The Future of the Euro: An Outsider's View

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My perspective on the European Monetary Union and the future of the euro is based on a special combination of three elements: (1) my strong belief in the standard economic argumentation summarized in the well-known theory of optimum currency areas, (2) my citizenship in a small Central European country that has just joined the European Union and will at some point be a member of the EMU, and (3) my current political role that forces me to reveal my position on my country's EMU membership.

Basic Arguments

I am convinced that the driving force behind European monetary unification has been strictly political, not economic. This often-used argument can be supported by my own experience based on numerous explicit conversations about it with key European political leaders. The economic arguments have been marginalized or taken only very superficially. The political ambition has been quite dominant. The euro has always been considered to be a useful instrument for the creation of the European political union.

Many statements of that kind can be quoted. European President Romano Prodi, in an interview on CNN (January 1, 2002), explicitly stated: "The introduction of the euro is not economic at all. It is a completely political step. . . . The historical significance of the euro is to construct a bipolar economy in the world." Two years before that, in the *Financial Times* (April 9,1999), he said: "The two pillars of the national state are the sword and the currency and we changed that."

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Gerhard Schröeder, in March 1998, still an opposition leader, said that "the Euro is a sick premature infant, the result of an over-hasty monetary union." After eight months as a German Chancellor, he made a different statement: "Our future begins on January 1, 1999. The euro is Europe's key to the 21st century. The era of solo national fiscal and economic policy is over." Spanish Prime Minister Felipé Gonzales said in May 1998: "The single currency is a decision of an essentially political character. . . . We need a united Europe. We must never forget that the euro is an instrument for this project." I can quote indefinitely but the words will be almost the same.

I believe that the largest part of the positive economic impact of European integration (as well as of EU enlargement) has come through the liberalization of trade and investment and has been already obtained. The marginal contribution of further economic or noneconomic unification will be close to zero, if not negative. Because of that, the birth of the euro and the enlargement of the EU in May 2004 do not represent any breakthroughs. I agree with Patrick Minford (2002: 36) that "trade patterns are determined by comparative advantage, not by monetary factors." I also agree with him that the role of the exchange rate risk as a factor determining foreign investment and the cost of capital is relatively small (Minford 2002: 29–32). Trade does not need to have the same currency on both sides of the transaction.

To look at the economic performance of the eurozone in the first years of the euro's existence, even the pro-European activists must admit that the overall expectations of an economic boost and the claims that the introduction of the euro would speed up economic growth have not been fulfilled. This is not a surprise for me and, to be fair, not everyone had such expectations. Rudiger Dornbusch, always sharp and consistent, whom we miss very much, wrote in 1996 that the "EMU moved from an improbable and bad idea to a bad idea that is about to come true." Many of us knew then and know now that the formation of a regional common currency is neither a necessary, nor a sufficient condition for healthy economic growth. It seems, on the contrary, that Europeans have imprisoned themselves in a rigid monetary arrangement that has led to a loss of a nonnegligible part of their originally existing flexibility.

When we look at the current European monetary and overall economic problems we have to—at least analytically—differentiate two issues: (1) the impact of a monetary union upon nonidentical countries, but countries that are at a similar level of economic development, and (2) the impact of entry into a monetary union of a country that is at a different level of economic development than the

dominant part of the union and is undergoing dynamic structural changes in an effort to catch up with its more developed partners.

Costs and Benefits of a Monetary Union among Similar but Nonidentical Countries

The conditions formulated four decades ago by Robert Mundell (1961), as regards the optimum currency area, are widely recognized. Their fulfillment guarantees a favorable balance between costs and benefits of a monetary union, their nonfulfillment does not. They include—

- the sufficient extent of labor mobility among parts of the monetary union;
- the lowest possible degree of a wage rigidity inside individual countries;
- similar endowments for factors of production and a symmetry of exogenous shocks and impulses;
- the existence of an adequate fiscal compensation mechanism.

These conditions are currently not fulfilled in Europe. Labor mobility is very low in the EMU compared with other monetary unions, and the required downward wage and price flexibility is almost nonexistent. The rigidities of the European labor market are well known and well documented (see Heckman 2003).

When labor markets do not function well, flexible exchange rates are all important. The asymmetric shocks and impulses appear again and again, which is not surprising because the eurozone countries are different. The size of fiscal transfers at the EMU level is, however, very small. There exists some international solidarity among EU members but its level cannot be compared with the solidarity in national states.

The assumed benefits of monetary unification—the reduction of transactions costs and exchange risk—will in reality be rather small. With the current level of financial and banking sophistication, transactions costs are saved only in tourist transactions, not in other fields.

I agree with Irish economist A. Coughlan (2003: 16) that "the economic advantages of being able to travel within the eurozone without having to change currency, and of being able to compare prices more easily between eurozone countries, are small compared to the economic disadvantages." I especially agree with his argument

(which I myself use quite often) that "people may be on holidays in other eurozone countries for 2–3 weeks a year, but they had to be working for the remaining 48–49 weeks at home." The above-average benefits can be gained exclusively by the permanently traveling EU politicians and their bureaucrats.

We should not forget that to adopt the euro does not mean to adopt a world currency but only a regional one where the exchange risk basically remains. It does not mean, of course, that I would suggest to create a world currency along the lines of recent suggestions of Mundell.

The costs of monetary unification are important. They include the loss of an independent monetary policy, which mostly means the loss of interest rate setting power, and the loss of exchange rate movements. When I say this, it is not an advocacy of the policy of competitive devaluations. I do not, however, believe that the European economies have sufficient alternative flexibility to avoid problems resulting from such a rigid structure. To eliminate two important policy variables—interest rates and exchange rates—means either to rely on a textbook level of perfect microflexibility or to be prepared for large fluctuations of the real economy, or to expect the acceleration of fiscal transfers inside the monetary union.

Such perfect microflexibility does not exist. The sluggishness of domestic prices and wages forces the exchange rate to be the shock absorber, which is not the same as competitive devaluation. It is easier, says President Robert McTeer of the Federal Reserve Bank of Dallas, "for your exchange rate to adjust to your economy and policies than for your economy and policies to adjust to a predetermined exchange rate" (McTeer 2002). Coughlan's arguments seem to be persuasive: "1993–99 was the only period in the history of the Irish state that it pursued an independent currency policy and allowed the exchange rate to float. . . . The intelligent use of an independent currency is the principal reason for the Irish economic boom, which has attracted such international attention in recent years" (Coughlan 2003: 16).

I would like to mention two other phenomena, which I put on the side of costs. First, a single currency (without fiscal unification) creates an environment for fiscal irresponsibility. We can even talk—together with Anthony de Jasay—about fiscal free–riding: "Each member state of the eurozone is caught between two alternatives—to engage in fiscal free-riding or to be the victim of free-riding by the others" (de Jasay 2003: 2). In the same spirit, Peter Kenen (1996) rightly asked whether the currency domain can be bigger than the fiscal domain. I do not think it can. When a country has its own

currency, fiscal irresponsibility carries its own punishment. Such punishment does not, however, exist in the current eurozone. The fiscal deficits in some of those countries after the establishment of the euro seem to support this argument.

Second, European monetary unification is the Trojan horse for overall harmonization of economic rules, policies, and laws in the EU. I am convinced that any eurozone problem will be in the future interpreted as a consequence of the lack of harmonization (of nominal unification) and will lead to another wave of a creeping harmonization. Hans Eichel, the German minister of finance, made it quite clear: "The currency union will fall apart if we don't follow through with the consequence of such a union. I am convinced we will need a common tax system" (*The Sunday Times*, December 23, 2001). Such an unnecessary and counterproductive harmonization (and centralization), which tries to eliminate comparative advantages of individual countries, is one of the most worrisome elements of the whole European integration process.

Comparing the above-mentioned costs and benefits, I am afraid that it is not true that the costs of the European monetary unification do not exceed the benefits. They do. Sluggish economic growth in Europe since the introduction of the euro is not a proof of that, but it is not an accident either.

Costs and Benefits of Entry into a Monetary Union of a Transition Country that Needs Real, Not Only Nominal, Convergence

Eight Central and East European countries became EU members in May 2004, and in their accession treaties with the EU, signed in April 2003 in Athens, they promised to enter the eurozone.

Many people in these countries look forward to it. They expect to gain from euro stability, from decreasing the exchange rate risk, and from a credible monetary policy. I am struck that they do not see the other side of such an arrangement because it is more than evident that the transition countries need maximum flexibility and should not introduce any artificial rigidities. They should not for political reasons take actions against their own economic interests.

The main costs for them will be the loss of an independent monetary policy that should be—for the countries in transition, for the countries undergoing radical structural changes, and for the countries at a lower level of economic development—visibly different from the policy of developed and more stable EU member countries of

Western Europe. It makes no economic sense for them to have the same interest rate as Germany or France (not to open another topic—the fact that ECB is not subject to any democratic control and has a deflationary bias in its policy).

Once the transition countries join the EMU they will lose the possibility of nominal exchange rate movements to adjust the real exchange rate. Moreover, they must comply with the inflation and interest rate targets of the Maastricht Treaty and with the Stability and Growth Pact conditions concerning budget deficits. There is an additional danger that there will be a very high risk of fixing the exchange rates away from long-term equilibrium because the convergence process will not be—in the moment of their entry into the eurozone—completed. The result will be the insufficient final exchange rates realignment (the problem we see with current eurozone members as well).

I repeat that I am not an advocate of misusing the exchange rate movements for competitiveness reasons. I myself at the end of 1990 radically devalued the Czechoslovak crown (but not in an attempt to gain competitive advantage) and immediately after that introduced a fixed exchange rate regime. I was afraid of setting an unsuitable exchange rate level, but the belief in the use of the exchange rate as an anchor for stabilizing inflation was then overwhelming. I was aware of creating a dangerous rigidity that would constrain future responses to internal and external pressures and impulses and tried to find an optimal moment for abandoning such an arrangement. I have to admit, however, that I did not find it (the floating of the Czech crown in the spring 1997 came too late).

But such an exchange rate-based stabilization of inflation is not our current task. The rate of inflation is very low and we need flexibility in nominal variables, not their rigidity. One clever Czech economist, then deputy minister of finance, Miroslav Koudelka, made 35 years ago a point that I still remember: "When everything is frozen, you may go skating but you cannot run a rational economic policy." It was an argument used in the Czechoslovak economic reform debates in the 1960s and I believe it is valid now as well.

Rigidities of a monetary union and a growing implicit macroeconomic disequilibrium will block real convergence and will create "transfer economies" like East Germany after reunification (Sinn and Westermann 2001). These economies, however, will be forced to exist without adequate fiscal transfers because they are not available in the contemporary EU.

My conclusion is that there is no need for these economies to rush into the eurozone.

The Future of the Euro

The euro is here and is here to stay. I do not expect its end even if I know that it is relatively easy to dismantle a monetary union. My own experience with the termination of the Czechoslovak monetary union in February 1993 suggests that it can be done without serious costs, smoothly and efficiently.

I expect, however, that to keep the European single currency will be costly in terms of economic growth and in terms of inevitable fiscal transfers aiming at compensating the weaker partners. It may even generate unnecessary tensions among nations. We should be aware of it.

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