Global Order and the Future of the Euro

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The performance of the euro can be assessed in relation to recent developments in the global economy as well as in relation to the vision of the architects of the European Monetary Union. I shall consider both perspectives and ask whether the EMU has lived up to the vision of its architects to create a new currency to serve as a bulwark for maintaining price stability over the medium term.

The Euro in the Global Economy

In a study for the National Bureau of Economic Research, Michael Dooley, David Folkerts-Landau, and Peter Garber (2003) describe recent developments in the global economy as attributable to the behavior patterns of countries in three geographical areas. The United States is one of the geographical areas. It is the center country of the global economy, and the system's financial intermediary. It does not manage its exchange rate and does not accumulate foreign reserves. It is both a trade account country and a capital account country. It seeks growth through its trade account and finance for its growth. It seeks investment through its capital account and foreign savings to finance domestic capital formation. The United States does not worry about its deteriorating international investment position.

A second geographical area is Asia, comprising China, Taiwan, Japan, Hong Kong, Singapore, Korea, and Malaysia. Asia is a trade account region. Exporting to America is Asia's main concern. Exports mean growth. Their growth-oriented trade surpluses are a source of finance for the United States, channeled through their central banks as official providers of capital to the United States. The Asian countries manage their dollar exchange rates, and their central banks

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consistently intervene to limit appreciation of their currencies. Exchange controls and administrative pricing are often resorted to. Some currencies are explicitly fixed, like the Chinese yuan, the Hong Kong dollar, and the Malaysian ringit. The Japanese yen and Korean won float but Japan and Korea accumulate vast official reserves in U.S. dollars. The Asian country currencies float against the currencies of the third geographical area.

The third geographical area comprises Europe, Canada, Australia, and Latin America. This is a capital account region. Private investors in the capital account region care about the risk/return of their international investment position, and have recently become worried about their U.S. exposure. Countries in the capital account region have floating exchange rates. Their governments do not intervene, and their official reserves have not increased.

The trade-weighted exchange rate of the German mark and then the euro and other currencies of the capital account region depreciated substantially relative to the dollar from 1992 through 2002. The real exchange rate depreciation was consistent with private investors of the region helping to finance the U.S. current account deficit.

Over the last five years, however, the U.S. current account deficit has been financed by official inflows from the trade account region as well as private inflows from the capital account region. The surge in the U.S. current account deficit has been the engine for growth in the rest of the world.

Until early 2003, the tripartite global economy was stable and sustainable in view of the trade account region's preference for official investments in the United States and the capital account region's preference for private financial investments in the United States. Lately, however, the countries in the capital account region have become concerned about the rise in U.S. international debts. The depreciation of the euro and other capital account region currencies was reversed in 2003. Normally, the solution would be for U.S. yields to rise and the dollar to depreciate sharply. The dollar has depreciated, but may not persist, and U.S. yields may not rise.

Instead, Asia may displace Europe in sending exports to the United States and may be ready to accept even larger inflows of U.S. securities. If that happens, U.S. yields would not have to rise.

The nub of this view of the global economy is that, if European investors decide to limit further purchases of U.S. assets unless U.S. yields rise, the euro will appreciate dramatically. European domestic savings will remain at home and yields there will fall. Asia's exports to the United States will displace Europe's, and growth in Europe will slacken. U.S. yields will not rise even as its current account deficit rises.

According to this view of the global economy, emerging market economies must choose between two models. One is the Asian model of exports as the engine of growth and fixed undervalued currencies. The other model is the European one of capital mobility and an appreciating euro.

The euro and the yen have recently strengthened against the dollar as the result of the reordering of the composition of some portfolios. Dollar weakness, however, may not last if the U.S. growth rate accelerates in coming quarters outstripping the growth rate of European countries.

The Euro in its Own Orbit

Having discussed the relation of the euro to one view of what has been happening in the global economy, I now turn to the performance of the euro in relation to the vision of the architects of the EMU.

There can be no doubt that the architects intended the strict fiscal conditions the Maastricht Treaty imposed before the activation of the euro and the Stability and Growth Pact thereafter as well as the narrow mandate of the European Central Bank to hedge the euro against lax monetary policy and profligate fiscal behavior by the governments of member states.

Yet despite the architects' efforts to erect barriers to loose monetary and fiscal policy in the EMU, risks are rising that the barriers will be circumvented with predictable baleful consequences for the euro (see Schwartz 2004). There are clear indications of a disposition among leading members of the EMU to inflate their way out of circumstances that require unpopular political decisions. Attempts by national governments to assert their wish for the ECB to modify its position on curbing inflation have thus far been resisted by the ECB. The long-run problem for the ECB is that monetary union was something the political elite of France and Germany sought. It was not a change that voters demanded. If farmers and organized labor come to believe monetary union delivers tight monetary and fiscal performance that hurts their interests, will they oppose policies that erode the purchasing power of the euro?

I consider first a threatened breach of the ECB's monetary policy guidelines. I then explore the implications of a likely modification of the Stability and Growth Pact in response to widespread belief that it is flawed. Next, I comment on budget deficits that loom for governments to meet unfunded commitments for social welfare. Leaders are aware of the need for reform of policies that authorize future unsustainable outlays for state pensions and other entitlements, but it is uncertain that reform will eventuate. Finally, I discuss whether new entrants to the European Union will be able to sustain fiscal discipline.

The Dispute about Monetary Policy Guidelines

The main complaint by critics of the ECB is that its focus on price stability has been at the expense of output stability. It has been charged with ignoring the need to lower interest rates when the euro area has experienced recession. As a result of its inattention to the output gap, monetary policy by the ECB has allegedly been contractionary. To satisfy the critics, the ECB would have to be more accommodative.

Other complaints center on the ECB's reliance in part on the money growth indicator in forecasting inflation. The money aggregate M3 has been assigned a reference value of 4.5 percent for annual growth, but the ECB does not automatically respond to deviations in money growth over the short term. According to the critics, since the ECB ignores the indicator, it might as well abandon it. To satisfy the critics, only the procedure of formulating monetary policy, not necessarily the outcome, would change.

The ECB has been charged with other failings, but the most serious is the one whose aim is to weaken its commitment to noninflationary monetary policy. As stalwart as it may be in defending its commitment, its performance in a democracy is ultimately determined by the preferences of voters. Are residents of the countries in the euro area resolute supporters of price stability? It is commonly believed that the reason the German public prizes price stability is the imprint of the historical memory of the destructive experience of two postwar hyperinflations. But what if their political leaders argue that other goals are more important? And is the public of other member countries as keen for stable prices as the German public is reputed to be?

Another uncertainty is the difference in the conduct of the ECB that the replacement on November 1, 2003, of Wim Duesenberg by Jean-Claude Trichet may occasion. Monetary policy under a new president may change. Whether the departure is in the direction of greater ease remains to be seen.

The one development that might reduce the immediate ongoing pressure on the ECB to be more accommodating is a robust economic recovery in Western Europe sooner rather than later. The forecast, however, is for a modest recovery.

The Assault on the Stability and Growth Pact

The Pact was adopted to prevent profligate government spending that would undermine the euro. Yet France and Germany have flouted the Pact's deficit rule in 2002 and 2003. The French budget minister, moreover, has announced that the deficit is likely to breach the cap until 2006. The French premier in August defended the country's violation of the budget deficit criterion. He stated that paring the deficit was not his priority. It was rather to restore growth and employment to the economy.

Smaller countries with balanced budgets are demanding fines for the violators. The Netherlands threatened to sue the European Commission to enforce the rules the big countries wrote but now contravene. No fines have as yet been levied. Duesenberg has advocated fines as much as 0.5 percent of GDP for countries that breach EU deficit limits. The fine that Duesenberg suggests is punitive. Would violators agree to pay such amounts? Germany and France have been lobbying the Commission to invoke a clause of the Maastricht Treaty that overrides the deficit rule because of "special" circumstances and thus absolve them from the obligation to pay a fine.

In October 2003, the European Commission chided France for taking no effective action to reduce its budget deficit. On October 21, it allowed France an extra year to comply with budget rules, but ordered it to reduce planned spending by 0.4 percent of GDP in 2004, particularly a cut in its generous health system. European finance ministers, however, on November 25, rejected the Commission's recommendations. The decision essentially suspended the Stability and Growth Pact.

A statement by the ECB, which met after the decision, condemned it as a risk to the credibility of the institutional framework and confidence in sound public finance. Ironically, in the aftermath, the euro exchange value appreciated.

The decision marks a divide between small countries and the big ones. In 2001, Portugal was forced to accept big spending cuts when its budget ran over the 3 percent ceiling. The resistance to such budget cutting by France and Germany aroused criticism by the Netherlands, Austria, Finland, and Spain, which opposed the special treatment of the two malefactors. Mr. Trichet told a committee of the European Parliament that there was no need to reform the Pact, as the big countries propose. Italy responded by urging a change in the ECB's statutes that would alter the bank's independence. At the end of 2003, monetary disunion, rather than union, was the situation.

The suspension of the Pact leaves unresolved the extent to which increased government spending, the objective of not only the big countries, will be tolerated. Portugal earlier was authorized to use state-owned companies' pension funds to cut its budget deficit. France and Germany could use the same means to finance spending. Leniency in the case of France comes as French finances continue to deteriorate. France has breached not only the budget rule but is close to exceeding the 60 percent of GDP public debt ceiling. It has been negotiating with the European Commission to find some way to permit it to proceed in rescues of four state companies on the verge of bankruptcy.

France and Germany can proceed with tax cuts and spending increases on infrastructure that they have proposed to continue through 2010. They can ignore the ECB's advice to rely on private resources to finance the spending plan.

A fudge would permit treatment of new spending as off-balance sheet, thus not adding to budget deficits. Would residents of the euro area accept subterfuges as certifying the euro's soundness?

Will Member State Benefit Programs Be Reformed?

The outlook for the euro is clouded by the immense financial burdens governments will bear during the coming half century if they honor their future unfunded commitments to pay generous pensions and health care expenses for aging populations. The pay-as-you-go pension system is hostage to the ratio of working population to the retired population. The demographics in the euro area project a declining proportion of working age people and a rising proportion of older people. This imbalance means that the contributions of workers will not suffice to pay benefits to increasing numbers of the retired. Unless the program is reformed either by reducing promised benefits or raising taxes, or public revenues are increased, deficits for governments will loom. Health care costs will also rise as the population ages, further impacting public finances.

Will EMU countries choose timely reforms or abandon monetary discipline by increasing the euro money supply to finance the requisite expenditures? What is in question is whether the commitment to fiscal and monetary discipline that was made when the euro was launched in 1999 is still credible. What is at stake is the market's confidence in the euro's suitability to serve as a store of value.

How Will Enlargement of EU Membership Affect the Euro?

In May 2004, the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia joined the European Union. To join the EMU and adopt the euro the countries would also need to become members of the Exchange Rate Mechanism for two years.

Except for Poland, the new entrants have small populations. All of them have large farm sectors. Their government operations are inefficient, and corruption is a problem. They will be beneficiaries of EU economic-development subsidies.

The Maastricht criteria do not include a measure of real rather than nominal convergence. In 2002, GDP per capita in the current EU averaged 24,094 euros; only 5,750 euros for residents of the accession countries. The divergence of average per capita GDP in the accession countries from the average in the euro area is substantial. Convergence will not be quickly achieved. In addition, structural reforms, including the rehabilitation of the banking and financial systems, are urgently needed. There has been a loss of fiscal control in four of the largest countries (Poland, Hungary, Czech Republic, and Slovakia), but political opposition to cuts in public spending or tax increases is strong. Each of the four accession countries has continued to spend freely on highways, bridges, and other public works. Budget deficits far in excess of the Pact's 3 percent of GDP ceiling are reported.

The EMU in its present configuration is not a union of equals. This condition will only worsen with the inclusion of new members. Is this a recipe for political disintegration? Would the euro survive political disintegration?

Conclusion

I have presented two perspectives on the euro. The first treats the euro in relation to a map of the world economy that recognizes three geographical areas. One area is that of the United States, the center country. The two other areas are a group of Asian countries and a group of countries that Europe dominates. The goal of the Asian countries is growth through exports, mainly to the United States, achieved by undervaluing their currencies, and a preference for offsetting their trade surpluses by official investment in the United States. The area dominated by Europe until 2003 also sought growth through exports, and its private investors used their savings to acquire dollar-denominated assets to offset trade surpluses. In 2003, however, European investors soured on U.S. assets and substituted euros for dollars in the composition of their portfolios. That explains the strengthening of euros and currencies of other countries in the third geographical area.

A projection based on this perspective is that the outcome sought by Asian countries will persist. The scenario calls for Asian exports to replace European exports to the United States and for the euro to appreciate, European savings to stay at home so the yields on them will decline, and European economic growth to weaken.

Although this perspective is an interesting insight into recent developments in the global economy, one may eschew the forecast.

The second part of my presentation asks whether the EMU has lived up to the vision of its architects to create a new currency that would maintain price stability over the medium term. I find grounds for immediate and long-range concerns with respect to the prospects for the stability of the euro's purchasing power. The immediate concerns arise from the pressures on the ECB to be more accommodative and the drive to weaken the Stability and Growth Pact that culminated recently in its suspension. The long-range concerns arise from the spending obligations the member governments have assumed to provide pensions and health care to their aging populations for the next half century, and from the enlargement of the EU to include 10 states that are less economically and institutionally advanced than the other member states. The outlook is for greater spending by governments than their projected resources unless forces not now visible will strengthen the resolve of political leaders to serve the cause of a sound euro.

References

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