary for true economic development at the same time as reducing the costs of servicing national debts and, therefore, reinforcing the strength of the Euro.

There were, however, drawbacks to this approach to having a potentially strong Euro. These stemmed from the fact that the European Union, although disclaiming the idea of becoming Fortress Europe, was about to give birth to the Eurobloc, which, when completed, would have the largest Gross Domestic Product (GDP) in the world. This implied that the Euro could well, if gradually, turn out to be the world's principal trading currency, the supply of which could be expected to exceed that of U.S. Dollars by around fifteen percent. With the Euro as the international vehicle currency that it was sure to become, the EU' s current account position would mean that it would be a major supplier of international liquidity. But, unlike the U.S.A., which issues dollar treasury bonds to finance its deficits, the EU, because of its current account surpluses, would have to export capital or, in other words, invest in borrowings made by outside countries.

This would have complicated the task facing the ECB in significant ways. The yield spread between investments in U.S. dollar bonds and those denominated in Euros is of key importance. The spread would have to motivate the EU to export Euros and those countries in deficit to it to borrow them. Thus Euro interest rates would have to be kept low relative to those for the dollar. Such a task isn't

too difficult, provided that the Euro achieves and maintains the advantage of being a stable currency. It also has to offer a large capital market offering good investment opportunities and, above all, the international central banks would have to hold increasing amounts of Euro (as opposed to U.S. Dollar) reserves.

Then would have come the tricky part. Around half of what each of the 'In' countries regarded as 'external' trade with other European countries was to become 'internal' trade within the Eurobloc. The separate European central banks wouldn't need to hold dollar or any other reserves to defend their currencies from the markets. A switch out of these reserves into Euro ones instead could put heavy selling pressure on the dollar.

Let's look at some of the numbers that were involved. The Eurobloc's total currency reserves at the end of June 1998 were worth roughly U.S.$320 billion, of which nearly 25 percent of the total, or just under $80 billion, were D-Mark reserves. [3] This left another $240 billion (in dollar reserves, assuming that virtually no other European currencies are kept as reserves to any significant extent). And around $120 billion could be expected to be considered unnecessary, if we take the required ratio of reserves to imports to be 0.1 (the average for most industrially developed countries over the last fifteen to twenty years).

In this scenario, it would have been almost inevitable that the Eurobloc would sell off its redundant dollar reserves, even if at a very cautious rate in order to avoid disrupting the international monetary system. While, in parallel, as more and more countries outside the Eurobloc bill and invest in Euro terms and hold Euro reserves, the Euro would become a reserve currency of equal standing with that of the U.S. Dollar. Intriguingly, these events would also help to keep European interest rates at a healthily low level.

Such a scenario would have presented the ECB with a two-pronged dilemma. On the one tine, there would be the question of how to keep the sale of unneeded

[3] Source: *The Economist* Financial Indicators, August 22nd, 1998, p. 83.

dollar reserves down to a steady trickle, while on the other tine trying to export Euros to offset — or even slightly more than offset — the Eurobloc's expectable trade surpluses. Because the more that outside countries issue debt denominated in Euros, the greater will be their tendency to hold Euro reserves rather than dollar ones. This would add to the downward pressure on the dollar. Unless, of course, the ECB counter-balanced their actions by investing in U.S. treasury bonds to help the U.S.A. finance its continuing deficits. But this would add to the Eurobloc's dollar holdings at the same time as soaking up its internal liquidity. In turn, this would put upward pressure on its interest rates, create cost-push inflation and defeat the ECB's explicit purpose, quite apart from destabilizing confidence in the Euro. The resulting confusion would have presented the decision-makers with awkward choices. We could have seen both the ECB and the U.S. Federal Reserve Bank (the Fed.) trying to steer through stormy seas between Scylla and Charybdis.

An alternative, and in some people's view more likely, **scenario** seemed likely to present the ECB with the need to contend with a considerably different set of events, engendered more by political than monetary developments.

This was postulated to be a scenario wherein, primarily, the various countries fail, for one reason or another, to maintain progress towards fiscal consolidation. It is a scene where disparities between national rates of economic development will have undermined the political will of several governments. (We have already seen evidence of this in the case of Italy's special arrangements.) Each of the governments gives, in its own way, fiscal incentives to 'special interest' segments of its economy without curbing other public spending. This impels them to increase their public sector borrowing, which puts upward pressure on the interest rates that the ECB has to maintain. Their governments' demands on the money supply compete with those of productive enterprise and reduce the rate of economic growth. This further undermines outsiders' confidence in the Euro-economy and weakens the currency. In turn, this raises the costs of imports and adds to the risks of demand-pull inflation.

The underlying problem facing each of the 'truant' governments is mainly that of the high percentage of unemployed people in the areas affected by the competition from the more efficient and better structured industries of the more highly developed nations within the EU. There is extensive social unrest, not least because of the continuous failures by the Council of Ministers to reform the Common Agricultural Policy (CAP) in a viable manner and what are viewed as inequitable allocations of fishing rights. For those people who are affected, to be forced by 'Brussels' to abandon the only activities by which they can earn a living simply adds to their resentment of the better quotas given to other members of the Community (EEC).

The fiscal incentives and subsidies given by the 'defaulting' governments result in artificial pricing and the consequent distortion of competition. Wages rise faster than genuine productivity gains, adding to cost-push inflation. This causes the ECB to consider increases of interest rates that would only exacerbate the cost-push inflation. However, in spite of the wage pressures, the accompanying lower levels of economic growth, coupled with the lack of consumer confidence and spending that is due to the high levels of unemployment, prevent the ECB from taking restrictive measures. Fortunately, demands from the European Council of Finance Ministers (ECOFIN) and the European Parliament for the issue of Eurobonds to finance the offending governments' excessive spending are expected to be firmly rejected by the ECB's governing council. There is to be no financing of fiscal indiscipline. This, naturally, causes the governments involved to pressure Brussels for extra social cohesion payments that the Community budget cannot afford. Growth rates are too low and the income from the community is correspondingly insufficient.

All this, and the other side of the coin, namely, the continued strength of the U.S. economy, means that the Euro has been weaker in the currency markets than might have been expected in other circumstances. And from one point of view this suits the EU and its immediate neighbours a lot better than previously accepted

wisdom would have acknowledged. Because of the level of imports, the current account surpluses may be very small, if indeed there are any. Thus there is no distinct requirement for capital exports. Also there will be less desire to reduce U.S. dollar reserves. In fact, holding on to these will serve to keep the Euro from weakening too much. The dollar reserves can be used to offset temporary trade deficits — always provided that the ECB manages to ensure that the Eurobloc's banking community doesn't indulge in the kind of unrestricted and unwise lending that occurred in Asia in the 1990s.

From the point of view of the countries outside the Eurobloc, this situation leaves them insecure as to what currency reserves they may require to hold in order to defend their own economies. The stability of the Euro is not sufficiently assured for them to wish to take on Euro-denominated liabilities. Yet the traditional esteemed status of the dollar looks as though it will surely diminish, because the USA's recurring current account deficits continue to increase.

Meanwhile, the Euro is fast becoming the darling of the corporate bond markets. As this progresses, the new currency is on its way to having the virtually free amount of loans that will rival that of the sovereignty of the U.S. Dollar. Consequently, the non-eurobloc countries may no longer be so happy to invest in U.S. Treasury bonds, even though, up to now (mid-1999) they have been hesitant to bill and invest in Euro terms or hold other than token monetary reserves in the new Single Currency.

As a result, it may well turn out that the nations of Central and Eastern Europe may soon recognize that concerted action will of itself reinforce the achievement of each of their own aims. If they then decide to bill all their exports of oil, natural gas and other mineral resources in either Euros or Japanese Yen, this will add strength and stability to the Euro at the same time as reducing their acquisitions of dollar reserves.

The countries that can afford to do so will slowly but surely begin to build up Euro reserves, which will again reinforce the stability of the currency. Gradually,

there will be more cross-border trade and a 'de facto' Greater European Trade Area will come into being. A trade area using a currency which will be able to face the U.S. Dollar on equal terms, without there being any necessity to hold the reserves of the one currency as opposed to the other, and thereby lead to greater harmony within world markets.