Opinion

The Euro Is Political, But it Will Bring Major Economic Changes

By Arne Jon Isachsen

Since January 1, euro bills and coins have replaced twelve European currencies as legal tender in a community approximately equal in size to the United States, in terms of people as well as of economic output.

This article examines how the transition to a fully-fledged monetary union will affect: the participating countries; other European nations including Britain; the Scandinavian countries and future EU members in Central and Eastern Europe; and the United States.

The Participating Countries

We should remember that without the solid support of Helmut Kohl, who was German Chancellor for 16 years, Economic and Monetary Union would never have gotten off the ground. It is hard to tell whether his enthusiasm for the project was a *quid pro quo* for French acceptance of German reunification, or whether Mr. Kohl's vision of a united Europe was the motivating force. He was probably influenced by both considerations.

EMU is first and foremost a political project intended to keep European integration moving forward. On January 1, the European Commission President Romano Prodi echoed this view, saying that the bills and coins would bring "an increase in European identity." Wim Duisenberg, President of the European Central Bank (ECB), predicted the euro would act as a catalyst for political integration in areas outside economics, such as defense and foreign policy.

From an economic point of view, a single currency was

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considered the natural next step after the establishment of the single internal market, providing for free movement of labor, capital, goods and services, in 1993. The hope was that the abolition of separate currencies would allow even bigger benefits to be reaped from integrated markets.

The economic consequences of the euro cannot be known in advance with any precision. Often, however, economists compare its micro-economic advantages with its macro-economic costs.

At the micro level, a single currency makes it easy to compare prices. That, in turn, stiffens competition, leading to more efficient use of resources. According to some researchers, a single currency will also lead to substantial increases in trade.

A comparison is sometimes made with the United States and Canada to illustrate the trade diverting effects of separate currencies. The existence of different dollars in the two countries, it is argued, may be the reason why East-West trade along either side of the U.S.-Canadian border is far greater than North-South trade across it.

The introduction of the euro has already had a profound impact on the working of EU capital markets. The market for government bonds denominated in euro is now significantly larger than that of similar dollar instruments. A deeper and more liquid market makes it much easier to raise capital without pushing up prices or interest rates.

The euro facilitates mergers and acquisitions in the 12-nation Euroland area. Banks will become relatively less important sources of funds, as companies increasingly raise finance directly on the market, through bills, bonds, and stocks. Euro financial markets will become more like those of the dollar and the pound.

Exchange rate is no longer a tool

On the macro side, member countries have lost the tool of monetary policy. The common rate of interest is set by the ECB for the euro area as a whole, and with the aim of keeping consumer price inflation below two percent. Individual countries can no longer use the exchange rate as a tool in stabilization policies.

National fiscal policies are also tightly constrained by the so-called Growth and Stability Pact, leading some experts to wonder whether such strict budgetary controls are appropriate during an economic slowdown, especially as nations have also lost the power to set their own interest rates. Even Hans Eichel, the German Finance Minister, is close to posing such a heretical question.

One should note that having a higher rate of inflation in, say, Ireland than in Germany, may be perfectly acceptable, given a much higher rate of growth of manufacturing sector productivity in Ireland than in Germany.

Labor markets may become more flexible

An important point is that removing national control over the exchange rate may change the way an economy works, so that past experience becomes less relevant in evaluating the future. When governments can no longer devalue their currencies, for instance, labor markets may become more flexible. This is suggested by the Finnish experience of the early 1990s.

Less emphasis, it seems, is now put on the loss of national monetary policies. The traditional models overestimate the precision with which successful monetary policies can be conducted, especially by small, open economies, in an environment of full capital account convertibility.

Other European Nations

In Britain, the largest EU country to stay out of the euro, Iain Duncan Smith, the Conservative Party's new leader, is very much against the UK joining. Perhaps more important, however, is the divide within the governing Labor Party. Prime Minister Tony Blair is pro-euro, Gordon Brown, the Chancellor of the Exchequer, much less so.

At any rate, a referendum must be held before the euro eventually replaces the pound, and a popular vote on the issue is still some years away. As of today, opinion polls suggest that well over half the British population is against joining the euro. Nearly three out of four Britons, however, expect their country to be part of Euroland by 2010.

For potential new EU member states, the euro is part of the deal, although they are unlikely to join the single currency immediately on EU entry. Like the existing euro members, the new members will have to restrain inflation and bring down nominal interest rates. The levels of their government debt and budget deficits will have to be held within narrow limits.

Some countries, such as the Baltic States and Bulgaria, have adopted currency boards, implying a strong commitment to keeping the exchange rate stable against the euro. (As Argentina's experience shows, however, it takes more than a currency link to ensure sustained economic growth – flexibility in the real economy is also necessary.)

It cannot be ruled out that larger economies, such as Poland,

with 40 million people, may negotiate an opt-out clause on joining the euro, as Britain and Denmark did. In that case, some sort of commitment to adopt the euro later may be included in the final agreement.

The currency systems of the Nordic countries (Denmark, Sweden, Norway, Finland and Iceland) were, until recently, quite divergent. Last March, however, Norway and Iceland adopted an inflation target (rather than an exchange rate target), as the Swedes did in 1993. Thus, three of the five countries now have a more or less similar system. Of the remaining two, Finland is a solid member of the euro zone, whereas Denmark has an old-fashioned peg to the single currency.

In September 2000, Danish voters decided against giving up their national currency. In economic terms, that was hard to understand. With a credible peg, Denmark had already given up independence in setting interest rates. But life is more than economics.

The financial turmoil that started with the crisis in Asia in the summer of 1997 hit Europe in 1998. With the expectation that Finland would join the euro, Finnish interest rates increased much less than those in Norway and Sweden. Thus, Finland benefited significantly from the euro and economic and monetary union, even before it was formally launched.

Denmark may remain outside the euro. Or it may join the monetary union when it so decides, given that it has met the required economic criteria. Sweden, on the other hand, has no official opt-out clause. And Mr. Göran Persson, the Prime Minister, seems inclined to put the issue before the voters within a couple of years.

If the UK joins the euro, however, it is likely that Sweden and Denmark will follow suit.

Finland is the only Nordic country in EMU

For Iceland, with a somewhat poor record on inflation, the new monetary policy regime may increase exchange rate volatility. Norway's currency has so far remained fairly stable against the euro. But there is currently no great political pressure for Norway or Iceland to join the EU, let alone the euro.

Until 1989-90 foreign policy in Finland was restrained by what was acceptable to the Soviet Union. Today Finland is the only Nordic country that is a full member of economic and monetary union. It is notable that Finland, in the course of a decade, has moved from the periphery onto center stage in Europe.

U.S. Concerns

For the United States, the coming of the euro brings good news as well as bad news. The good news is a more coherent and less fragmented European market, opening up new business opportunities for U.S. companies. Also, time and money are saved when dealing in one currency rather than in a dozen.

The bad news is that the dollar may face serious competition in international financial markets, as well as in international commodity markets. It is estimated that about $400 billion is held abroad, in the form of notes. Now, the United States does not pay interest on these liabilities. Given an interest rate of five percent, annual "seigniorage" benefits of some $20 billion thus accrue to the United States.

Is only one big currency best?

Add to that the advantage that foreigners are also acquiring interest-bearing claims denoted in dollars, and another $20 billion can be added to U.S. accounts.

The euro, now that it is tangible money, in the form of bills and coins, and not only virtual money, in the form of deposits, may take over part of this business. In historical terms, the country that provides military security in an area, usually also reaps international seigniorage. How will a change in this tradition, if it materializes, go down in the United States?

The economist Charles Kindleberger argued some decades ago that the world is best served by one and only one hegemonic currency; the argument being that several will easily lead to unnecessary volatility of exchange rates. With currency blocks of the size of the United States and the EU, in which exports constitute less then 15 percent of Gross Domestic Product, this argument becomes less relevant.

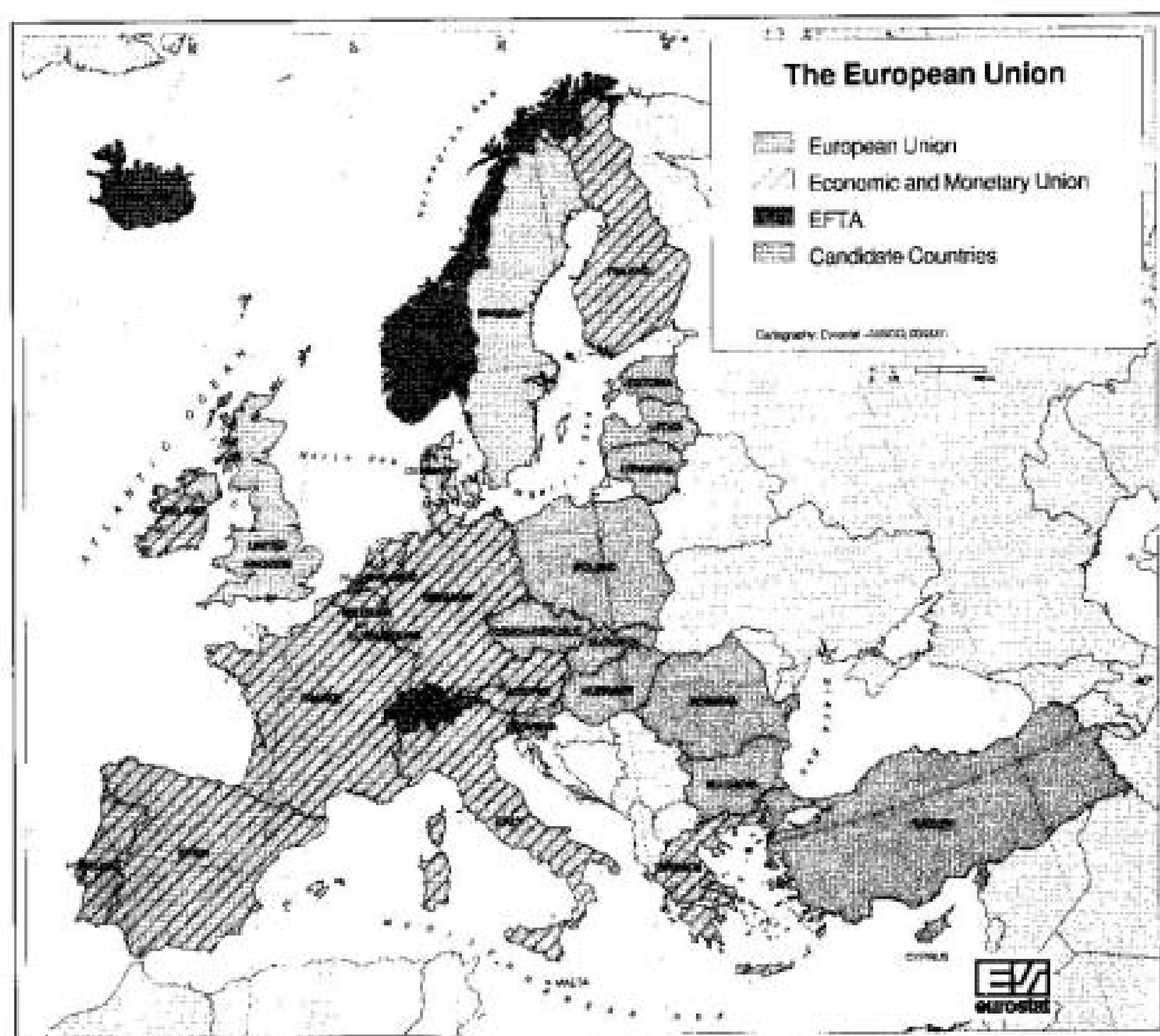
For American companies it is convenient that business partners in other nations are happy to stay with the dollar. Thus, U.S. companies that do most of their business in dollars are less influenced by volatile exchange rates. It is convenient for American businesses that commodities such as oil are priced in dollars.

This argument is even stronger in the capital markets. Being able to borrow in your own currency confers an advantage. Financial risks are reduced and costly hedging activities are not required. Some economists have argued that the dollar's role as the international vehicle currency has made it too easy for Americans to borrow abroad.

On the macro side, if the euro launches an effective chal-

lenge to the role of the mighty dollar, perhaps making it a little less mighty, a rapid depreciation of the dollar could follow. This, in turn, might generate inflationary pressures and a tightening of monetary policy that would slow down U.S. economic growth.

Let me end on a sporting note. As long as Pete Sampras undoubtedly was the number one world tennis player, he did not concern himself too much with the runners up. When, however, he faced serious competition and was about to be dethroned, he may have become a bit uneasy about the success of others. For the moment, the U.S. view of the euro generally resembles that of Pete Sampras as undisputed top dog. ❑



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