The Euro's Finest Hour?

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The euro has proved a safe haven for countries lucky enough to have made it into this exclusive club in time

A COUPLE of years ago, as we were preparing to celebrate the euro's 10-year anniversary, a common theme was that the new currency had not yet faced a serious challenge. Little did we know! The financial—and now economic—crisis has presented the euro area with a large number of varied tests. Many in Europe believe that the adoption of a single currency has been vindicated and that the euro is now in full ascendancy. I agree with the former but seriously doubt the latter.

The number one reason for creating a single currency has always been to avoid speculative attacks on exchange rates because wide currency fluctuations threaten the European Union's single market for goods and services. This is why the decision to adopt the euro was made at a time when capital movements were liberalized (Baldwin and Wyplosz, 2009).

The number one lesson from the crisis is that this objective has been achieved. The Swedish krona and pound sterling are down—deeply. Most currencies in central and eastern Europe have been very volatile. Several of these countries have called on the IMF for support, and their troubles are far from over. Meanwhile, some advanced European economies, including Austria, Greece, and Ireland, face extremely difficult times because of bank distress or shaky public finances, or both. But one thing they don't need to worry about is their currencies, because they don't have any. The euro works and that is no mean feat.

Safe haven?

And yet the euro has not shielded some member countries from speculative pressure, which has taken the form of large spreads on government bonds. During previous crises, large spreads used to emerge alongside pressure on exchange rates that often resulted in depreciations or devaluations. A common interpretation of the spreads was in terms of the interest rate parity principle: spreads signal expected depreciations (although, as is well known, the empirical success of the interest rate parity principle is shaky at best).

The emergence of spreads within the euro area reflects either a belief in the markets that the country could abandon the euro or that the government might default partially or totally on its debt obligations, or both. The media have discussed the possibility that some countries may leave the euro area, but most observers have dismissed this possibility on the grounds that the costs borne by a departing country would far exceed the benefits, especially in the midst of a crisis. It is likely, therefore, that the spreads reflect mostly default risks, which may or may not be justified. The point is, this is a perfectly normal occurrence within a currency area. In fact, the very low spreads observed before the crisis were sometimes described as an oddity, and some even suggested that the markets weren't sensitive enough to large public debts. Now it seems that the markets are too sensitive.

Euro pessimism turns to optimism

Members of the European Union that are not members of the euro area have now seen what a difference the single currency makes. In Denmark, which was granted an opt-out clause in 1992, the protection provided by the euro during this crisis has made an impact: the Danish population, which twice voted against adopting the euro, may now be shelving its long-held opposition to joining the monetary union.

A brief debate also erupted in the United Kingdom, but that served only to cement widespread opposition to the euro. Much the same applies to Sweden, whose population has also voted against adopting the euro.

The other countries that joined the European Union in 2004 have not yet fulfilled the admission criteria for all sorts of reasons, good and bad. Being kept outside of the club made many of these countries reluctant to join, but the crisis is now leading these countries to rethink their reluctance. However, they still face the same tough admission conditions, known as the Maastricht criteria.

The Maastricht criteria were developed nearly two decades ago in a very different environment. Inflation had just been brought down—barely so, in some countries—after a long period of price instability. It was felt that the European Central Bank (ECB) would need to quickly establish its credibility as an inflation fighter. This meant that to be admitted to the euro area a country would have to demonstrate its firm commitment to price stability, hence the tough entry conditions.

But now that the ECB has achieved a high degree of credibility with the markets, such caution is unnecessary—if it was ever needed at all. Central bank governors from the new member states will join a central bank governing council that has well-established procedures. Given the negligible risks of admitting countries identified as "not yet ready" on the basis of outdated criteria and the significant distortions to the European Union's single market generated by the deep currency depreciations that are taking place right now as a result of the crisis, one would have hoped that the Maastricht criteria might finally have been set aside. But it is perhaps not surprising that existing euro area members have reiterated that the rules must be followed, no matter what. The ECB, too, is sticking to the rules, even though it has felt the need to provide swap lines to a number of central banks under pressure in central and eastern Europe.

A single regulator for a single market

Another major lesson from the crisis may not be taken on board. From the beginning, it was clear that operating a currency area with as many regulators and supervisors as there are member countries was dangerous (Begg and others, 1998). For a long time, banks were mostly national, lessening the need for centralizing information and preparing for international lending of last resort.

But the logic of having a single currency is that the banking system will become increasingly pan-European, with banks operating across borders and owned by shareholders from many countries. And that is, of course, exactly what has happened, thanks in large measure to efforts by the European Commission. Bad luck had it that two of these large transnational banks—Fortis and Dexia—failed as a result of the financial crisis. This led to messy emergency interventions with messy outcomes.

One would hope that the crisis would help wear down national resistance to centralized regulation and supervision. To push this process along, a committee led by Jacques de Larosière recently proposed to create a European Systemic Risk Council and a European System of Financial Supervision, which would rank above national regulators and supervisors. But early reactions indicate that even albeit this limited, but potentially evolutionary, overhaul will not pass muster with national governments.

Reacting to the crisis

How has the euro area managed its macroeconomic policies so far? The ECB reacted immediately and forcefully to disruptions on the interbank market brought on by the financial crisis by injecting previously unthinkable amounts of liquidity into the markets. It soon developed a dichotomy, distinguishing between its two core functions. To achieve orderly conditions in the financial markets, it would provide as much liquidity as needed. Liquidity provision, however, would not interfere with setting interest rates, which would remain driven by monetary policy objectives, or so went the argument.

The two intermediate objectives pursued by the ECB were temporarily disjointed: set the policy rate and close the gap between the interbank and the policy rates. The dichotomy had some logic to it, but only up to a point. Indeed, a key channel of monetary policy transmission is the market rate, which therefore matters at least as much as the policy rate for monetary policy. Trust in this dichotomy may help explain why it took 14 months for the ECB to start lowering its policy rate, which it did for the first time in October 2008, after a final increase that took place as late as July 2008.

In fact, the ECB was more concerned about inflation, which had been rising steadily since 2006, than about growth and unemployment. Along with most other forecasters, the ECB did not anticipate that the financial crisis would eventually provoke a recession. Given that monetary policy operates with long lags, the ECB should have started to lower its policy interest rate much earlier. Of course, this is now obvious, but it wasn't at the time. Still, in comparison with other major central banks, the ECB was late in loosening monetary policy. This characterization may be unfair, but it goes some way toward explaining why some EU countries are reluctant to give up monetary policy independence.

Muted reaction also characterizes fiscal policies, which remain a national prerogative. Many governments believed that the automatic stabilizers—much larger in continental Europe than in most other countries—would be enough to counteract the macroeconomic effects of the financial crisis. With few exceptions, discretionary fiscal stimulus has so far been quite subdued.

The muted fiscal response may be attributed in part to the Stability and Growth Pact, which imposes a ceiling on budget deficits. As the recession has deepened, the Pact has been quietly set aside because it allows for some flexibility in "exceptional circumstances." Yet the Pact may well provide a useful anchor for limiting slippages that will prove hard to correct once the recession is over. But, meanwhile, with interest rates now at the zero lower bound, the euro area is not actively trying to counter the ongoing contraction in economic activity. Resumption of growth will have to rely on private spending or exports. Europe will not replace the U.S. locomotive.

Thus, just when the euro is demonstrating its usefulness and is poised to attract new recruits, policymakers are displaying considerable—some would say excessive—prudence in macroeconomic policies and in dealing with potential new members. Are they driven by fear of rocking the boat? Difficulties in coordinating very different economic circumstances? Lack of a common framework of analysis?

Vindicated at last

At the same time, there is a sense of vindication in Europe. In September 2008, for instance, Peer Steinbrück, Germany's Finance Minister, suggested that "the U.S. will lose its status as the superpower of the global financial system. . . . America will not be the only power to define which standards and which financial products will be traded all over the world. . . . The dollar will remain a very reliable and important currency, as well as the euro, as well as the yuan and the yen, so I think it will perhaps be the starting point of some changes."

Many in Europe have seen China's suggestion that the dollar's days as hegemon should now draw to a close as a powerful signal in the same direction. Aware that dominant currencies lose their status only after a major shake-up, they see the current financial crisis as the trigger. After all, they say, the crisis originated in the United States and exposed the cracks in the Anglo-Saxon approach to finance. They further note that the U.S. banking system is poised for massive shrinkage that will make room for the more prudent European model.

Time will tell, but I fear that the Europeans are setting themselves up for a big disappointment. Prudence is a virtue, but it has its costs, well captured by the risk-return trade-off. Financial regulation is not a matter of more versus less, but of quality in both setting up rules and implementing them. History—and current debates—do not indicate that Europe has a comparative advantage with either. The dollar may have lost some of its shine, but the euro area's slowness in dealing with the crisis and, in the longer run, its lower trend growth rate does not set Europe on a path of ascendant economic and financial power.

Economic ascendancy is taking place in Asia, but the region's financial markets are a long way from challenging New York and London—and then there is the issue of Asia's demographic decline. Furthermore, any rebalancing of power within the international financial institutions is bound to bring to an end the historical overrepresentation of Europe.

A plausible bet is that the crisis will deliver a better regulated Anglo-Saxon financial system, more dominant than ever, which will further shape emerging markets in Asia and elsewhere, while Europe will remain a beacon of prudence, with a currency that fails to attract—and include—a significant number of converts within the continent. ■

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