



## Europe's Struggling Currency Union

By John H. Makin

Clear signs of political and economic stress have emerged from Europe in recent weeks. Rumors have circulated about discussions of a possible breakup of Europe's currency union, and one renegade Italian official, Welfare Minister Roberto Maroni, expressed a wish that Italy could return to the lira in order to get some help from a weaker currency to relieve Italy's current recession. Perhaps more telling, 54 percent of Germans polled would like to abandon the euro and return to the deutschemark. Similarly, the inflationary impact of the move from the gilder to the euro was cited by many of the Dutch citizens who voted decisively against ratifying the European Constitution.

The well-publicized May rejections by France and the Netherlands of the European Constitution and the historic defeat of the Germany's Social Democratic Party (SPD) in North Rhine-Westphalia have alerted the world that all is not well in the European Union. Consequently, the euro—long touted as a store of value superior to the U.S. dollar, especially in view of the rising U.S. current account deficit—has dropped by about 10 percent against the dollar, from 135 in March to 121 in mid-June.

### European Union Will Survive

Despite all the discussions of a possible breakup of the European Monetary Union together with obvious political pressures building in Europe over weak growth, it is highly unlikely that the European Monetary Union will collapse any time soon.

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Europe's leaders are determined that European unification and all of its trappings will go forward even if economic performance has to suffer as a result. And therein lies the problem. Europe's determination to stick with monetary union, coupled with the European Central Bank's determination to focus only on inflation targeting (even if it means sharply lower growth or recession, as has already occurred in Italy), suggests that hard times may lie ahead for many of Europe's economies.

There are sound reasons to suppose that the economic pain in Europe will rise from its already high level, especially in countries, such as Germany and Italy, that are already under stress. The rest of Europe, however, will not escape the negative economic pressure either, and the result of another year of slow growth and rising unemployment may be to accelerate a leadership turnover in Europe to a younger generation. Germany already looks set to elect a fifty year-old leader of the center-right Christian Democratic Union (CDU), Angela Merkel, later this year as it rejects a long period of SPD leadership under Chancellor Gerhard Schroeder. Schroeder's government lost support from many in its left-leaning base, partly because of efforts to rein in Germany's extravagant social insurance programs.

Europe's future is an important factor underlying the stability and growth of the global economy and, of course, the welfare of its own population. The combined population of the euro area is larger than that of the United States, and the combined gross domestic product (GDP) is almost as large. But the economic success and political stability of Europe will require more than slavish devotion to a common currency.

## Europe's Single Currency Obsession

The idea for a common European currency had its proximate origins in discussions during the late 1970s between Valéry Giscard d'Estaing and Helmut Schmidt, the leaders then of France and Germany. The Germans were sufficiently concerned with the rapid rise of U.S. inflation and the poor prospects for the dollar as a viable store of value that they conceived the idea, as part of a move toward European union, that Europe should have its own currency. The demise of the Soviet Union and fall of the Berlin Wall, just over a decade later, gave strong impetus to the movements toward European political and monetary union. By 1997, European countries were pursuing policies that amounted to a peg of their currencies to each other in anticipation of the introduction of a single currency, the euro, in January 1999.

The euro was clearly to be modeled on the deutschemark as a hard currency, which would be managed in a manner that assured low inflation rates in the euro currency area and thereby low interest rates. The European Central Bank (ECB) was located in Frankfurt, just a few miles from the Deutsche Bundesbank, which oversaw the post-war elevation of the deutschemark to hard-currency status. The prospect of adopting the euro as the currency of Europe was especially attractive to countries like Italy and Spain with less stellar records in keeping their currencies stable. Countries that used the new common currency would, in effect, be able to borrow at the same interest rates that Germans could enjoy as a result of their long history of hard-currency policies, which scrupulously avoided an inflationary loss of value of bonds denominated in deutschemarks.

The euro had its ups and downs after its introduction in January 1999. Initially, the euro traded at a price \$1.18 on the expectation that it would command a premium over the dollar as a superior store of value under the management of the stern European Central Bank, which was charged only with maintaining low inflation. That is, it was not to be distracted by concerns about asset prices, growth, and unemployment as was the U.S. Federal Reserve, the steward of the dollar's purchasing power.

In fact, the euro fell steadily against the dollar during most of the first two years of its existence, reaching a low on October 26, 2000, of about \$.82. Just before that, central banks in Europe, Japan, and the United States had purchased euros to stem what was perceived as an excessive weakness of Europe's new currency.

The primary underlying reason for the euro's tumble was the rush from Europe into the surging U.S. stock market during 1999 and early 2000. Even though the NASDAQ crashed in March 2000, flows did not begin to reverse in earnest until after it was clear later in the year that the U.S. tech bubble would not reflate. After October 2000, the euro rose consistently over an uneven path for about four years, reaching a high of about 136 in 2004 amidst fears of a rising U.S. current account deficit.

Yet the strength of the euro during the post-bubble period came at a price. First, Europe's main economy and often its engine of growth—Germany—entered the currency union at what amounted to an overvalued exchange rate. As a result, German manufacturers squeezed down costs in order to improve competitiveness, relying in effect on falling unit-labor costs as a way to restore competitiveness rather than a falling currency. Growth rates in other parts of Europe also suffered, and by 2003 it was necessary for Germany and France to abandon the fiscal restraints originally imposed as a condition for membership in the European Union. Their budget deficits were allowed to rise above 3 percent of GDP and have remained at that level, sustained by continued outlays under generous social programs and constricted revenues as their economies have underperformed.

Europe, and especially export-oriented Germany, received a reprieve after 2002 from the surge in Chinese growth. Germany's exports to China rose rapidly, giving its manufacturing sector a boost. Meanwhile, the ECB continued to pursue tight monetary policies, so the euro appreciated further, thereby undercutting Europe's advantage in its traded-goods sector.

## Growth Down, Political Tension Up

The ECB did cut short-term rates to 2 percent in 2003, and rates have remained at that level ever since while the European economy has weakened. Signs of weakness became especially clear as ten-year bond yields fell from about 4.4 percent in the middle of 2004 to 3.4 percent by early 2005. After a brief rise to 3.8 percent, in sympathy with rising U.S. rates during the first quarter of this year, German bond yields have since dropped to about 3.1 percent—nearly a full percentage point below yields on U.S. Treasury ten-year notes. As Federal Reserve chairman Alan Greenspan has noted, the "conundrum" regarding long-term rates is a global one. In the case of Europe, lower interest rates are signaling

both falling inflation and falling expected real rates as expected growth in the economy has dropped during 2005. Italy officially entered recession in May 2005, and Germany is not far behind. Long-term interest rates are surely signaling the expectation of still weaker economic growth in Europe. Simultaneously, the European Central Bank has indicated that it sees no clear need to alter the current level of short-term interest rates.

Exacerbating problems for Europe's economy, and Germany's in particular, has been a change in China's economic policy over the past six months. The Chinese authorities have decided to slow domestic growth by slowing the flow of loans from its banking system to state-owned enterprises. This is part of an effort to shore-up the quality of the balance sheets of China's banks as foreigners contemplate bidding on partial ownership of those banks. To compensate for the slower domestic growth resulting from slower credit growth, Chinese authorities have boosted exports and quelled imports. Consequently, Germany's exports to China have dropped sharply, and with that development one of the major supports for German growth has dissolved. Weakness in the global traded-goods sector has appeared in the United States as well. Unlike the U.S., however, Germany does not have a housing boom to support domestic household balance sheets and thereby to boost domestic consumption. As a result, German growth is falling rapidly. The drag on overall European growth is becoming obvious as well.

Weakening economies in Europe have translated into rising pressure for political change. The previously noted loss by Germany's left-of-center SPD Party of North Rhine-Westphalia in the May 2005 election has been likened to the Republicans carrying New York and California in a presidential election. Clearly, it is not politically viable for even a left-leaning German government to try to rein in social costs while the German economy is so weak. The unemployment rate is above 11 percent, and growth is slipping toward zero. Until the second quarter of this year, the European economy also had to contend with the deflationary impact of a rising currency and rising real rates under the heavy hand of the European Central Bank.

The decisive rejection by French and Dutch voters of the European Constitution in May also suggests widespread discontent concerning economic conditions in

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Europe. The connection between economic underperformance and rising political tension that threatens the political leaders of Europe increases the likelihood that the political pressure on the heretofore independent European Central Bank will rise over time. It is that prospect coupled with the opportunity to earn a full percentage point more on U.S. government ten-year notes than on German government 10-year notes that has caused the euro to drop by about 10 percent against the dollar over the past two months.

The poor performance of some European economies and the unevenness of performance among them—Spain, Ireland, and even France are still experiencing strong growth and strong real estate markets—is a byproduct of Europe's bold currency experiment in which full currency union preceded political union. Normally, political union precedes monetary union. The union of the thirteen colonies in 1776 was followed six decades later by the controversial introduction of the first Bank of the United States. The Federal Reserve System did not appear until 1913.

## An Awkward Currency Structure

Europe's choice to impose monetary union prior to political union yielded the awkward result that its currency union now has one central bank and twelve discrete national treasuries. When one buys a euro, one buys a claim on an amalgam of governments with decidedly uneven records with regard to fiscal discipline. This creates an awkward problem. The currency union means that Italy, with its rising budget deficit and recession, can issue bonds denominated in euros that yield the same interest rate that is paid by euro bonds issued by the more fiscally conservative German government. In fact, the equality of yields on short-term government liabilities in Europe is assured by a policy of the ECB to buy all government-issue debt at par. Even with this official pegging exercise, Italian ten-year notes pay about 20 basis points more than German ten-year notes. The difference is tied to the small probability of

withdrawal from the European Monetary Union by either of these countries.

The more serious problem is the moral-hazard issue that arises in a monetary union with one central bank oriented toward low inflation and twelve treasuries with sharply differing economic systems to manage. The expedient move by the Italian government would be to borrow heavily in order to finance a large fiscal stimulus to boost Italy out of its recession. The effective peg between interest rates on Italian government liabilities and German government liabilities means that the Italians will be under increasing pressure to employ Keynesian fiscal stimulus to boost their economy. The Italian Finance Ministry answers to the Italian government, not to the European Central Bank, thus the institutional bias to use deficit finance to boost the economy out of recession.

Such expedient use of fiscal stimulus by governments experiencing recession in the European Monetary Union has been made easier by the fact that Germany and France have elected to overlook the constraints originally capping fiscal deficits of European Monetary Union members. Their lack of fiscal rectitude in the face of slow growth and expensive social programs led to this outcome.

It is not clear how Europe will resolve the conflict between slow growth and rising unemployment and the attendant need for fiscal stimulus with the strict anti-inflation policies of the European Central Bank. The markets may help to resolve part of the dilemma by reducing the value of the euro against other currencies in the face of uncertainties about how the rising economic and political pressures within the European Union will be resolved. However, the ability of a currency adjustment to stimulate adequate growth in Europe will be somewhat limited by the chronic excess capacity in the global traded-goods sector, which has been intensified by China's decision to pursue export-led growth as it reduces the flow of credit to domestic industries.

## A Political-Monetary Dilemma

The negative votes on the European Constitution in France and the Netherlands, coupled with the likely loss of the center-left SPD party in the upcoming September national elections in Germany, carries a message for politicians. Either they must wrest some accommodation

from the European Central Bank to help the growth of domestic demand through lower interest rates or they will have to pursue old-fashioned deficit financing of government programs (including tax cuts) to stimulate domestic demand, possibly prompting a tightening by the orthodox monetarists at the ECB. Failing that, existing governments may begin to suspect that their days are numbered, just as those of the Schroeder government in Germany appear to be.

While painful, Europe's experience with a currency area where the conditions for a common currency (structural flexibility and a high degree of labor mobility) are not met carries with it important lessons for policymakers. Germany, it appears, can survive—though not thrive with—the strictures of a tight money policy that forces structural adjustment in the corporate sector, resulting in lower unit-labor costs. German corporations have managed to survive, and in some cases to prosper, within the confines of the European Monetary Union. German households, however, have not fared as well and have come to rely more heavily on Germany's generous social safety net.

Meanwhile, other countries such as Italy have not succeeded in containing costs so that, given the still relatively high level of the euro against other currencies, Italy is no longer a viable competitor in many of the sectors of the global traded-goods economy in which it once prospered. Although the divergent experiences of European countries with the strictures of the common currency have been somewhat eased by a system of transfers paid from one set of European economies to another, that expedient also appears set to break down. Another one of the frequently cited reasons for the decisive Dutch rejection of the European Constitution was the fact that they paid substantial funds into the European government and received nothing in return. As the European pie shrinks, the viability of having the relatively strong subsidize the relatively weak will erode.

Probably the most intense proximate pressure will come to fall upon the European Central Bank. As the European economies weaken and through the example of what will very probably be the SPD loss of German elections in September, European governments may rethink the independence accorded the European Central Bank to pursue only price stability. Compromise is always possible, and we may simply see interest rate cuts

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from the European Central Bank if inflation rates in Europe continue to come down.

Whatever the outcome, institutions in Europe are rigid enough and its politicians are stubborn enough so that over the next two or three years we shall probably witness a major turnover among European leadership in

which the younger generation of politicians aged fifty and under will seek more imaginative solutions to Europe's difficult economic, political, and social problems. That will be a good thing. Younger, more pragmatic leaders will see that, ultimately, Europe's monetary arrangements need to change.