

The Euro After Five Years

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THE ADVENT OF THE EURO at the beginning of 1999 fundamentally transformed the European monetary and financial landscape. Upon the introduction of the new common currency, the member nations of the European Union (EU) transferred their sovereignty over monetary matters to a new supranational institution. The newly created European Central Bank (ECB) located in Frankfurt, Germany, acquired responsibility for monetary policy in the euro zone, which comprised the twelve members of the EU that elected to participate in the common-currency scheme. Since the transition from the old to the new monetary system raised a host of complex issues, the euro was introduced in several steps. After a lengthy preparatory period, it came into existence formally on 1 January 1999, but the authorities allowed three years to elapse until putting the new euro notes and coins into circulation.

241

Given its current age of five years of circulation, the euro is still a young currency. Therefore, it is probably too early to provide a comprehensive assessment of its performance. Nonetheless, considering the experience gained to date, I will discuss four somewhat controversial issues arising from the new common currency: the relationship between the euro and economic growth, monetary unification and economic convergence, the performance of the ECB, and the difficulties related to the accession of the Eastern European countries.

THE EURO AND ECONOMIC GROWTH

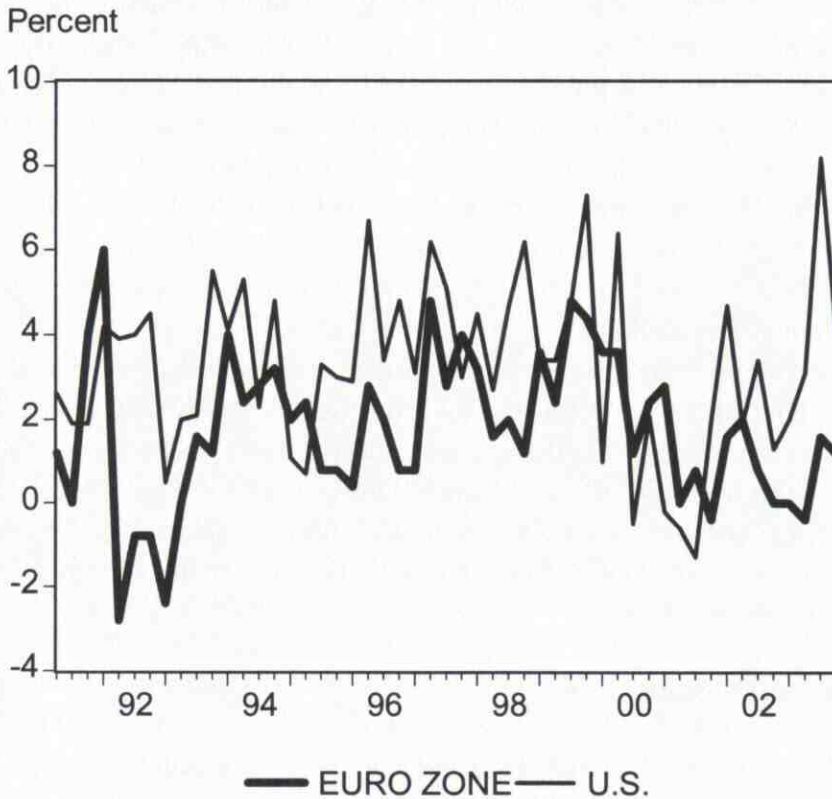
Prior to 1999, proponents of the euro argued that the new common currency would enhance the economic welfare of Europeans by stimulating growth. Thanks to the

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introduction of the euro, companies engaged in international trade and international financial transactions would be able to reduce their costs. Within the euro zone, the costly exchange of national currencies would become superfluous. Adjustments in internal exchange rates would also be a thing of the past. Since companies would no longer be compelled to grapple with exchange rate uncertainty within the euro zone, they would be able to avoid costly mistakes in planning their production and distribution of goods and services. Moreover, the existence of a common currency would promote the internal transparency of prices and thus boost competition. As a result, consumers would benefit from price cuts triggered by a more competitive environment. The optimistic forecasts about positive growth effects have not materialized as may be

FIGURE 1: EURO-ZONE AND U.S. GDP REAL GROWTH, 1991 I - 2003 IV



Sources: ECB, U.S. Bureau of Economic Analysis;
quarter-on-quarter annualized percentage changes, seasonally adjusted

seen from figure 1, which compares the growth in real gross domestic product (GDP) of the euro zone and the United States since 1991.¹ Until the business-cycle peak of 1999, the countries ready to join the euro zone achieved relatively high rates of real GDP growth, although they failed to keep up with an even stronger U.S. performance. However, since 1999, the growth gap between the euro zone and the United States has widened considerably. Both countries and regions dipped into a sharp recession in 1999. While U.S. real growth began to recover again in 2001 and gathered steam in 2003, the euro-zone economy has stagnated for the last two years and is only now showing signs of a modest recovery.

Analysts generally attribute the disappointing economic performance of the euro zone to a host of structural rigidities inhibiting real growth and overwhelming whatever positive effects might emanate from the euro. In its most recent survey on the euro zone, the OECD (2003) provides a succinct summary of these rigidities. Real growth suffers mainly from two sets of structural defects: first, obstacles to the free movement of services within the euro zone and, second, various labor market rigidities. While internal barriers to the flow of goods have largely disappeared, European markets for services remain fragmented, except in banking. The obstacles to free service flows range from quantitative restrictions, residence requirements, authorization and registration procedures, requirements on the legal form of enterprises and on professional qualifications, to restrictions on the posting of employees. For example, in the United States it typically takes one week to establish a new business, while France and Germany require six and sixteen weeks respectively.

As far as labor markets are concerned, unemployment remains high in most countries of the euro zone even though it has declined from the peak reached in the 1990s. Much of European unemployment is not attributable to the recent cyclical stagnation, but to structural rigidities in labor markets, discouraging firms from creating new jobs and the unemployed from seeking work. These rigidities consist of relatively high legal minimum wages acting as a deterrent to hiring low-skilled labor, job protection laws, and onerous payroll taxes. It should be emphasized that in several European countries, widening the scope for hiring employees on temporary contracts has relaxed job protection laws. In particular, such contracts tend to employ low-skilled young employees. However, their employers typically will not transform their temporary contracts to permanent ones. Thus, recent reforms of job protection laws have enhanced job insecurity for young employees, while their older colleagues remain well protected against dismissals.

Mobility of labor within and between the countries of the euro area is low when compared with labor movements in the United States. Within national borders, government-subsidized housing and collective agreements between employers and trade

unions frequently inhibit mobility. If collective agreements provide for uniform and rigid wages across entire industries, mobility is likely to suffer. Since under such agreements wages are insensitive to regional differences in labor market conditions, they do not prompt employees to move from areas with high unemployment to areas with low unemployment. Across national borders, employees willing to move run up against such obstacles as lack of required language skills and non-portability of pension schemes.

Other institutional features of European labor markets induce people to withdraw altogether from the labor force. In a number of countries, overly generous financial support tames the willingness of the unemployed to search for work. In addition, European social security systems frequently offer excessive incentives to leave the labor force through early retirement or disability schemes. Consequently, the EU authorities and national governments must implement deep-reaching structural reforms if the euro is to release its full powers as a growth catalyst. Since structural reforms tend to be painful and unpopular, European governments have shied away from them. Even so, various, albeit modest, reform schemes have recently been launched.²

MONETARY UNIFICATION AND ECONOMIC CONVERGENCE

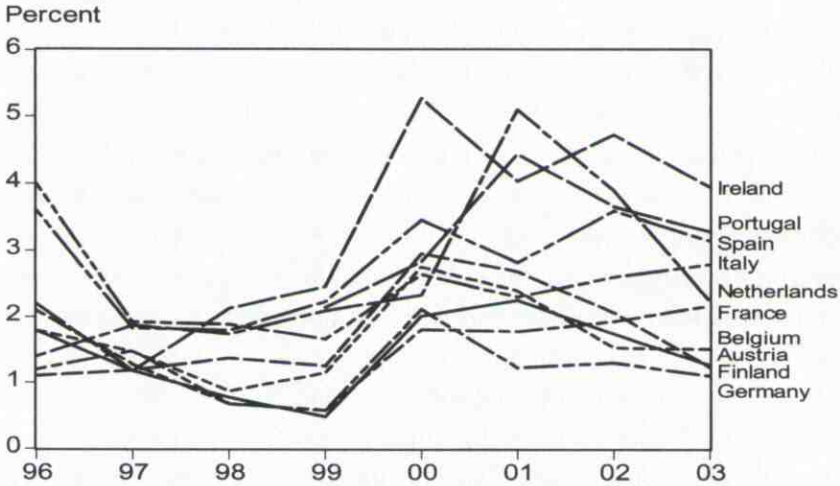
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The adoption of a common currency implies a common monetary policy for the entire euro zone. As the euro replaced the former national currencies, short-term interest rates became identical across the euro zone. Since central banks, including the ECB, influence economic activity through changes in short-term interest rates, the existence of a common currency precludes monetary policies aimed at managing economic conditions in individual countries. The ECB cannot set different short-term interest rates for the different countries. It can only conduct a "one-size-fits-all" monetary policy, that is, it must keep in mind the economic needs of the euro zone as a whole. It cannot tailor its actions to the requirements of individual countries.

A "one-size-fits-all" monetary policy would be wholly appropriate if the euro zone were characterized by a high degree of economic convergence among the individual countries. The ECB possesses a precise mandate: it must achieve and maintain price stability within the euro zone. The ECB has elucidated its mandate by stating that it defines price stability as an annual inflation rate of close to two percent. The mandate also allows the ECB to smooth cyclical fluctuations in output and employment, as long as its actions do not violate the goal of price stability. Clearly, if the euro zone were characterized by economic convergence in the sense that the inflation and real growth rates of all the member countries moved in parallel, a "one-size-fits-all" monetary policy would not raise any problems. What would be good for the euro zone as a whole would also be appropriate for each member country. Therefore, the question

arises whether economic convergence within the euro zone has been strong enough to obviate the need for policy actions aimed at individual countries.

FIGURE 2: DISPERSION OF EURO-ZONE INFLATION RATES



Source: International Monetary Fund, International Financial Statistics; percentage rate of change in harmonized index of consumer prices

245

FIGURE 3: STANDARD DEVIATION OF EURO-ZONE INFLATION RATES, 1996-2003

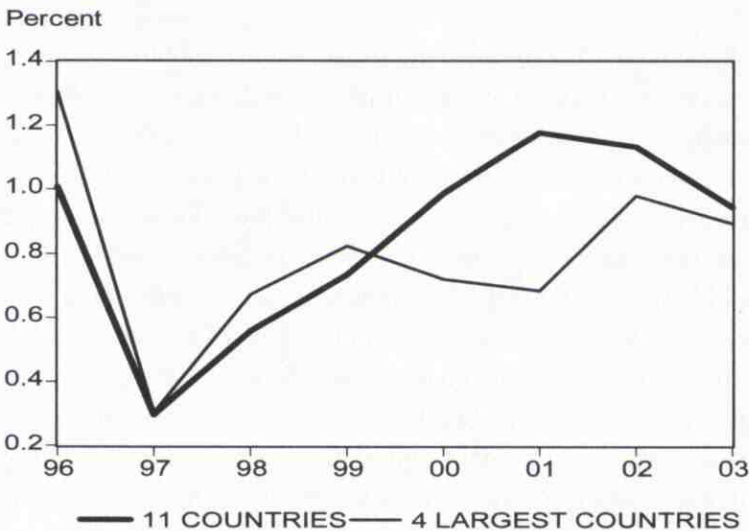


Figure 2 describes the development of annual inflation rates for individual euro-zone countries over the periods preceding and following the introduction of the euro.³ Surprisingly, the dispersion of inflation rates within the euro zone appears to have widened, rather than narrowed, after the introduction of the euro in 1999. The same conclusion emerges if the standard deviations in the individual countries' inflation rates from their averages are calculated. Evidently, the standard deviations, displayed in figure 3, increased from 1997 to 2001, but declined somewhat again thereafter.⁴ A similar result is obtained if only the four largest countries of the euro zone are considered.⁵ As indicated by figure 2, national inflation rates in 2003 ranged from a low of about one percent in Germany to a high of roughly four percent in Ireland.

While the gaps between national inflation rates widened, it is harder to draw conclusions about the convergence or divergence of real growth rates since 1999. A recent study focusing on monthly industrial production data uncovers some evidence of convergence in business cycles within the euro zone since the adoption of the euro.⁶ Therefore, the question of whether a "one-size-fits-all" monetary policy is appropriate for the euro zone remains open and will require further investigation.

As the ECB's chief economist, Otmar Issing correctly emphasizes, the Frankfurt institution cannot do anything about the disparities in national inflation rates and business cycles.⁷ Should these disparities persist, they will have to be accepted as an economic cost that will reduce the net benefit the euro zone is likely to derive from monetary unification.

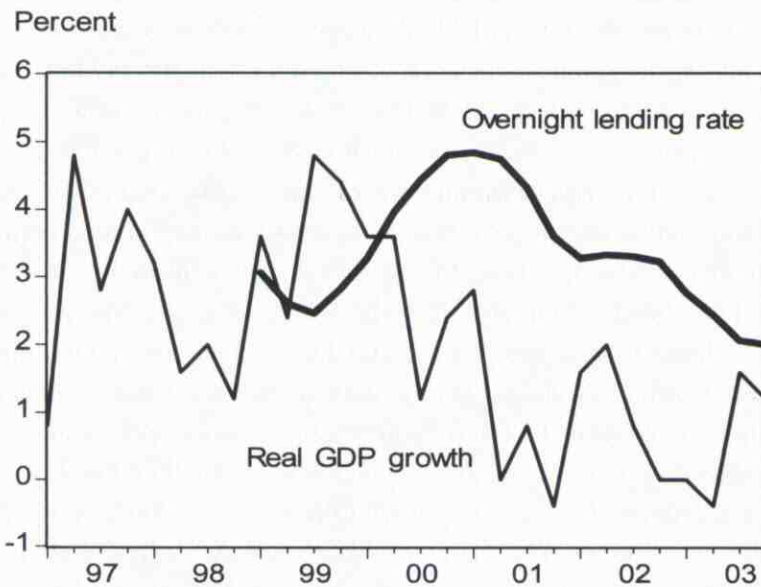
PERFORMANCE OF THE EUROPEAN CENTRAL BANK

When the ECB was established, it suffered from a credibility problem. As a new institution, it did not possess a track record confirming its willingness and ability to guarantee price stability. To enhance its credibility, the ECB was modeled after the German Bundesbank, an institution praised for its outstanding stability record. The ECB has acquired a good reputation and substantial credibility. From the summer of 2000 to the end of 2003, euro-zone inflation tended to exceed somewhat the ECB's threshold of two percent. However, in January 2004, it dipped below this level and is likely to stay near the ECB's objective in the coming months.⁸ Therefore, the ECB has largely achieved its mandate, an outcome that has boosted its credibility.

If analysts are critical about the ECB's performance, they tend to stress two other issues. The first concerns the ECB's policy approach, the second the role of output and employment in setting monetary policy. As for the first issue, the ECB relies on a two-pillar approach for charting its policy course. Under the first pillar, it scrutinizes a host of variables that are likely to throw light on the future development of inflation. In

particular, it regularly establishes and publishes forecasts of inflation for the subsequent two years. The second pillar involves an analysis of monetary developments, notably of the growth in the broadly-defined money stock M3. In this way, the ECB takes into account the largely monetary nature of inflation, as excessive money growth may fuel inflation in due course.

FIGURE 4: EURO-ZONE INTEREST RATE AND REAL GDP GROWTH



Source: ECB, real GDP growth as in fig. 1

Analysts frequently criticize the ECB for its reliance on money growth as a policy indicator. They argue that money-stock data does not yield useful information on future inflation. As a matter of fact, most central banks, including the U.S. Federal Reserve System, have abandoned the practice of setting targets for money growth or of relying on money as a guide to monetary policy. Nevertheless, analysts are not entirely fair in discounting the ECB's second pillar. Numerous studies indicate that money growth does shed light on the likely development of euro-zone inflation.⁹ Therefore, the ECB does not monitor a useless indicator as its critics frequently contend. The problems arising from the second pillar lie in the difficulties of relating monetary developments to future inflation. Since 2001, the euro-zone money stock M3 has grown at relatively high rates, reflecting the ECB's expansionary monetary policy. If, over the

coming years, M3 continued to increase at this rapid pace, inflation, in all likelihood, would climb above the ECB's objective. However, despite the brisk expansion in the money stock, the euro zone does not face an imminent threat to price stability. So long as real growth remains subdued, inflation will stay near the ECB's objective because the continuing slack in the economy will preclude strong price hikes by producers. Only if the current cyclical recovery accelerates significantly will strong money growth become a problem, calling for a shift to a tighter monetary policy stance.

The second major criticism leveled at the ECB derives from the stability mandate of the Frankfurt institution. Critics scold the ECB for interpreting its mandate for achieving and maintaining price stability too rigidly. Like the U.S. Federal Reserve, it should not only worry about price stability, but also pay attention to cyclical movements in output and employment. Critics frequently blame the euro zone's disappointing economic performance on the ECB. In their view, the ECB should have emulated the Federal Reserve and done more to support real growth and employment.

A close look at the facts suggests that critics overstate the differences between the ECB and the Federal Reserve.¹⁰ Even if a central bank such as the ECB aims its policies mainly at price stability, it must react to cyclical fluctuations in output and employment because these variables provide important advance information on future inflation or deflation. Thus, policies designed to avoid sustained inflations and deflations will also help to moderate cyclical fluctuations in output and employment.

As may be seen from figure 4, the ECB indeed reacted to the cyclical contraction in real GDP growth, which had set in around the middle of 2001, by significantly lowering short-term interest rates. Had the ECB failed to cut interest rates, in all likelihood, it would have pushed the euro zone into deflation. Thus, it would have violated its mandate for preserving price stability. Even though the ECB relaxed monetary policy in response to the cyclical downturn in economic activity, it could have reacted more speedily and more vigorously to the contraction. Real GDP growth reached a cyclical peak in the third quarter of 1999, but the ECB did not start to ease monetary policy until May 2001. Moreover, it was relatively slow to lower interest rates, despite the fact that the recession in the euro zone turned out to be more severe and more protracted than had initially been anticipated. The ECB was probably too concerned about its credibility. It did not fully exploit its scope for counteracting the economic downturn because it believed that a stronger dose of monetary ease would conflict with its stability mandate.

Interestingly, the U.S. Federal Reserve's reaction to the downturn was also surprisingly slow, despite the U.S. central bank's professed intention to combat the recession vigorously. Although U.S. real GDP growth attained its cyclical peak in the fourth quarter of 1999 (figure 1), the Federal Reserve did not attempt to relax monetary policy

until the beginning of 2001. In contrast to the ECB, the Fed's slow response did not mirror excessive caution. Instead, the Fed was misled by fuzzy macroeconomic data, as the U.S. recession had started earlier than the statistics had initially indicated.

ACCESSION OF EASTERN EUROPEAN COUNTRIES

On 1 May 2004, ten new member countries from Eastern and Southern Europe will join the EU. Provided they satisfy the so-called Maastricht convergence criteria, they will also be able to participate in the common European currency. Of course, applying the "one-size-fits-all" European monetary policy to the new members will be a major challenge. In particular, most of the accession countries from Eastern Europe are at a much lower stage of economic development than the existing EU members. Therefore, the question arises whether early participation in the euro system will be sensible for these countries in the face of the still wide economic gulf between Eastern and Western Europe.

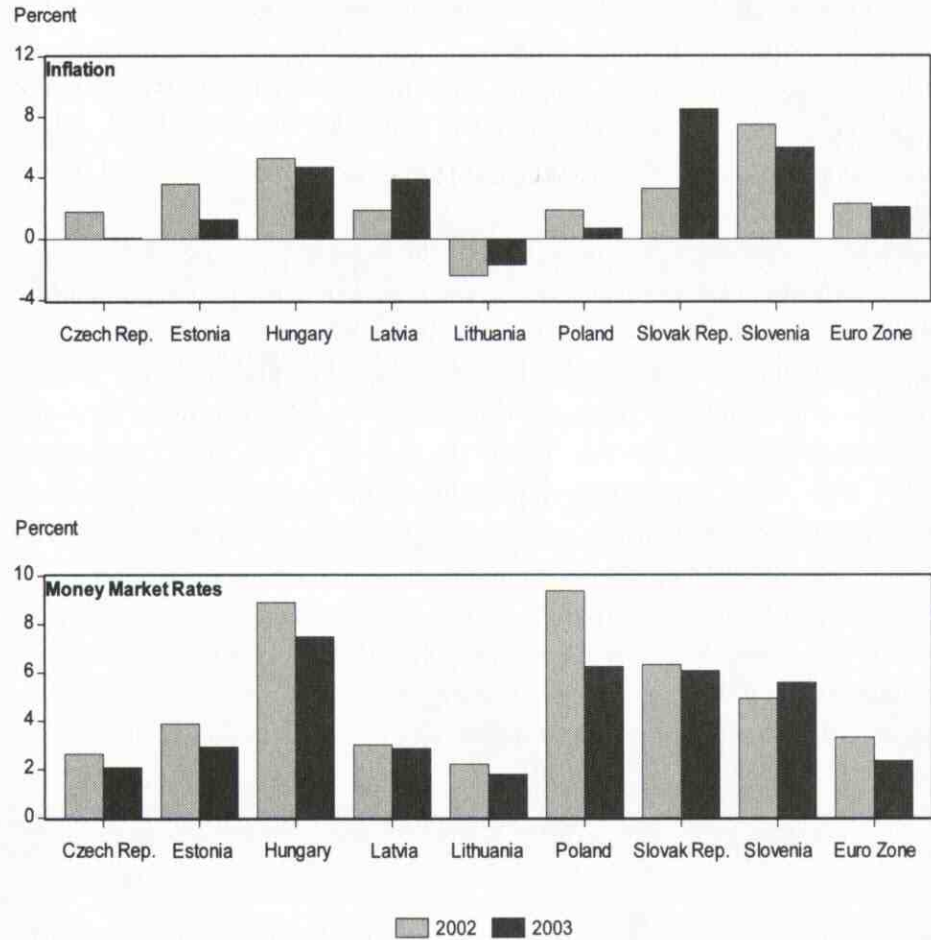
A full discussion of the implications of the euro for the accession countries is beyond the limits of this article. Figure 5 presents evidence on the convergence of two variables that are highly relevant for participation in the euro system. It compares the inflation and money market rates of the eight eastern European accession countries with those of the euro zone. If these countries were to adopt the euro, their money market rates would have to adjust fully to the euro-zone level. Their inflation rates would also be pulled toward the level prevailing in the euro-zone. Clearly, countries with inflation and money market rates already close to euro-zone levels could introduce the common currency without requiring painful adjustments of their economies to a radically different monetary environment. Figure 5 indicates that Hungary, Poland, the Slovak Republic, Slovenia and possibly some of the Baltic countries might encounter serious difficulties if they were compelled to adopt the euro quickly. Thus, these countries should not rush into the risky venture of introducing the common currency.

CONCLUDING REMARKS

Five years after the genesis of the euro, it is not clear yet whether the economic benefits of the new common currency outweigh its costs. A major benefit has been the creation of a large area in Europe enjoying low inflation and low interest rates. By contrast, the euro has not acted as a growth catalyst as many proponents of the new common currency predicted. Of course, the economic benefits of the euro may become visible only in the long run. Be that as it may, one important point about European monetary

unification should not be forgotten. The new common currency was not introduced on the basis of an economic benefit-cost calculus. Rather, the main driving force behind monetary unification was the belief that the euro would promote political integration of Europe by welding together the EU members into an ever closer political union.¹¹

FIGURE 5: INFLATION AND MONEY MARKET RATES OF EASTERN EUROPEAN ACCESSION COUNTRIES AND EURO-ZONE, 2002-2003



Source for inflation and money market rates: International Monetary Fund, International Financial Statistics; money market rate for Hungary: treasury bill rate, for euro zone: three-month interbank rate; for Hungary and Poland money market rates for 2003 cover only first three quarters and first two quarters respectively

NOTES

1. Real GDP for the euro-zone covers Greece, which adopted the euro with a two-year delay in 2001.
2. Blanchard (2004) provides a more positive assessment of European reform efforts.
3. Fig. 2 excludes Luxembourg and Greece.
4. Fig. 3 covers Luxembourg, but excludes Greece.
5. The largest countries are Germany, France, Italy and Spain. Ideally, to compute the standard deviations, each national inflation rate should be multiplied by a weight measuring the economic significance of the respective country.
6. Michael Massmann and James Mitchell, "Reconsidering the evidence: Are eurozone business cycles converging?" *Center for European Integration Studies Working Paper No. B05* (Bonn: University of Bonn, 2003).
7. Otmar Issing, "The single monetary policy of the European Central Bank: One size fits all," *International Finance* 4 (2001): 441-62.
8. Inflation is measured by the rate of increase in the harmonized index of consumer prices (hicp), a price index calculated by all the euro-zone countries on the basis of the same method. The ECB aims at a positive inflation number in order to allow for measurement problems in the hicp and for the dispersion in the national hicp rates from their euro-zone average.
9. See the recent survey of the literature by Calza and Sousa (2003).
10. See Rich (2004) for a more detailed examination of this issue.
11. A number of works were useful in the writing of this essay: Olivier Blanchard, "The economic future of Europe," *NBER Working Paper No. 10310* (Cambridge, MA: National Bureau of Economic Research, 2004); Alessandro Calza and João Sousa, "Why has broad money demand been more stable in the euro area than in other economies?" *ECB Working Paper No. 261* (Frankfurt am Main: ECB, 2003); OECD, *Economic Survey of the euro area*, (Paris: OECD, 2003); Georg Rich, "European monetary policy: Can the ECB learn from the Fed?" *Center for European Integration Studies, EMU Monitor, Pressemitteilung No. 11* (Bonn: University of Bonn, 2004), <http://www.zei.de/zei_english/f_search.htm>.

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