

# WOULD EUROPE BE BETTER OFF WITHOUT THE EURO?

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*Mairead Gallagher addresses the question that is on many people's minds at the moment, but more importantly tackles the fundamental structural problems of the European Monetary Union. The essay serves to remind us that there are benefits to the single currency, and argues that addressing its flaws is a more constructive course to take than questioning its initial wisdom.*

## **Introduction**

In light of the current financial crisis, much speculation has surrounded the issue of whether 'Europe would be better off without the euro'? This paper seeks to address the issue but also proposes that the real question should in fact be whether collectively, individual euro area countries are prepared to take on board the lessons learned from the current situation and implement necessary institutional reforms (counter-cyclical fiscal policy, improved regulation and increased flexibility in labour markets) in order to realise the benefits of the European Monetary Union (EMU) rather than further handicap the area.

Before considering the implications of the currency union for the current crisis, I will review the pros and cons of the EMU in relation to 'optimum currency area' (OCA) criteria (Mundell, 1961). I will then follow with a review of the impact of the euro on Europe in terms of: improving the credit environment, sources of divergences in inflation across the euro area, effects on competitiveness and the role of fiscal policy as a stabilisation tool.

## **OCA Analysis of EMU**

OCA theory focuses on integration and asymmetries. It attempts to weigh the relative costs and benefits of monetary union against one another to ascertain whether the region in question is an OCA. Essentially, increased integration raises the efficiency benefits while asymmetries increase the stability costs. Difficulty in quantifying the respective pros and cons hinders this task; yet the general consensus is that Europe is not an OCA. Nonetheless, one must acknowledge that in deciding whether

Europe would be better off without the euro, there are factors beyond the economic considerations mentioned in this paper which warrant attention – after all the euro is a political construct.

The main criteria cited for successful monetary union are (Frankel and Rose, 1998): trade integration, similarity of shocks and positive correlation between business cycles, labour mobility and fiscal transfers.

### **Loss of Monetary Policy Autonomy**

The primary cost of monetary union arises from the impossible trinity – a fundamental idea in international economics which states that the following three policy objectives cannot be simultaneously achieved: monetary policy autonomy, capital mobility and a fixed exchange rate.

By definition a currency union implies fixed exchange rates and the Single European Act disallows capital controls; consequently, euro area members renege on the possibility of exercising independent monetary policy as an adjustment mechanism to shocks. The magnitude of costs resulting from monetary union depends on the degree of asymmetric shocks and the availability of adjustment mechanisms to adapt appropriately to such asymmetric shocks (discussed below). With independent monetary policy redundant, fiscal policy becomes increasingly important to euro area members, as does the need for labour mobility and the existence of fiscal transfers.

### **Trade**

One of the initial arguments for EMU was the expected increase in trade resulting from the lower transaction costs associated with the euro. Frankel and Rose (1998) propose that the optimum currency area criteria are endogenous, such that EMU would promote intra-European trade which would in turn lead to more similar business cycles among members – increasing the benefits of EMU (as well as reducing asymmetric shocks). The counter-argument, as proposed by Krugman (1993) and others, is that as trade becomes more integrated, specialisation will occur which will cause more asymmetric shocks within the euro area.

Evidence to date does not support the specialisation argument; however, given that the pro-trade effect from the euro is estimated to be in the range of 5-15%, with 9% being the best estimate (Baldwin, 2006) it is difficult to support the assertion that business cycles will become more closely aligned due to the trade integration mechanism. Despite a near 10% increase in trade flows for euro area members, it does little to alleviate the pain of forgoing independent monetary policy, especially since non-member countries experienced about a 7% increase in trade due to the euro (Baldwin, 2006).

### **Common Shocks**

It is widely accepted that in responding to common shocks the ECB delivers superior solutions than would be attained if monetary policy was conducted at individual country level. Eichengreen (2010) remarks that ‘the last decade would have been very difficult for Europe without the euro. There would have been chaos in foreign exchange markets after 9/11, after the Madrid train bombings, and after Lehman Brothers.’ It is conceivable that uncoordinated monetary policy would inadequately account for spillover effects arising from individual country level actions, possibly leading to excessive or insufficient policy responses.

Furthermore, monetary union has facilitated global cooperation in relation to common shocks. The ECB and Federal Reserve participated in coordinated policy interventions to stabilise the euro-dollar exchange rate in 2002 (Lane, 2009). Such cooperation would be too cumbersome to be timely and effective if decision making had to take place between the Federal Reserve and each individual euro area country. Yet, despite the success of the ECB in dealing with common shocks, the euro area is also subject to considerable asymmetric shocks which cannot be stabilised using monetary policy. The implications of these asymmetric shocks will be considered later.

## **Labour Mobility**

Labour mobility provides a mechanism for adjusting to asymmetric shocks. If a country or region experiences a negative shock, unemployment will rise in response to a decline in output. With a mobile labour force, workers who become unemployed can migrate to other regions in search of work. This mechanism reduces the need for stabilisation policy, thus reducing the costs of monetary union.

However, according to Wyplosz (2006, p.215) ‘the labour mobility criterion is not even remotely satisfied’. Evidence from 2003 shows that only 1.5% of people were born in a different EU country from the one in which they live, compared with over 30% of residents in the US living in a different state to which they were born (Feenstra and Taylor, 2008). This trend is not expected to have changed significantly as euro area labour mobility continues to be hindered by language and cultural barriers as well as further impediments associated with differing social welfare systems across the euro area. Without labour mobility, ‘competitive disinflation’ is necessary, which involves periods of sustained high unemployment and wage disinflation until competitiveness is regained and the current account deficit and unemployment are reduced (Blanchard, 2007). The process is prolonged if wages are subject to nominal rigidities; in this case re-establishing competitiveness requires either productivity growth above that in other regions and/or inflation to erode the real wage. Competitiveness and the ability to stabilise shocks are seriously compromised by the preference for social protection in continental Europe. Without institutional reform, many euro area countries will endure the painful process of ‘competitive disinflation’ currently faced by Portugal, Ireland, Greece and Spain. The detrimental effects are evident in the case of Germany, whose growth was consistently lower than that of the euro area from 1995-2006 as it underwent this process (Blanchard, 2007).

## **Fiscal Transfers**

The US is commonly used as a benchmark for EMU. One stark contrast between the euro area and the US is that the euro area does not provide insurance against asymmetric shocks. While fiscal federalism is a prominent feature of the US economic system no such feature exists in the euro area; rather fiscal policy is conducted independently at national level. Furthermore, the EU budget is only about 1% of EU GDP compared with about 33% for the US, which indicates the limited capacity of the euro area to finance fiscal transfers. Fiscal federalism acts to cushion asymmetric shocks by providing fiscal transfers from non-affected countries to affected countries, facilitating fiscal stimulus. Therefore, some centralisation of fiscal policy within the euro area could serve to alleviate the problems with asymmetric shocks.

However, there are several drawbacks from such an insurance system, including political resistance and issues of moral hazard. To circumvent moral hazard, the Maastricht Treaty explicitly included a 'no bailout clause'. However, that clause has been reneged upon in response to the current financial crisis, as the European Financial Stability Facility (EFSF) has been set up to provide funds to troubled euro area economies.

## **Improvement in Credit Environment**

A significant benefit of adopting the euro, particularly for peripheral countries, was gaining access to the integrated euro area bond market; a much larger pool of funds from which to obtain finance than would have been available in their previously underdeveloped domestic bond markets. By entering the EMU and subsequently designating monetary policy to the ECB, euro area countries were able to import low inflation and therefore credibility. With monetary policy conducted by the ECB, whose commitment is price stability, inflation risk premiums fell significantly. Prior to joining the euro, countries such as Italy had a poor reputation with regard to devaluation and consequently faced large risk premiums on domestic denominated bonds.

Wyplosz (2006) recognises that even with a tight peg in a fixed exchange rate system, instances occur where the temptation to run inflationary monetary policy becomes too high to resist. In a currency union this possibility is eradicated, bringing clear benefits to the euro area by increasing credibility and thus eliminating speculative attacks on the currency (attacks are still possible on sovereign debt however).

The euro led to a substantial convergence in yield spreads across the euro area. The impact was largest in peripheral countries where spreads above the DM were significant prior to monetary union. These countries 'faced a permanent reduction in the cost of capital' (Lane, 2009, p.8). The sharp rise in the availability of long-term credit coupled with expectations that entering monetary

union would lead to growth and convergence with the 'core' economies translated into an increase in aggregate demand in the periphery – particularly in Greece, Ireland, Spain and Portugal.

### **Insulation From Potential Foreign Debt Crisis**

The global savings glut in the early 2000s certainly contributed to the increase in the supply of credit. However, without the integrated euro markets the impact on the periphery would have been limited because pre-euro domestic equity and bond markets were too small and illiquid to attract substantial investors.

Furthermore, for countries with less developed securities markets the savings glut would have led to a rise in the accumulation of foreign currency debt. With respect to the current financial crisis, if national central banks had insufficient foreign reserves to provide liquidity to domestic banks a foreign debt problem, as well as an amplified banking crisis, may have ensued (Lane, 2009). The euro has to some extent protected Europe from a worse crisis, in that less financially developed European countries would have accumulated considerably more foreign debt if the euro and its integrated markets did not exist.

### **Diverging Inflation Rates and Implications for Competitiveness**

Asset bubbles appeared in some national housing markets and were further inflated by expansions in bank credit, predominantly in Spain and Ireland. Sustained increases in demand caused inflationary pressure, which led to both wage and price increases in the booming euro area economies and in turn contributed to an eventual decline in competitiveness. It is clear that a 'one size fits all' approach to monetary policy is not appropriate in the euro area. With some economies booming and others almost stagnant, inflation differentials began to emerge between countries. Inflation across the euro area in 2000 ranged from 1.5% in Germany to 5.6% in Ireland, with a range of 2.4 percentage points over the period 1999-2004 (Lane, 2006).

In accordance with the Fisher Equation (Fisher, 1977), with all euro area members facing the same nominal interest rate (by definition of a fixed exchange rate), differences in inflation across countries leads to differences in the real interest rate each economy faces. Rather perversely, those who are experiencing higher than average inflation face a lower real interest rate thus stimulating the economy even further, while those with lower than average inflation face a higher real interest rate thus dampening growth in their economy. In this respect, the euro serves to amplify the differences in economic fundamentals between euro area economies. A self-correcting mechanism exists to offset divergences in growth and inflation, however, this process is more harmful to growth than taking preventative measures to maintain sustainability before becoming uncompetitive. The self-correcting mechanism occurs where prices and costs of factors of production rise to make the economy less competitive. This eventually leads to a slowdown and accompanying unemployment.

Traditionally an economy would engineer a devaluation of its currency to regain competitiveness. However, with the devaluation option no longer available and with many economies experiencing low productivity growth, the only alternative is to decrease nominal wages and prices of non-tradables (Blanchard, 2007). This is a painful process as previously noted; Germany pegged to the euro at an overvalued rate and thus suffered from the inability to compete with exporting countries. The German economy underwent a process of competitive disinflation which resulted in their economy growing at a consistently lower rate than that of the euro area. If euro area economies aren't prepared to implement necessary reforms to labour markets and fiscal systems then the costs of monetary union may overshadow the benefits.

Heterogeneity between euro area members is further augmented by the single currency in that different countries have different sensitivities to fluctuations in the euro exchange rate, as determined by their trade linkages. For example, Ireland trades much more extensively with the US and the UK (as a % of GDP) than other members of the euro do. Therefore, fluctuations in the euro exchange rate impact Ireland's ability to export, which feeds back into home demand through the impact on real wages in Ireland and in turn has implications for inflation.

If euro members continue to harbour such differences in fundamentals it is possible that Europe would be better off without the euro unless adequate stabilisation tools can be employed. Accordingly, fiscal policy has become increasingly important for moderating the effects of business cycles.

### **Fiscal Policy as a Stabilisation Tool**

The availability of cheap credit enabled countries to run current account deficits and perhaps even encouraged pro-cyclical fiscal policy. Many countries justified their current account deficit because of expectations of higher growth and a lower real rate of interest (Blanchard, 2007, p.4). However, hindsight tells us that the level of aggregate demand in these economies was unsustainable, particularly in view of the housing bubbles.

Furthermore, markets did not sufficiently penalise countries running deficits. Market failure occurred because investors believed that euro area securities were equally risky; there was a general failure to properly account for default risk from individual countries. 'An increase in the deficit by 1 per cent of GDP raises the spread by 4 basis points for a non-euro area country but only by 1.5 per cent for a euro area member' (Eichengreen, 2007, p.22). These market failures could be attributed to a lack of belief in the 'no bailout clause' in the Maastricht Treaty. Irrespective of market failures, peripheral countries should have paid heed to the large volume of literature which reiterates the importance of running 'sufficiently large surpluses during boom periods in order to finance the loss of revenue and increased spending commitments during downturns' (Lane, 2006, p.16). Overheating could have been abated to some extent using counter-cyclical fiscal policies, which would also have enabled national authorities to form a 'rainy day fund.'

While in some respects monetary union may have aggravated the current situation for Europe, forewarnings regarding the need for counter-cyclical fiscal policies were abundant and ultimately, fiscal policy responsibility lies in the hands of national policymakers. Given the current economic situation, the question to be asked is not so much whether Europe would be better off without the euro but whether euro area countries would be better off designating control of fiscal policy to some independent institution.

The constraints imposed by the Stability and Growth Pact may have encouraged pro-cyclical fiscal policy by inhibiting the degree of expansionary fiscal policy possible during downturns, yet not imposing rules regarding the level of surpluses required during upswings. Many euro area countries now find themselves locked out of the bond markets – a consequence of imprudence in the good years combined with recent contagion effects. As a result, despite the fact that countries such as Germany, Netherlands and Austria proceeded more cautiously, they now have to contribute to the bailout packages for weaker euro area economies.

## **Exiting the Euro**

Euro area members are currently stuck between ‘a rock and a hard place’ (The Economist, 2010). The weaker economies may find the option to leave the euro and devalue their currency appealing, particularly as they are faced with years of austerity to complete the disinflation necessary to become competitive again. On the flip side, stronger creditor countries may wish to exit the euro to avoid subsidising countries with excessive deficits and unsustainable debt to GDP ratios.

Effects of exiting differ between economies. In the case of weaker economies, investors would anticipate that they will run inflationary monetary policy which would result in credit-rating downgrades, higher risk premia and larger sovereign spreads; access to bond financing is unlikely to improve by leaving the euro (Eichengreen, 2007). As for stronger economies, the costs of leaving are more political in nature, in that domestic exporters would be severely harmed by currency appreciation, perhaps causing political backlash. Regardless of which type of economy exited, capital flight would ensue, further jeopardising the future of the euro.

Perhaps the most important reason to remain within the currency union is that, in abandoning the euro, a country may be denied the privileges of the single market (Eichengreen, 2007). While it is not clear that this would happen, it is a very big risk to take – particularly for exporting nations.

## **Conclusion**

From the initial review of the euro area in relation to OCA criteria it is clear that there is insufficient flexibility within the euro area to absorb asymmetric shocks. The costs of these shocks are heightened by a lack of labour mobility and an absence of adequate insurance transfers. Furthermore, there is a lack of empirical evidence to support the view that trade integration results in greater

homogeneity between euro area business cycles. With frequent or sustained asymmetric shocks, all else equal, Europe would be better off without the euro. Quite simply, the costs of monetary union might be too high given the limited flexibility.

However, all else is not equal. Monetary union has brought great gains to Europe in terms of improving the long-term credit environment and attracting foreign direct investment (see Lane, 2006), which have facilitated growth and a significant degree of convergence across countries. Moreover, the level of financial integration achieved through monetary union has insulated many European countries from possibly worse crises resulting from foreign debt problems and following speculative attacks. Without the euro it is conceivable that there would be chaos in the foreign exchange markets due to defaults and speculative attacks, which would have a huge impact on trade (with the euro, attacks are limited to sovereign debt).

It is evident from the persistent divergences in inflation that a 'one size fits all' monetary policy is inappropriate. However, the effects of these divergences could be ameliorated through labour mobility, national authorities running more counter-cyclical fiscal policies and by the development of a fiscal transfer system.

Whether Europe would be better off without the euro remains indeterminate. For some countries it is very costly to remain in the currency union, particularly in view of the austerity measures necessary to regain competitiveness (or on the other hand the cost of funding bailouts). Future euro area prosperity is conditional on institutional reform in financial regulation, fiscal policy and labour markets.

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