

The vision is political — one continent, one peaceful people. But monetary union could also mean big economic trouble for Europe and the world.



Euroland: The Morning After

By **LAWRENCE B. LINDSEY**

For many European politicians, monetary union is the next step in the dream of a United States of Europe. What few Americans — or Europeans — realize is that the European Monetary Union could profoundly affect one of the most successful international alliances in history. And, in this case, ignorance is not bliss.

Since the advent of the cold war, Washington has been inclined to support the vision of European federalists. A united Europe, it was widely argued, was likely to be a more effective bulwark against Soviet expansion — as well as one that could pay for its own defense. With victory in the cold war, this rationale for supporting European federalism disappeared. Yet the Clinton Administration, preoccupied with domestic issues, never paused to re-examine the issue.

It is now beginning to sink in that a united Europe could threaten American interests. Indeed some European federalists, jealous of the role of the dollar in world trade, hope that this is so.

Charles de Gaulle used to fret that America was the only country in the world that did not have to worry about running a chronic trade deficit because the rest of the world would absorb the surfeit of dollars as official government reserves. And such sentiments live on: In the fall of 1997, Europeans floated the rumor that the People's Bank of China would substitute the newly created euro for a substantial portion of its reserves. Though Beijing denied the rumor, it hasn't scotched visions of creating a potent competitor for the dollar.

From the perspective of the United States, the introduction of a rival currency should not be all that worrying. True, a successful global currency is a profitable asset since the outstanding currency amounts to an interest-free loan to the issuing government. Foreign holdings of dollars approach roughly \$300 billion, saving Uncle Sam roughly \$15 billion in interest payments.

The United States probably saves an equal amount because dollar-denominated assets are so readily accepted as a way to store wealth, reducing the interest cost of borrowing in dollars. All told, the dividend to America's financial hegemony is probably worth some \$30 billion annually.

But even European chauvinists do not expect the euro to replace the dollar entirely as the reserve currency. And in any event, the competition should generate some ancillary benefits for the American economy.

Start with the reality that a strong Euro would make the rest of the world less forgiving of an undisciplined monetary policy in America. This would make a rerun of the inflationary spiral of the late 1970's much less likely, since world financial markets would short-circuit any attempt to ease the pain of recession with a flood of dollars.

The real worry is not the emergence of a competitor for the dollar, but consequences of monetary union on European policy and politics. For whatever impact the euro might have on the role of the dollar is sure to be dwarfed by its impact — direct and indirect — on trade, price stability and, ultimately, the health of the global economy.

A CURRENCY'S FACTS OF LIFE

"All currencies end badly," wrote René Sédillot, the French financial historian. They are born out of political hope, then die when changing political priorities make their existence untenable. And the current European national currencies are failing because they stand in the way of a key political objective: containing German influence.

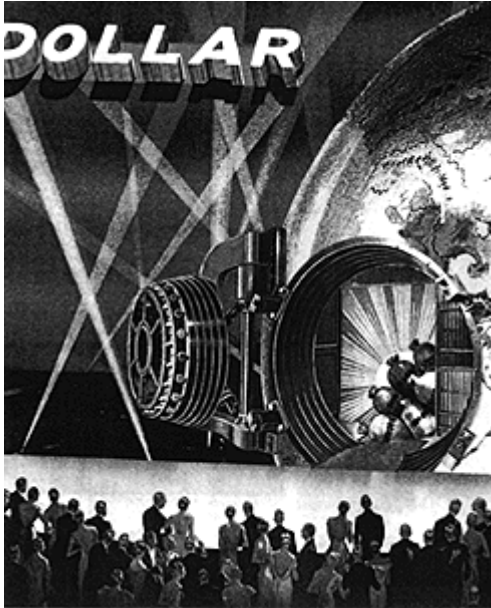
The German industrial and financial engine has dominated Europe since the 1950's. As a result, the German mark has dominated Europe monetarily. France's monetary policy has not been made in Paris and Italy's has not been made in Rome because neither country can afford to go its own way on interest or exchange rates.

The Germans acquiesced, albeit reluctantly, to a change in this system as part of a broader deal negotiated by Helmut Kohl, who was chancellor at the time. Kohl's vision for Germany was shaped by his personal experiences during and after World War II. His twin goals for Germany were reintegration of east and west and then integration of a united Germany into Europe. Like most European federalists, he favored a united Europe as the way to prevent continental wars and, in particular, to avoid a repeat of the disasters of the 20th century.

In return for Germany's giving up the mark, the rest of Europe accommodated it by agreeing to be governed by a European Central Bank on the German model. At least on paper, this bank will be as independent of political pressures as any in history and will have price stability as its objective.

But the economic ramifications of a single currency zone are far-reaching, and Europe may pay dearly for its failure to factor them into the political equation. To understand why, step back a bit. In an economy the size of Europe there are bound to be significant regional differences in performance. And in a world of multiple currencies, exchange rates usually serve as buffers, increasing the competitiveness of depressed regions by allowing their currencies to depreciate. Thus, for a single currency to be successful, politicians must find other ways to ameliorate regional differences.

As a practical matter, there are two principal alternatives: moving workers and reducing income inequality with fiscal transfers. Roughly one American in six changes residence each year, and seven million to eight million move to another state, typically to take new jobs. During the California recession in the early



1990's, 1.2 million people left the state, with many going to the rapidly growing Rocky Mountain region. Utah's labor force grew by 24 percent in just four years.

Europeans do cross borders in search of work, but the patterns are quite different. While there are ongoing flows from poorer regions to richer ones, individuals rarely leave one rich part of Europe for another rich part in response to the changing labor markets.

America's national tax system also serves as an automatic income stabilizer. During the business cycle of late 1980's and early 1990's, California's marginal contributions to federal receipts fell from 17 percent in the boom to just 8 percent during the bust.

This difference generated a net fiscal injection of roughly \$11 billion in 1994 alone, or more than \$350 per resident. The impact on Massachusetts was even greater; it had a swing of \$550 in per capita tax payments from peak to trough.

Europe has neither a potent automatic stabilizer like the United States income tax nor a tradition of demand-driven migration. Taxes are still national. And although mandatory national contributions to the European Union are somewhat sensitive to economic activity, the fiscal buffer is far less effective than in the United States. Furthermore, linguistic and cultural differences present much greater impediments to migration. Thus, the forces cushioning regional recessions are far less effective.

The problems created by currency union are already apparent on the periphery of Europe. While an easy monetary policy is being used to ameliorate the recession in the French-German core of Europe, Ireland, Spain and Portugal are booming. Ireland and Portugal should be raising interest rates. Instead, they have had to lower them to converge with the rates prevailing in France and Germany. As a result, their real estate and financial bubbles will continue to inflate.

But regional tensions are not the only sort of problem the new European Monetary Union faces. There is a natural conflict between the legal mandate to pursue price stability and the desire of politicians to spur growth in a continent-wide economy that has suffered from record unemployment for the better part of a decade. Unfortunately, the new arrangements in Europe will not provide an easy way out.

On first glance, the structure of the new European Central Bank resembles that of the Federal Reserve's Federal Open Market Committee. The members of the E.C.B. and the F.O.M.C. reflect roughly the same balance of power between the center and the regions. Membership in the F.O.M.C. includes seven Federal Reserve Board governors, appointed by the President. In addition, the 12 regional bank presidents take turns as voting members. In the E.C.B. there will

be six officers at the center joined by the heads of the 11 national central banks whose governments are part of the European Monetary Union.

But consider how the members are picked. In the United States, the presidents of the regional banks are jointly selected by the regional board of directors and by the board of governors in Washington. What's more, three of the nine members of each regional board — including the regional board's chairman, deputy chairman and a majority of the "search" committee for the regional President — are selected by Washington. It is only a slight exaggeration to say that the Federal board of governors selects the regional bank presidents.

It is also important to stress that in the United States, state and local political authorities have no formal say over the selection of these regional bank presidents. And since each of the 12 Federal Reserve regions include portions of several states, it is hard to organize political coalitions to influence the selection process in less formal ways. This system produces policymakers who tend to be above the political fray and interested in national — as opposed to regional — economic issues.

By contrast, the European Central Bank is built up from the regions. The national banks of the members will each send their heads to Frankfurt to sit on the E.C.B. governing council. These individuals will, in turn, have great say over the selection of the central bank officers. The center-based candidates are therefore responsible to the regions, while at the U. S. Federal Reserve the regional representatives are responsible to the center.

In addition, European member governments select the regional representatives. And though the central bankers are technically independent, it is only natural that they will reflect the views of the governments that select them. Thus while the Fed tends to act like a corporate board, the E.C.B. is designed to work more like a legislature.

A corporate board generally tries to find a single policy in the best interest of the whole. A legislature tends to arrive at a compromise reflecting the path of least political resistance. The difference between the two approaches is often hard to detect. But in a crisis, corporate directors are far more capable of acting decisively than legislators.

A second component of the governance problem is that the new European Central Bank lacks democratic legitimacy and accountability. Federal Reserve Board governors are appointed by the President and confirmed by the Senate. Their independence is derived from their long (14-year) tenure, which insulates them from electoral politics. Nonetheless, they remain indirectly accountable to the electorate that sustains and supports all political institutions.

Governors of the Federal Reserve are continually asked to testify before the Congress on a variety of subjects. Not only is their job tenure dependent upon the national legislature, the existence of the Federal Reserve can be changed by legislation at any time. By contrast, the European Central Bank is created by treaty among the member states and has no escape clause or process for amendment except by unanimous agreement of the signatories.

THE EFFECT ON POLITICS AND ECONOMICS IN EUROPE

What conclusions can we draw about the likely behavior of the new European Central Bank and its effect on the European economy in coming years? One is that it will be preoccupied with the mechanics of integration.

Establishing an entirely new currency is a daunting practical challenge. At first, domestic currencies will continue to circulate and the euro will be used only for large payments and as the unit of value in new government bonds. Then, during a short transition to begin in January 2002, the economies of Europe will switch to the new euro-denominated notes and coins. The technical details, particularly the establishment of a new euro settlement system, are likely to consume a major portion of decision makers' time.

This is not a hopeful development at a moment of global financial crisis. The distraction has already been reflected in Europe's failure to adapt to the changing global environment. In 1998 Europe failed to pull its own weight in the distressed world economy: Its imports from Asia grew more slowly than American imports from Asia. This not only harmed Asia, which was struggling to climb out of depression, it also stirred latent protectionism in the United States: President Clinton recently complained that America has become the importer of last resort.

Look, too, for rising tensions between the new central bank and the elected officials of national European governments. The central bankers will naturally want the euro to be viewed as a "hard" currency — a good store of value — rather than a "soft" currency apt to depreciate in crises. Failure to establish this at the inception would be catastrophic for the new currency because credibility, once lost, is virtually impossible to regain. But with Europe choosing left-leaning Social Democratic governments in the most recent elections, don't expect the national capitals to acquiesce with grace. Already the newly elected Red-Green government in Germany is at odds with the Bundesbank.

This fight will end in one of two ways. Either the E.C.B. will successfully maintain a "hard" euro policy, or the politicians will successfully undo Chancellor Kohl's deal for an independent central bank with an exclusive mission of price stability. I'm betting on the politicians, if only because the E.C.B. lacks the democratic legitimacy needed to make unpopular policies stick.

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Heads we lose, tails we lose. If the bank prevails, the key stimulative tools now available to government will all but vanish: The Maastricht Treaty, which created the euro and committed the E.C.B. to stabilizing prices also placed limits on the capacity of member governments to run budget deficits. Deficits were to be limited to 3 percent of gross domestic product.

Since many European countries, mired in recession, are already up against the 3 percent limit, the fiscal option is officially off the table. Politicians are mulling a way of getting around the treaty's strictures: "Infrastructure investments" (such as roads, bridges and other forms of political pork) may be ruled outside of

national budgets. But such a dodge would make the E.C.B.'s goal of establishing credibility a bit more difficult and is likely to be resisted.

The lack of palatable direct options for fighting recession leaves European politicians with an unpalatable indirect one: protectionism. A host of trade conflicts with the United States already loom, with subsidies to Airbus, Boeing's main global competitor, at the top of the list. Others are bound to occur in agriculture, financial services and intellectual property. The most likely consequence of a "hard" euro, therefore, is a more intransigent European position on trade.

Unfortunately, a victory for the politicians over the E.C.B. would not necessarily defuse trade tensions because other, more technical issues are likely to push Europe toward a "hard currency" stance. One of the key problems any monetary authority faces is determining the standard for judging the efficacy of monetary policy. The objective of the new European central bank is to maintain price stability. But there is no single "market basket" in Europe to serve as a benchmark for prices. Instead, the E.C.B. will have to deal with a variety of national price indices, each assembled under different methodologies.

The European bank might seek to stabilize a weighted average of all the market baskets. But just how does one stabilize prices in general when some member states are enjoying inflationary booms with full employment while others are in recession and suffering falling prices?

Remember, too, that financial markets will lack experience in interpreting the European Central Bank's policies. And almost inevitably, financial players will look to the one remaining yardstick of stability with which they are familiar: the exchange rate. So even if the bank does not formally target the exchange rate of the euro against other major world currencies, Europe will not be able to ignore it.

If, for example, the exchange rate were to slip to parity with the dollar, it is virtually certain that the markets would assume that European monetary policy was too loose. On the other hand, when the soon-to-be euro's effective exchange value went to \$1.20 last year, the screams of pain from European exporters caused some central banks to intervene in favor of the dollar. Thus, it is likely that attention will be paid to maintaining the euro in the \$1 to \$1.20 range.

If the politicians prevail, one of the key effects of an easier monetary policy will be an exchange rate between the euro and the dollar near the 1:1 end of this band. European exports will become more competitive in the American market, while American exports will become less competitive in Europe. This would amount to disguised European protectionism, and the euro would, inadvertently, undermine the long Atlantic consensus in favor of free trade. The best we can hope for is that both America and Europe recognize that in a world of exchange rate instability, the world simply cannot afford competitive devaluations in the two largest economies.

The high-profile, brute-force nature of exchange rate manipulation makes it the most dangerous weapon one can use in a trade war. Garden-variety protectionism, by contrast, usually plays out in dozens of confusing, numbingly

boring cases fought before domestic courts and the World Trade Organization. But the exchange rate can be the topic of headlines in the financial press — and if things get bad enough, in the popular press as well. Will we see *USA Today* headlining "Euro strikes new low blow against dollar"? Or will *Le Figaro* expound on the "La Dollar Menace"?

From this perspective, the current buzz about the euro replacing the dollar as a world reserve currency seems out of place. If the new euro is used as a weapon in a trade war, or even as a last-ditch means of exporting Europe out of recession, it will not be perceived as a reliable store of value. Indeed, if the euro is used as a recession fighter, the more likely challenge to the prevailing Atlantic relationship will come from a weak euro, not a strong one.

There is another reason to expect the euro to be weak. Under the current multi-currency regime, most of the effect of one European country's devaluation is felt by other European countries. In a devaluation of the Italian lira, for example, the major losers would be French farmers and German manufacturers. As such, using exchange rate policy as an economic tool has widely been viewed as anti-European.

But with a single European currency, this constraint will vanish. Devaluation becomes pro-European since the losers will be American and Asian exporters and the winners will be their European counterparts.

Of course, European consumers have as much to lose from competitive devaluation as foreign producers. For better or worse, though, European policy makers have shown a proclivity to be much more producer-friendly — and less consumer-friendly — than their American counterparts.

Europe's multi-currency system is dying because it no longer serves Europe's governing elite. But the economic ramifications of the decision to switch to just one currency are global, not merely local. America is surely right in worrying about potential competition from the euro. But it is not the sort of competition that most Americans or Europeans expect. It will be a competition driven by weakness, not strength.

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