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ABSTRACT

This paper was prepared for a session of the 2009 American Economic Association meeting devoted to examining the views of American economists about the euro and the European Economic and Monetary Union on the tenth anniversary of the euro. I had written an article in 1992 in the Economist and subsequent articles in the Journal of Economic Perspecties and in Foreign Affairs. I begin by reviewing the arguments that I offered at that time about the claimed advantages of a single currency and about what I regarded as the disadvantages. I then discuss my claims that the primary motivation for the creation of the euro was political, not economic and that the creation of the euro could lead to increased conflict within Europe and with the United States. I conclude with a discussion of the implications for the EMU of the current recession and the likely future economic conditions in Europe.

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Reflections on Americans' Views of the Euro Ex Ante

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I am pleased to participate in this session on the 10th anniversary of the start of the Euro and the European Economic and Monetary Union.

There is much to celebrate on this occasion. The Economic and Monetary Union achieved its goal of establishing a viable single currency for its member nations. The European Central Bank has focused successfully on its mandated goal of price stability. Although today's inflation rate of slightly higher than 3 percent exceeds the official target rate, the ECB has succeeded in avoiding the high and volatile inflation of some earlier years.

But these 10 years have not been a particularly challenging time. With no serious downturn, the ECB has been able to focus on the goal of

* Professor of Economics, Harvard University, and president emeritus of the National Bureau of Economic Research. These remarks were presented at the American Economic Association meeting, January 2009, at a session devoted to examining the views of American economists on the euro before the introduction of the euro ten years earlier.

price stability. Not all countries shared equally in these good times but there was enough prosperity to avoid conflicts over economic policy.

That may be about to change. We are now experiencing a major global economic downturn and a global economic crisis. These conditions are worse than any that I have experienced before. The downturn in the United States is likely to be longer and more damaging than any since the depression of the 1930s.

Conditions in Europe are also deteriorating very rapidly. More significantly, there are now substantial differences among the EMU countries. While Germany has an unemployment rate of 7.5 percent, the unemployment rate in Spain is 12.8 percent. The contrast is even greater for the 12-month change in industrial production – down 3.9 percent in Germany but down 11 percent in Spain. Even in France industrial production is down 7.2 percent.

There are also very large differences in the trade balances of the individual countries. Germany had a trade surplus over the past 12 months of $280 billion while Spain has a trade deficit of $154 billion. Even France has a trade deficit of $83 billion.

These differences in economic conditions call for differences in monetary and fiscal policies. But the single currency implies that there can be only one monetary policy for the entire eurozone. For fiscal policy, the rules of the EMU limit the ability of individual countries to have any significant countercyclical fiscal deficit. At the same time, there is no mechanism for a common fiscal policy for the entire EMU.

These restrictive conditions – these policy limits – and the fact that the country with the strongest current performance is also the largest and most influential member of the eurozone – suggest that economic performance in the other countries will be worse than they would otherwise have been and that some of those countries will be unhappy and frustrated.

<u>My Early Comments on EMU</u>

I owe my place on this panel to three articles that I wrote before the start of EMU – a short piece in the <u>Economist</u> in 1992 and longer articles in <u>Foreign Affairs</u> and in the <u>Journal of Economic Perspectives</u> in 1997.

I welcome this opportunity to comment on what I said in those three articles – and on what I did not say.

Let me begin with some things that I did not say there or anywhere else but that some euroskeptics did say and that some people have attributed to me as well.

- I never said that the Euro would not come into existence.
- I never said that the Monetary Union would inevitably collapse.
- And I never said that the Euro would lead to war within Europe or with the United States.

My articles emphasized three points:

- First, the economic advantages of a single currency in promoting trade and competition would be outweighed by a higher rate of unemployment and by the risk of higher long-term inflation.
- Second, the primary motivation for the creation of the euro was political, not economic.
- Third, the creation of the euro could lead to increased conflict within Europe and with the United States.

I continue to believe that all three positions are correct. I think the current economic crisis may demonstrate that more clearly.

I will now look at each of these three statements. I will then come back to the implications of the current recession and of the likely future economic conditions in Europe.

My 1992 article in the Economist appeared roughly a year after the Delors report of the Economic Commission which bore the title "One Market, One Money." The Delors report and others argued that the common market in goods and services that had been created by the European Union required a single currency to be effective – thus "one market, one money."

These proponents of the single currency said that a single currency was needed to facilitate trade and that a single currency would promote efficiency by permitting price comparisons.

EMU advocates in Britain argued that these economic gains were worth the political sacrifices – the loss of sovereignty over monetary affairs and over other economic policies that would result from joining the EMU.

But Britain already had the free trade advantages of being a member of the European Union. I argued that there were in effect no net economic gains – more likely a net economic loss -- to compensate Britain for the political costs of joining the Economic and Monetary Union.

Certainly there is nothing in economic theory or in historic experience to suggest that international trade requires a single currency. The argument that one market requires one money was the kind of political slogan that frankly bothered me as an economist.

I was also not impressed by the idea that a single currency would facilitate price competition that would improve market efficiency. The housewife in Madrid buys her bread locally. So knowing what bread costs in Berlin or Rome is irrelevant. The industrial buyer who may already shop for steel or chemicals in different national markets could easily compare prices stated in different currencies with the help of a pocket calculator.

In contrast, the economic costs of a single currency are very real. A single currency means a single monetary policy and a single exchange rate.

A single monetary policy for a group of heterogeneous countries that experience different shocks cannot be optimal – the problem is that, when it comes to monetary policy, one size cannot fit all. If monetary policy has to consider unemployment as well as inflation, the average cyclical unemployment rate will be higher with a single currency.

A single currency also means that a country that experiences an increased trade deficit caused by a reduced demand for its export products cannot be helped by a natural – i.e. automatic -- exchange rate adjustment.

Comparison with the United States

A common reaction to these arguments by the single currency advocates was that the U.S. is a large continental country with diverse economic regions. Why, they asked, should a single currency be good for the U.S. but not for Europe? Here's the answer.

There are three important differences between the U.S. and Europe that allow the U.S. to be more nearly an optimal currency area.

The first is mobility. In the United States, when demand falls in one region people move out of that area and others do not move in as readily. When New England lost its shoe industry to foreign producers, the population in the New England states fell relative to that in other parts of the country.

In Europe that does not happen to nearly the same extent for at least three reasons. Language is the most obvious. While elite executives and academics move among countries, the average citizen does not have the language skill to make that move. Cultural traditions also militate against mobility. Americans are movers with a tradition of immigration to the U.S. and movement from the east coast to populate the rest of the country. Europeans are much less likely to move even within their own country. A third reason is national loyalty. A Frenchman is a Frenchman and a Spaniard is a Spaniard in ways that do not apply to someone from Connecticut or Arizona.

So the greater mobility in the U.S. helps to stabilize national unemployment when there are idiosyncratic regional shocks to demand.

Second, the greater wage flexibility in the United States also helps to offset local demand shocks. When demand falls in a U.S. region, wages rise more slowly in that area, inducing movements in location and in production. European wages are much less flexible as a result of custom, legal rules, and union power.

The third condition that allows the U.S. to operate successfully with a single currency is that Washington offsets about one-third of any local fall in incomes by reduced collection of federal taxes and increased unemployment benefits. There is nothing comparable at the European level where fiscal authorities are national.

The Political Motivation for EMU

At a certain point after writing my 1992 Economist article I began to think that European leaders might also understand that the economic case for EMU was very weak or non-existent. Perhaps they made arguments like "one-market needs one money" and ignored the adverse effects because they wanted the single currency for another reason.

That brought me to the second idea that I emphasized in my writing: that the primary motivation for EMU was political – to create eventually a political union, a federal state with responsibility for domestic and international affairs. I explored that idea in the Journal of Economic Perspectives and in Foreign Affairs.

European political leaders since Jean Monet made it clear that they wanted a political union. Some of them saw this as a way of avoiding another intra-European war like the Franco-Prussian war and World Wars one and two. Thus, German Chancellor Helmut Kohl was very clear when he spoke of "containing a potentially dangerous Germany within Europe."

But other political leaders spoke of developing a strong European entity as a counterbalance to the United States. The French were particularly fond of making this argument.

Helmut Schlesinger, the long-time head of the German Bundesbank, wrote the following in 1994: "the final goal is a political one in which the economic union is an important vehicle to reach this target. Since 1952, since the beginning of the European community, the final goal was and is to reach a type of political union in Europe, a federation of states, an association of states or even a stronger form of union. The political target has been guiding Germany since the beginning and will continue to do so in the future."

So it couldn't be clearer. The economic arguments were not the real reason for the EMU. They were a way of selling the political union to a public not yet ready for political union as something very different. But to the political leaders, EMU was a step toward political union.

If the people throughout Europe carried euros in their pockets, they would feel more like Europeans and less like Belgians or Italians. Even the choice of the name for the currency –the euro - underlined this purpose.

If each national central bank lost power to a European Central Bank in Frankfurt, people would realize that a powerful political union was being created.

The political leaders had many different reasons to want a political union. As I already noted, some of the idealists thought it would prevent a return to war in Europe. That was the view stressed by Kohl. But was that his real reason – or like the specious economic arguments of others – just part of selling the EMU and ultimately political union to the people of Europe?

In my Foreign Affairs article I noted that a political union with a single currency had not prevented the United States from having a terrible civil war. That comment led the editors of Foreign Affairs to put the caption "EMU and War" on the cover of that issue, attracting attention to my article but also leading many who didn't actually read the article to believe that I was saying that EMU would lead to a European civil war.

But preventing war by (in Helmut Kohl's words) "containing a potentially dangerous Germany within Europe" might not be the only or even the dominant reason why Germany had political union as its goal. Germany is the largest economy and has the largest population. It is now the geographic center of Europe.

Germany might well expect that it would become the dominant force within any future political union.

The French had a different view of the way that power would evolve. As I explained in those articles, the French saw a political union as a way of achieving equality with Germany – and perhaps even the leading role in the field of foreign policy. The Bundesbank had been the dominant force in monetary affairs before the EMU but with the creation of the EMU the French would be equal to the Germans at the ECB. If Britain could be persuaded to join, the Bank of England would no longer be an independent player in monetary affairs.

The contrast between German expectations of a hegemonic role and the French expectation of at least equal influence is but one example of the potential for conflict within the EMU.

Potential Conflicts

Such potential conflicts are the subject of the third theme that I explored – conflicts between Germany and France, conflicts between those two dominant countries and the other members of the EMU, and conflict with the United States.

Conflict does not mean war. Rather it can be the failure to cooperate and the attempt to undermine the goals and influence of other countries.

We certainly saw this in the behavior of France with respect to US policy in Iraq and the French attempt to block US actions at the UN Security Council. We see it now in the coordinated European policies with respect to Iran – where the European economic interests cause it to refuse tough sanctions against Iran. And we see it in the coordinated European policy with respect to the Palestinians.

In the article in <u>The Journal of</u> <u>Economic Perspectives</u> I put the potential conflict between a more unified Europe and the United States into historic perspective by recalling what happened in 1956 when the United States forced England and France to abandon their attack on the Suez Canal. Conrad Adenauer, the German chancellor, was in Paris on that day and said this to the leaders of the British and French governments: “France and England will never be powers comparable to the United States and the Soviet Union. Nor Germany, either. There remains only one way of playing a decisive role in the world, that is to unite to make Europe. … We have no time to waste: Europe will be your revenge."

We as economists may not think about "playing a decisive role in the world" as a key goal of government actions but the elected officials who guide long-run political strategy do.

Current Economic Conditions in Europe

The very negative current economic conditions in Europe may cause substantial economic policy disagreements among the EMU countries.

Germany is still resisting any substantial fiscal deficits and the ECB has a much higher interest rate than the Federal Reserve or the Bank of Japan. Spain with a 13 percent unemployment rate and a trade deficit of 10 percent of GDP must want a more expansive monetary and fiscal policy than Germany. Smaller countries may now feel that they have lost control over their economic future.

In these circumstances, it is possible that one or more countries might actually withdraw from the EMU. It is clear why some national political leaders – or would be leaders -- might consider such an option.

Doing so would allow their reinstated national central bank to choose an easier monetary policy. The national central bank could also create the currency needed to act as a lender of last resort to national commercial banks. The country's fiscal authority would no longer be bound by the restrictions of the Stability and Growth Pact and could therefore pursue a large fiscal stimulus. The international value of the currency could adjust to make local products more competitive.

A country might threaten to leave the EMU unless policy became more expansive. If policy did not change, it might face the difficult choice between leaving the EMU and losing face by backing down from its threatened action.

If this happens, how would the remaining members of the EMU respond? The Maastricht Treaty has no provision for a county to leave the EMU, just as the US constitution has no provision for a state to secede.

Would a country that left the EMU be forced out of the European Union as well, thereby losing the free trade advantages of the EU?

The next few years will clearly be an important testing time for the European Monetary Union and for the Euro.

Cambridge MA

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