The Euro at Ten

By Michael Boskin

Palo Alto – The beginning of 2009 will long be remembered for terrible economic news and controversial economic policy in virtually every country. It also marks the 10th anniversary of the euro, the common currency further knitting together several hundred million Europeans in their economic and financial affairs. It is worth pausing to commemorate this remarkable event, and the effect the euro's existence has had on the current global crisis.

The euro was launched in January 1999 for a complex set of economic, financial, political, and historical reasons. It was the final icing on the cake of the plan by many post-World War II leaders, driven by the memory of two horrible world wars originating in and consuming Europe in the previous half-century, to forge closer economic and political ties.

Ten years ago, there were real concerns about launching the new currency. Would people give up their old national currencies and use the new euro? Would it maintain its value against the dollar? (Launched at $1.18, it plunged to almost $0.80 early on, then rose, peaking at nearly $1.60 in 2007-2008, before falling back to around $1.30.)

When a group of individual currencies is replaced by a single currency, as the Deutsche mark, French franc, Italian lira, Spanish peseta, and others were by the euro, there are two primary benefits: lower transaction costs and greater transparency.

Having neither the cost and inconvenience of constant currency transactions nor the uncertainty that arises from fluctuations among currencies is a boon to the common currency area. And pricing of goods and labor throughout the currency area, which previously had different exchange rates, becomes much more transparent. The cost of cell-phone minutes in Italy, for example, is much more easily compared to those in Germany or France.

These twin benefits complement the scale advantages of free-trade areas. Europe is still realizing the full potential of these benefits, but struggling with natural cross-border mergers and the failure or replacement of prominent national companies by better competitors from other countries.

Many proponents of the euro claimed that it would quickly evolve as an alternative reserve currency alongside the dollar, or even replace it, in global markets. Most of world trade is still invoiced in dollars, but the euro has gradually emerged as a viable alternative – a strong currency backed by the hard-earned inflation credibility of the European Central Bank.

What, then, of the costs? Why don't all nations join currency areas, or why not create a single global currency, as Nobel laureate Robert Mundell suggests?

One obvious reason is that there are also disadvantages to a common currency area. Suppose that southern Europe is hit much harder by today's recession than northern Europe. An economy has two potential ways to adapt to and mitigate its downturn. First, its currency would naturally depreciate, making exports more competitive and imports more expensive. This partially cushions the downturn. Alternatively, labor could migrate from high-unemployment southern Europe to lower-unemployment northern Europe.

The United States offers an important example of such labor mobility. In the early 1980's, when US unemployment reached almost 11%, many workers moved from the so-called Rust Belt – the hardest-hit industrial area of the upper Midwest – to other parts of the country. In the early 1990's, when California had a more severe recession, people sought jobs in neighboring states. Labor migration operated as a safety valve against even worse unemployment.

Labor migration in Europe is, historically, far less extensive. Many don't want to abandon the deep roots they have in their home regions; others don't want to move to another country, where language and culture may be obstacles. With limited labor mobility, and the euro removing the other shock absorber (exchange-rate adjustments), great pressure will fall on those countries with the worst downturns. This has led some economists to question whether the euro zone is a good idea at all, and to predict that, when confronted with a test of a severe differential recession, it will break apart.

Low inflation, no currency risk, decreased transaction costs, and greater transparency have made the euro a success. But the decreased flexibility in response to economic shocks will certainly test it. At present, it is boldly highlighting the disparate, even discordant, fiscal responses now being embraced by European Union governments.

This raises the old question about whether a currency union can work without a fiscal union, or at least stronger and more binding fiscal rules (the Maastricht deficit commitments are too easily breached). To that we must add coordinated financial regulation and bailout policies, as deposits flow rapidly across borders in response to national guarantees and insurance in the euro zone.

Will the euro's second decade be as successful as the first? The financial crisis and deepening recession have created many challenges. The euro zone's less competitive economies are tethered to monetary policy (interest rates) set by the ECB, but pursue diverse approaches to bank bailouts and fiscal stimulus. Italy and Greece, in particular, face serious debt issues amid financial market concerns about the possibility of default or their leaving the euro zone. The gaps between German bond yields and Italian and Greek yields are at record levels. The price of default insurance has tripled.

But the weaker economies get the inflation credibility of the ECB and protection from severe exchange-rate swings. Indeed, avoiding continuous competitive devaluations is more a blessing than a curse. On balance, that may even make membership more appealing for non-members such as Denmark and Poland.

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