

LETTERS

WHERE CREDIT IS DUE

You observe (Michael Milken, "From the Chairman," First Quarter 1999) that balance sheets don't account for economic value. Why would they? They were designed for collateral lenders worrying about getting their money out in liquidation scenarios. But established firms rarely liquidate, so what's the sense in valuing their debt against that unlikely outcome?

It seems to me your contribution was to convince people to apply the same reasoning to new, growing firms, as in:

Firms are organic and carving them up destroys value. So it'll rarely happen, Mr. Creditor, get over it. There's no more gold standard. Instead of giving you stuff to hold against your early-stage risk, you'll get a firmer payout promise, the liquidity that comes with it and maybe an upside kicker – warrants, etc.

As firms mature, no one would dream of valuing their debt against liquidation value rather than cash flow. Maybe the ultimate example is the non-interest-bearing government debt in your pocket. What's a dollar worth, other than its pro-rata share of America's earning power?

How about writing about how your ideas would apply to emerging market restructuring? I'm no expert, but it seems that the international agency approaches have been focusing on protecting current creditors by requiring steps to pump up currency value, rather than on building the long-term value of the economies – which, after all, aren't going away.

– Mitch Berns
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OH YE OF LITTLE FAITH

In "Euroland: The Morning After" (First Quarter 1999), Lawrence Lindsey warns the United States to expect no good from the euro. He argues that the inherent flaws of the construction are such that the euro is likely to be a weak currency, and that its weakness will disrupt trans-Atlantic trade and cooperation.

Lindsey's skepticism is misguided and his view of trans-Atlantic cooperation too narrow. The creation of a monetary union by 11 continental European nations covering 250 million people is a major historical event. Only once or twice before – and never on this scale – have nations been united in monetary union other than by the force of arms.

Lindsey seems to agree with American economists like Martin Feldstein, who have argued that monetary union is such a bad idea economically for Europe that the only justification is political. In Lindsey's words, "Europe has not factored the economic ramifications into the political equation."

But the builders of the European Monetary Union (E.M.U.) did not only want to strengthen their political union, and "contain Germany." They also wanted to

enhance the economic well-being of their citizens.

Paradoxically, Americans, who ought to understand this better than anyone else, often do not appreciate the push that a common currency can provide for economic integration. Monetary union will undoubtedly make capital more mobile within Europe. Cross-border investment will no longer be deterred by the complexities of accounting in different currencies and by the risk of divergent economic policies. Europe will move closer to the ideal of a unified business space.

This development could have profound implications for growth. It will encourage consolidation, and push European businesses to more efficient scales of operation. United States multinationals will be a part of that consolidation, as the recent wave of trans-Atlantic mergers suggests.

Furthermore, as the states of the Union compete with one another, there will be pressure for many of the Continental countries to reduce their regulatory and tax burdens. More flexibility in labor-market regulations could, over time, bring the majority of Europe's unemployed back into productive employment.

The central argument of E.M.U. skeptics in the United States has been that Europe lacks the labor mobility and the automatic stabilizing effect of Federal tax receipts to make the common currency workable. The risk is that a region deprived of the ability to devalue its way out of economic difficulties will become permanently depressed.

This is possible – which is why greater internal market flexibility is called for on the Continent. But the goods and services markets of the European Union are already so integrated that it is difficult to conceive of a sectoral problem large enough to merit devaluation that would not in fact be shared by all – and therefore would not be amenable to a currency fix in the first place.

Interestingly, the two examples of unsynchronized macroeconomic imbalance that Lindsey gives – overheating in Portugal and Ireland – could be corrected by tighter Portuguese and Irish national fiscal policy. There is nothing in the Maastricht treaty to stop a national government from running a fiscal surplus.

In my judgement, then, the economic risk is more theoretical than real, and the economic potential is substantial. Of course, it will take more than a European Central Bank to insure that these potential benefits are realized. Much will depend on how governments respond to the competitive pressures they are already feeling. If the current calls for "harmonization" (read "regulatory restrictions maintenance") prevail, a great opportunity will have been lost.

This is one of the reasons why British membership is important: Even the Labor Party will not give up Thatcher's structural gains lightly. If the competitive pressures that the E.M.U. has intensified lead to substantial deregulation, the E.M.U. will have unleashed new forces for growth.

In passing over this potential boost to the real economy, Lindsey misses an important part of the story. Instead, he analyses the construction of the

European Central Bank, and points to some of its weaknesses.

In his opinion, the frailty of the European Central Bank's (E.C.B.) constitution will tend to produce a weak euro. This will permit European businesses to undercut their American competitors in a manner that will be against American interests. If the weakness goes too far, it may promote protectionism in the United States.

Lindsey then paradoxically argues that a strong euro would be against American interests, leading Europe to protectionism to ward off cheap imports. "Heads I lose. Tails I lose."

Does Lindsay simply yearn for greater trans-Atlantic currency stability? Certainly if that was a medium-term objective, the euro would help – though it is not on my short list of the main benefits of the E.M.U.

More generally, "The Morning After" raises the question of the relationship of the European construction to America's interests. Lindsey starts his essay by questioning the logic of United States support for European integration in the aftermath of the Cold War. One response is that "What is good for General Motors (or Coca Cola) is good for America," and prosperity in our principal trading partners is good for American-based multinational corporations. More subtly, a politically stronger Europe is a better ally. Think also of the importance of the European Union as a beacon – eventually a haven – for the former Soviet satellites of Eastern Europe. To be able to absorb them and stabilize them, the European Union must be strong.

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OH YE OF LITTLE FAITH PART 2

Like other skeptics at each stage of the process of European integration, Larry Lindsey offers many small objections to one big idea. The big idea is that Europeans can stop killing each other, competing for power and falling victim to totalitarianism by joining in a common framework for which peace, a free economy and democracy are cornerstones.

Lindsey is right that Americans should not worry that the euro will replace the dollar as a reserve currency. Experience since January really has demonstrated that to be the case. Perhaps Americans should instead think of the euro as a slightly weaker D-mark. Lindsey is also correct that the euro's very existence will raise difficult problems of adjustment among the present 11 Euroland economies, as well as among other European nations that eventually qualify and choose to join. But, as with existing European Union institutions, monetary union is more likely to trigger changes that are more salutary than harmful.

When the Maastricht Treaty first set forth the criteria for participation, there was widespread skepticism that they could be met by more than a handful of strong-currency countries. Yet, by the deadline, 14 of the 15 members of the E.U. were able to meet the criteria for inflation rates, government debt, budget deficits and long-term interest rates. Would anyone argue that, without the discipline

imposed by Maastricht, this could have happened, even as double-digit unemployment plagued Europe?

Lindsey doubts the new European Central Bank will be able to withstand political pressures toward easing, and says he is "betting on the politicians." Again, parallel arguments have been heard at each stage of the European Union's evolution from its founding. Political leaders in the big-member countries, it was feared, would always intervene to serve their own interests rather than the general E.U. interest.

There have, indeed, been some nasty episodes along the way. Yet, in the end, conflicts have been resolved and compromises made in ways that maintained the integrity of the integration process. In the case of the European Central Bank, it already seems clear that, by refusing to ease to please big-country politicians, the bank can play a positive role in furthering the structural reforms needed to insure Europe's long-term competitiveness.

It is possible, of course, that Lindsey is right and the integrationists are wrong. If that proves to be the case, United States security, as well as its economic interests will suffer, and Europe's long string of postwar successes will be broken. But as with previous tests of the integration movement, monetary union is far more likely to leave Europe stronger, freer and more prosperous than it would otherwise be.

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