



# **The Euro: Success or Failure?**

**by Ben Patterson**

**European Movement  
Briefing 6 (revised)  
January 2009**

## Introduction

As the Euro passes its tenth anniversary, there are – or should be – a lot of red faces. According to many politicians and pundits in the 1980s and '90s, a single currency for the EU was not feasible<sup>1</sup>. Living standards were too far apart, labour too immobile, the EU budget too small and national governments too fond of their sovereignty.

Then, when the Euro was successfully launched in 1999, the same people confidently predicted that it was bound to fail<sup>2</sup>. *The Times*' Anatole Kaletsky wrote repeatedly about a currency area paralysed by tight monetary policy and inflexible labour markets, sliding into stagnation.

Yet today, in the words of the *Economist* of 3 January 2009, the Euro is being seen as

*“a haven..., attractive because of the currency zone's size, political stability and sound monetary policy”.*

Despite some grumbles about rising prices, the European Central Bank (ECB) actually has a better record on inflation than even the German *Bundesbank*. The Euro area has generally had a trade surplus with the rest of the world. Germany, the area's largest economy, is the world's leading exporter, having overtaken China in 2004.

One result is that countries outside the Euro area are anxious to get in – a good indicator of a successful organisation. With the accession of Slovakia this year, sixteen of the EU's twenty-seven Member States have already adopted the Single Currency; and a poll published in the *Financial Times* on 29 December 2008, found strong support for further expansion. It also found an expectation that the Euro would

*“overtake the dollar in global importance within the next 5 years”.*

No country was in favour of going back to national currencies.

---

<sup>1</sup> See, for example, *The Times* leader on 6 October 1995: “Death of an EMU”.

<sup>2</sup> Papers in 1997 by Martin Feldstein, Professor Economics at Harvard, for example, described EMU as a “dangerous experiment”, and predicted rapid and dire economic and political consequences.

## The creation of the Euro

A first attempt to achieve full monetary union in the European Community (as it was then called) was launched in 1970 with the Werner Plan<sup>3</sup>. This envisaged successive steps towards an “irrevocable locking together of exchange rates” by 1980; and the first steps of the Plan were actually implemented, with currencies linked in what became known as “the snake in the tunnel”. This system, however, fell apart following the economic crises of 1973 and after.

In 1979 came the launch of the European Monetary System (EMS), with the participating currencies – all except Sterling – linked in the Exchange Rate Mechanism (ERM). This proved extremely successful in bringing down rates of inflation and limiting exchange-rate volatility. In 1990 the Pound, entered the Mechanism. But this system, too, was badly shaken in 1992/3 by turbulence on the world's capital markets, with Sterling's membership being “suspended” on “Black” Wednesday 16 September 1992.

The lesson of these events was clear: systems which relied on fixing the exchange rates of separate currencies were not enough – or, in the words of UK Prime Minister Thatcher's economic adviser, Alan Walters, were “half-baked”. Only a Single Currency would do.

By this time detailed plans for achieving full Economic and Monetary Union were already on the table. The 1989 Delors Report<sup>4</sup> proposed reaching EMU in three stages, with a single currency forming the key element of Stage 3. During the negotiations on the Maastricht Treaty the UK Government floated the alternative proposal of a “parallel ecu”, to exist alongside national currencies, and eventually replace them as a result of market forces. But it was too late. The Single Currency was already unstoppable. Instead, the UK negotiated its “opt-out” (or rather, option to “opt in”).

---

<sup>3</sup> *Report to the Council and the Commission on the realization of economic and monetary union in the Community* (8 October 1970).

<sup>4</sup> *Report on economic and monetary union in the European Community* (Committee for the Study of Economic and Monetary Union, May 1989).

There followed a debate as to how the “convergence criteria” for participating in the Euro area should be interpreted. Those calling for strictness, particularly on the reduction of annual budget deficits below 3% of GDP, were against letting in the “Club Med” (Italy, Spain, Portugal and Greece), arguing that the new currency had to be as good as the D-Mark. In 1997, 155 German economists predicted disaster, calling for the start of full EMU to be postponed.

Yet, by March 1998, all of the then twelve EU countries except Greece had qualified; and fears that the “Club Med.” would soon debauch the Euro through fiscal deficits and inflation proved groundless. Kaletsky wrote:

*“How could the EMU sceptics (myself included) have been so wrong?”*<sup>5</sup>.

On 1 January 1999 the ten participating national currencies<sup>6</sup> ceased to exist, and became “non-decimal subdivisions” of the Euro. The new European Central Bank (ECB) assumed responsibility for official interest rates and other instruments of monetary policy. There was no disruption of the financial system, no turbulence on the money markets.

Similarly, at the beginning of 2002, euro-denominated banknotes and coins replaced the national notes and coins with none of the widely forecast bottlenecks or jammed Automatic Telling Machines. Introducing an entirely new currency also made possible the incorporation of new design features into the banknotes and coins<sup>7</sup>.

Technically, as the most sceptical admitted, the introduction the Euro was a *tour de force*.

---

<sup>5</sup> *The Times*, March 3, 1998.

<sup>6</sup> Belgium and Luxembourg already shared a currency. Greece joined in 2001.

<sup>7</sup> For example, in the cases of both €-denominated notes and coins, the special concerns of the blind were fully taken into account (e.g. differing milled edges to the coins and large relief figures on the notes). Up-to-date anti-counterfeiting features were also incorporated into the notes, and detailed procedures for identifying and withdrawing counterfeits established. As a result – and despite fears that the unfamiliarity of the currency would make it easy to pass off forgeries – the amount of counterfeit Euros in circulation has been minimal.

## What is a currency for?

Those who travel regularly within the Euro area experience the most obvious success of the Euro: the money in their pockets, purses and wallets is as good in one country as in another. There is no longer any need to lose 5-8% of it swapping one lot of banknotes for another, or ending up with little stocks of unchangeable low-denomination coins<sup>8</sup>.

Sceptics tend to argue that the benefit of using the same currency in different countries is of diminishing importance as credit and charge cards replace notes and coins. Using plastic, however, does not end exchange costs. Rather, it disguises them.

What, after all, is the function of a currency? Over the years, theoretical economists have endowed the concept of money with almost mystical properties. Basically, however, it is a system of measurement: it enables people to estimate relative values in buying and selling, and to store their savings. As in the case of all measurement, the wider the interaction between groups and societies, the greater the value of uniform standards

The counter-argument – that calculators and computers enable people to get behind the “veil of money” and work out real comparative values – misses the point. It could be used just as well against the general use of a decimal base in mathematics.

The economic application is the theory of “optimum currency areas” (OCAs). Briefly, this states that economies should have a single currency if the costs of having different ones (exchange risks, transaction costs, the standing temptation for governments to inflate their way out of trouble, etc.) outweigh the advantages (the ability to de/re-value or float the currency, the ability to set independent interest rates,

---

<sup>8</sup> In the mid-1980’s, as the European Parliament’s *rapporteur* on the Single Market, I carried out a study (which was published in *The Times* on 5 November 1987) leaving London with £100, and touring the then twelve EU capitals. In each the money was changed into local currency, but none spent. How much would be left on returning to London? The answer at that time was £55.50. Many similar exercises were subsequently carried out, yielding even greater losses.

etc.) A more specialised outline of the theory is given in the Box opposite.

### Stability and Inflation

The concept of money as a system of measurement also helps in understanding why price stability was made the overriding objective of Euro area monetary policy. There is general agreement that rapid depreciation of a currency – externally through devaluation, internally through inflation – severely damages the utility of a currency and the economy using it, as well as enabling governments to defraud those who have lent them money.

At the same time, a zero rate of inflation is not necessarily a wise target: new products and changes in the quality of goods make price indexes an inexact science. Critics of the ECB have indeed accused it of “sado-monetarism”: of trying to establish a track-record for super-stability at the cost of low growth and high unemployment.

Yet this has clearly not been the case. The original target inflation rate of “below 2%” was changed to “below and close to 2%”; and in practice the Bank has accommodated a 2% rate, setting official short-term nominal interest rates in the historically low range of 2-4¾%, and expanding the money-supply (M3) within an annual 4% to 9% range, (though targeting a 4.5% rate of expansion).

Moreover, although the Treaty does give primacy to price stability, it also requires the Bank to support “*the general economic policies in the Community*”.

### The International Dimension

One of the strongest arguments deployed in favour of EMU during the 1990s was that it would insulate the EU from international financial storms. In a world of free capital movements, in which the turnover on the foreign exchange markets was over \$1000 billion *a day*, there was always the danger of huge speculative pressures on individual currencies. Taken as separate currency areas, Member States traded over 30% of their GDP externally. As a single currency area, this would fall to the US figure of 10-12%.

### The theory of Optimum Currency Areas

The initial formulation of what should determine the area covered by a currency was a paper published in 1961 by Nobel Prize winner R. Mundell<sup>9</sup>. The purpose of money was to be “a convenience”; the ideal currency area was “the world”.

Given the practical need for stabilisation policies in existing economies, however, an area needed a separate currency if, in the event of some macroeconomic shock, the costs of adjustment through changes in wage and price levels or through factor mobility – labour and capital – would be higher than those of altering the exchange rate.

R.I. McKinnon<sup>10</sup> added that exchange rate policy was in any case an inappropriate instrument of adjustment for any small, open economy trading a substantial proportion of GDP. (The vulnerability of small, and even medium-sized, countries trying to run their own currencies has been amply demonstrated in recent months).

Any two countries reacting to a shock in the same way – i.e. *symmetrically* – and trading significant proportions of their GDP bilaterally, should therefore fix their exchange rates or form a currency union. Milton Friedman observed in 1953 that a group of countries

*"all of which firmly adhered to, say, the gold standard would thereby in effect submit themselves to a central monetary authority, albeit an impersonal one. If, in addition, they firmly adhered to the free movement of goods, people and capital without restrictions, and economic conditions rendered such movement easy, they would, in effect, be an economic unit for which a single currency.... would be appropriate"*<sup>11</sup>.

<sup>9</sup> Mundell R., "A Theory of Optimum Currency Areas", *American Economic Review*, 1961.

<sup>10</sup> McKinnon R.I., "Optimum currency areas", *American Economic Review*, 1963.

<sup>11</sup> Friedman M., "The Case for Flexible Exchange Rates" in *Essays in Positive Economics*, Chicago, 1953.

The economic events of 2008 have gone a long way to confirm this view.

*“When the waters get choppy, it is safer to be on a big ship,”*

former chairman of the US Federal Reserve Bank Paul Volcker is reported to have said International investors have preferred to keep their money in the big global currencies like the Dollar or Euro rather than those backed only by relatively small economies. The ECB has been able to emulate the US’s Fed’s policy of “benign neglect” as far as the exchange rate is concerned.

This helps explain the apparently supine response of the Bank to the fall in the Euro’s exchange rate against the Dollar between 1999 and mid-2001. A convincing explanation was advanced at the time by the Bank for International Settlement:

*“...the newly created euro may have proved too successful. Larger and more liquid markets, along with relatively low interest rates, encouraged the issue of euro-denominated bonds whose proceeds could then be exchanged and used to finance investment elsewhere”<sup>12</sup>.*

As Delors himself observed, EMU was indeed

*“transforming Europe’s financial markets more quickly than anticipated by all but the most fervent euro-enthusiasts”<sup>13</sup>.*

The best example was the rapid integration of government bond markets; but the private bond market now supports an annual gross issuance of more than €1 trillion, substantially exceeding (at least until now) the approximately €800 billion raised through public sector issuance. Equity markets too have integrated, with the share of equity held in other Euro area countries rising from 20 to 40%.

On international markets, as the Commission’s report *EMU@10*<sup>14</sup> observes,

*“the Euro has firmly established itself as the world’s second international currency”.*

The proportion of disclosed reserves held in Euros has risen to 25% of the total (and could be higher if undisclosed reserves are taken into account). The Euro’s role as a trade invoicing or settlement currency is also rising, now accounting for 50% of the area’s own trade, and 60% of other EU countries’.

### **Some criticisms**

It is an interesting feature of discussions on the Euro that – apart from the charge of ECB “sado-monetarism” – most criticisms are levelled, not at the management of the currency itself, but at the policies of Euro area national governments. One of the most persistent critics has been the ECB itself, whose *Monthly Bulletins* have repeatedly complained of national fiscal laxity and failure to carry out structural reforms.

#### **1. The Stability and Growth Pact**

No feature of EMU has generated more bad publicity and *Schadenfreude* than the so-called “Stability and Growth Pact”. Contrary to widespread belief, the Pact was not part of the Maastricht Treaty, but was negotiated and adopted by the Council of Finance Ministers in 1997 to strengthen the Treaty’s “excessive deficit” procedure. Where the Treaty requires national budget deficits to be normally below 3% of GDP, the Pact calls for budgets “close to balance or in surplus” over the economic cycle. It also toughened up the sanctions against erring governments.

While most Euro area countries have stuck to both Treaty and Pact rules, some have not. In particular, the two largest EU area economies, France and Germany, overshot the 3% deficit limit for some years in succession. The possibility of sanctions, proposed by the Commission (as it was legally bound to do), produced a revolt by the Finance Ministers (ECOFIN) – particularly those of France and Germany – who demanded a “re-interpretation” of the Pact to

<sup>12</sup> BIS 70<sup>th</sup>. Annual Report, Basle, 5 June 2000.

<sup>13</sup> In *Der Euro und Europa*, Deutsche Bank and Weiss Verlag, 2002.

<sup>14</sup> *EMU@10: successes and challenges after 10 years of Economic and Monetary Union* (COM(2008) 238 final, 7.5.2008).

make it more flexible. They argued that cyclical factors should be taken more into account when calculating deficits, and that more attention should be focused on the level and sustainability of overall public debt. A legal wrangle ended with the Ministers by and large getting their way<sup>15</sup>.

These events gave rise to widespread criticisms. A number of economists had always argued that it was not possible to operate a system where monetary policy was centralised, but fiscal policy decentralised. Many concluded at the time (2002/3), that the collapse of the Pact heralded the collapse of the Euro itself.

A second school of thought, however, argued that the Euro had been liberated from a stifling fiscal straightjacket. The initial Pact, they believed, had been flawed, and could result in damaging pro-cyclical fiscal policies (e.g. raising taxes and cut expenditure during a recession). Fining countries with excessive deficits, so making the situation worse, was held to be absurd<sup>16</sup>.

These criticisms, of course, contradict each other. In any case, Germany had by 2007 returned to an almost balanced budget, and France had succeeded by then in reducing its budget deficit below the 3% limit.

Indeed, the actual position (see Table opposite) is that only one country, Greece, had a budget deficit above the 3% level in 2007; and seven countries were actually running budget surpluses. In the case of overall public debt only Belgium, Greece and Italy were substantially above the target level of 60%.

<sup>15</sup> The ECOFIN Council adopted, on 20 March 2005, a report on “*improving the implementation of the Stability and Growth Pact*”, setting out proposals for reform, which were subsequently endorsed by the European Council. The Report now forms part of the Pact. But the changes did not find much favour with the Bank (see *ECB Monthly Bulletin* for August 2005).

<sup>16</sup> The European Parliament’s *rapporteur* on the Pact, an eminent Greek banker and politician, presciently reassured other Members of the Parliament’s Economic and Monetary Affairs Committee on this point in 1996: “Don’t worry. When it comes to it they won’t be made to pay.”

What really matters in practice – in the words of the Treaty itself – is “*the sustainability of the government financial position*”. One indicator of this is the proportion of debt that is long-term: a need to borrow at short maturities is a sure sign that a government is in trouble. But long-term debt now accounts for well over 90% of the Euro-area total.

**Table: Budget balance and Public Debt, as % of GDP, 2007**

<i>Country</i>	<i>Budget surplus (+)/deficit(-)</i>	<i>Public debt</i>
<i>Belgium</i>	- 0.3	83.9
<i>Cyprus</i>	+ 3.5	59.5
<i>Germany</i>	- 0.2	65.1
<i>Greece</i>	- 3.5	94.8
<i>Spain</i>	+ 2.2	36.2
<i>France</i>	- 2.7	63.9
<i>Ireland</i>	+ 0.2	24.8
<i>Italy</i>	- 1.6	104.1
<i>Luxembourg</i>	+ 3.2	7.0
<i>Malta</i>	- 1.8	62.2
<i>Netherlands</i>	+ 0.3	45.7
<i>Austria</i>	- 0.4	59.5
<i>Portugal</i>	- 2.6	63.6
<i>Slovenia</i>	+ 0.5	23.4
<i>Finland</i>	+5.3	35.1
<b>€area (15)</b>	<b>- 0.6</b>	<b>66.3</b>

Source: *ECB Bulletin*, December 2008.

Another possible indicator is provided by the yield spreads on different long-term government bonds (German 10-year bonds are the benchmark); and here the current situation is less reassuring. When exchange risks ended in 1999, all spreads were narrow. During the recent economic turbulence, however, all spreads have widened considerably: that on ten-year Italian bonds has risen from 16 basis points to 140 points.

It is nevertheless possible to argue that this widening is less related to budget deficits and public debt than to how far countries are perceived to be facing general economic difficulties. In the case of Ireland, the spread is even wider than in the case of Italy, despite

the fact that the country had a budget surplus in 2007, and a low level of debt.

In reality, therefore, a fiscal doomsday for the Euro area is unlikely – though the ECB may be right in maintaining that some governments should try harder to run budget surpluses in good times to prepare for the bad, as advised in the Book of Exodus.

## 2. Do we need a Federal Budget?

Linked to the issue of fiscal sustainability is that of whether an area with a single currency also needs a significant central budget. This, it has been argued, is needed:

a) so that there can be an “overall fiscal stance” for “Keynesian” stabilisation purposes. It would then be possible, for example, to run federal deficits in times of recession, and a squeeze in times of boom.

b) to promote economic convergence by redistributing resources between regions, either through discretionary payments out of the budget, or through the automatic operation of the “fiscal pump” (prosperous regions pay more tax, less prosperous receive more unemployment benefits, etc.).

Comparisons are generally made with the United States, where the Federal Budget amounts to around 33% of GDP. By contrast, the Budget for the EU as a whole is currently about 1% of GDP. The MacDougall Report of 1977 considered that a budget of some 5-7% of GDP would be necessary to make significant counter-cyclical and redistributive fiscal policies possible.

Unlike the US, however, where State budgets are relatively small, the national budgets of EU Member States are considerable: between 40 and 60% of GDP. Fiscal stabilisation policies can be achieved by coordination – one of the purposes of the Treaty and Pact provisions. This, in fact, is what is currently happening in the face of the threatened recession in 2009-10.

In the case of redistribution, the Structural and Cohesion Funds are small, though warmly welcomed by recipient countries. But perhaps as important, if not more important, are the funds available through the European

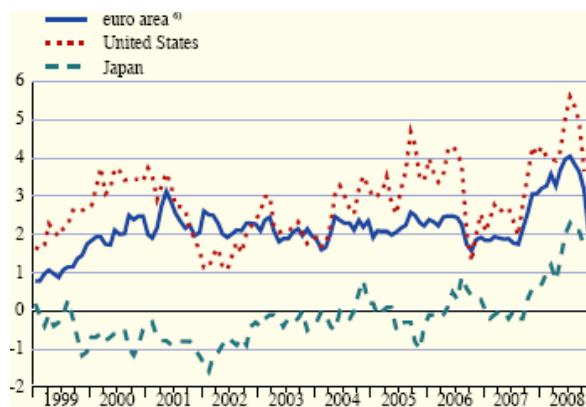
Investment Bank, which approved some €56 billion of new loans in 2007.

Free capital movements, indeed, are an essential – and, some would argue, even a sufficient – condition for a currency area, and were a priority in Stage 1 of the Delors Plan for EMU. Provided investment flows to areas of lowest labour and other costs, disparities in economic performance will erode. The experience of Ireland, which has moved from having one of the lowest to having one of highest standards of living, is significant.

## 3. Interest Rates and Convergence

One of the most frequent charges levelled at the Euro area is that “one size fits all” interest rates do not work. If nominal interest rates are uniform, but inflation rates vary, *real* interest rates will also vary. The “one size” nominal rates may be too low for countries with relatively high inflation (e.g. Spain), and too high for countries where there is a risk of deflation (e.g. Germany). In 2002, for example the *real* ECB minimum bid rate (nominal 3.25%) was 2.15% in Germany, but only 0.15% in Spain.

### Inflation, 1999-2008



Source: ECN Bulletin, December 2008

The counter-argument has been that EMU in itself promotes convergence. As markets integrate, inflation differentials should shrink and economic cycles align. What initially appear to be long-term structural differences – like the preference for variable-rate mortgages in the UK – will erode as behaviour patterns adapt.

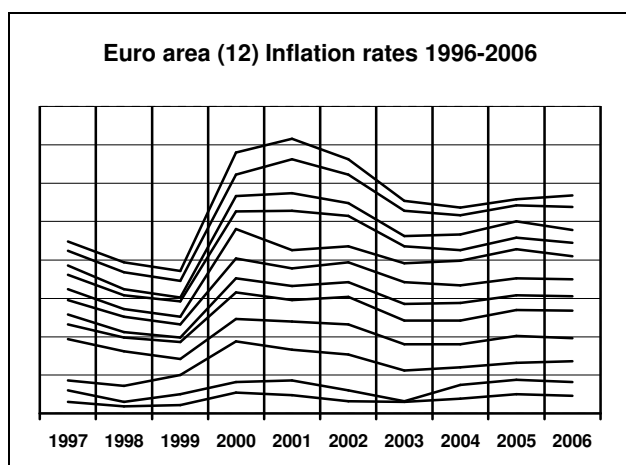
Overall, the rate of inflation in the Euro area has been remarkably stable, remaining very

close to the ECB's 2% target rate except for brief upward "blips" in 2001 and 2008.

On the other hand, as the Commission observes in *EMU@10*

*"there have been substantial and lasting differences across countries in terms of inflation and unit labour costs."*

Inflation rates converged during the period of qualification for EMU (see Chart below). They then diverged, before re-converging after 2002, but still with 2 to 3 percentage points between the highest (Spain at 3.1-3.6%) and the lowest (Finland 0.1- 1.3%).



Source: Eurostat

It is possible, however, to take a less pessimistic view than the Commission. In conditions of free trade in goods, inflation differentials are usually associated with the so-called Balassa-Samuelson effect. Countries with a relatively low standard of living experience higher inflation as they catch up, a result of differing productivity changes in tradable and non-tradable sectors. This, indeed, has been happening.

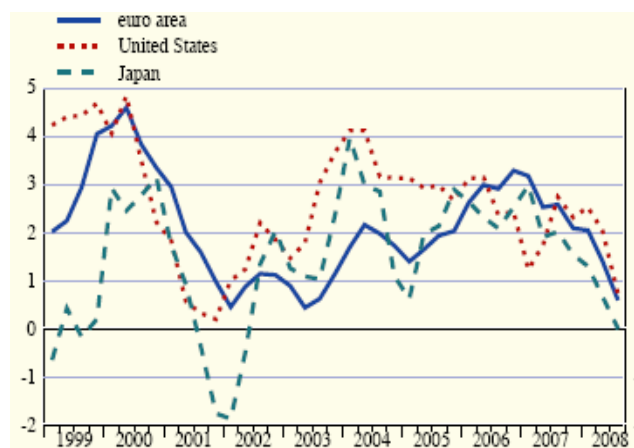
#### 4. Trade, Growth and Structural Reform

Perhaps the most serious criticism of the Euro area is that the creation of a Single Currency has failed to stimulate economic growth, and has therefore perpetuated relatively high levels of unemployment. The removal of exchange risks, reduced transaction costs and a new price transparency, it had been hoped, would increase trade and internal competition, adding to the stimulus of a barrier-free Single Market. The Single Currency has certainly

had the forecast effect<sup>17</sup> of increasing trade between Euro area countries, which rose by up to 20% relative to GDP in the period 1998-2001.

Yet the economic growth statistics look poor. Euro area growth fell from an annual rate of just above 4% in 2000 to below 1% in 2002/3, recovering only modestly in 2004/5 before briefly exceeding a respectable 3% in 2006/7. Figures for 2008 and forecasts for 2009, not surprisingly, show a sharp decline.

#### Growth rates of GDP, 1999-2008



Source: ECN Bulletin, December 2008

Five Euro area countries achieved overall growth rates higher than those of the UK (see Chart below). All countries experienced a sharp slow-down in 2001-3; but the Euro area average was badly affected by the performance of Germany.

This is generally attributed to three factors:

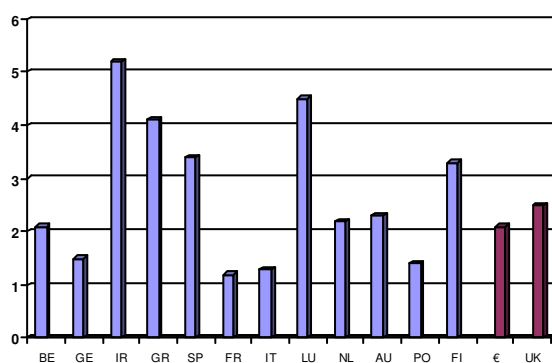
1. **The legacy of reunification.** The old East German mark was exchanged at par for D-Marks. The result was to make the new *Länder* uncompetitive, placing a large financial burden on the rest of Germany.
2. **The conversion rate of the D-Mark** into Euros in 1999. At nearly 2 D-

<sup>17</sup> See "The Potential Effect of EMU entry on British Trade" by Andrew K. Rose in *Submissions on EMU from leading academics* (HM Treasury, September 2002). This surveyed 24 studies on the effects of currency union, concluding that it "is associated with an approximate doubling of trade". Other studies (for example, Fielding and Shields in *Economica*, November 2005) have confirmed the findings.

Marks to the Euro, this was the central ERM rate when the decision was taken, but most commentators consider this to have been an over-valuation. The German economy has been obliged to restore competitiveness though comparatively low inflation, with the penalty of low growth and high unemployment.

3. The reluctance of German governments – like those of other Euro area countries – to carry out **structural reforms** (especially the reform of labour markets).

### Average growth rates 2000-2007



Source: Eurostat

All three explanations carry weight. It is worth noting, however, that only the second can be directly attributed to EMU. The others have arisen from domestic political choices. The painful process of adjustment – whether deliberate or not – has also started to bear fruit in the success of German exporting and the recovery of economic growth.

Many commentators have also tended to underestimate the extent to which labour market reforms have already been taking place. As long ago as 2004 the ECB noted in its *Annual Report* that

*“over recent years a number of countries have implemented reforms in their tax and benefit systems in order to reduce non-wage labour costs and encourage labour supply...including the continued reform of income tax systems, the restructuring of social security and benefit systems, and policies to increase the average retirement age.”*

Nevertheless, in the context of the Euro area, “structural reform” must also refer to the mobility of economic factors *between* economies; and here some criticism is justified. The Single Market in goods has made substantial progress as result of the “1992” package of reforms, but in other sectors there is still some way to go. Opening up markets in services is only just beginning. In the case of labour, intra-country mobility is restricted not just by linguistic and cultural factors, but also by institutional rigidities: e.g. in the field of pensions.

These criticisms, however, refer to the EU in general rather than the Euro area in particular. The barriers need to be removed in any case if there is to be a real Single Market.

### 5. Unemployment

The average rate of unemployment in the Euro area remained stubbornly above 8% for many years, despite all the efforts of national governments – for example, the 35-hour week in France, now being abandoned – to get the figures down. It can even be argued that, given the reported rigidities in the Euro area’s labour and service markets, this is the “natural” rate for the area consistent with stable inflation (i.e. the area’s NAIRU<sup>18</sup>).

Unemployment figures taken on their own, however, can be deceptive. If they are taken in conjunction with the *employment* figures, a different picture emerges. As the *Economist*<sup>19</sup> had already observed in 2005, employment in the Euro area was rising much faster than unemployment was falling

*“as reforms have dragged previously discouraged workers into the labour market.”*

It was not until 2007 that the Euro area’s unemployment rate fell below 8%. But between 1999 and then, sixteen million new jobs had been created.

Moreover, the main reason for the US’s trend growth rate of around 3%, as opposed to the Euro area’s 1.8%, has been a faster increase in the US population. Growth of GDP per

<sup>18</sup> Non-Accelerating-Inflation Rate of Unemployment.

<sup>19</sup> November 19<sup>th</sup> – 25<sup>th</sup>. 2005.

head has been more or less the same (US 1.5%, Euro area 1.4%).

The *Economist* went on to observe that the Euro area had achieved this growth, unlike the US (and the UK one might add), without huge increases in the current account and budget deficits; so

*“its record is more sustainable than America’s.”*

### Politics and Perceptions

All EU governments are tempted to blame “Europe” for difficulties of their own making. Electorates generally have little idea how EU decisions are taken, and are only too willing to believe that there is a vast, unelected Eurocracy in Brussels, imposing absurd regulations out of the blue. Kaletsky has observed that

*“in the Netherlands, France and Germany, the euro has started to be blamed for inflation, economic instability and unemployment”, while admitting that “some of these charges may not be intellectually sustainable”<sup>20</sup>.*

Blaming the ECB is easier than admitting failure to open up EU markets or to carry out painful domestic reforms.

Following the introduction of €-denominated notes and coins, there was an outcry in Euro-area countries that this had led to price increases – in Germany, the Euro was dubbed the “Teuro”<sup>21</sup>. Throughout the Euro area, 83% of people thought that the conversion into Euros had resulted in a general rounding-up of prices<sup>22</sup>; and, indeed, there was evidence that cafés, restaurants and other service industries had used the introduction of new and unfamiliar notes and coins to disguise increased profit-margins.

Yet, when the actual inflation figures were published, they indicated that the changeover had had virtually no overall effect on prices. The explanation lay in the difference between *actual* and *perceived* inflation. The prices of goods bought frequently – for example, cups

of coffee – had been rounded up, often by 10% or more. The prices of goods bought less frequently – clothes, consumer durables, cars – had fallen as a result of increased competition. The public, however, had perceived only the changes in the former items. In Italy, the problem was compounded by the shift from a single unit, the Lira, to a two-tier system of Euros and Cents.

The situation in Italy is also instructive for another reason. The substitution of the Euro for the Lira brought a massive gain for the Italian economy: the sharp reduction in interest rates cut, at a stroke, the burden of interest payments on the substantial outstanding public debt – then and still above 100 per cent of GDP. This was a significant factor in enabling Italy to meet the fiscal conditions for Euro area membership. Now, however, the Euro has been getting the blame for low growth and unemployment. There has even been wild talk of leaving the Euro area re-creating the Lira.

What Italians are missing, of course, is the freedom to devalue. But depreciation of the Lira was the main reason for high pre-Euro interest rates. A return to the old policy would have immediate, substantially adverse fiscal effects, as well as ruining Italy’s international credit rating. Fortunately for Italy, the markets do not seem to believe that anything like this will happen.

It is also worth noting that there are likely to be long-term penalties for being *outside* the Euro area but *inside* the Single Market. In the absence of other trade barriers, companies wishing to supply the market as a whole will prefer to locate where there is least currency risk (i.e. in the Euro area) rather than in a peripheral economy. This applies both to internal investment and to inward investment.

### The UK and the Euro

Judged by the criteria of economic growth, unemployment, inflation and – until recently – fiscal sustainability, the UK has outperformed the Euro area ever since 1999. Why, then, should we adopt the Euro? We’re doing OK without!

<sup>20</sup> *The Times*, Thursday August 25, 2005.

<sup>21</sup> The German “teuer” means “dear”.

<sup>22</sup> Eurostat, May 2002.

The first problem with this argument is that other statistics can be cited pointing in the opposite direction: for example, productivity (GDP per hour worked<sup>23</sup>), where the UK does worse than every Euro area country except Greece, Portugal and Spain. The UK is running a trade deficit (both goods and services) equal to -2.4% of GDP, whereas the Euro area has been running annual surpluses of around +0.2% of GDP.

In addition, the argument implies that the case for adopting the Euro is stronger if the UK economy is doing relatively badly. Politically, this may seem attractive: the present situation – where the Pound and the Euro are almost at par – certainly presents a temptingly simple opportunity.

From an economic standpoint, however, this would be the wrong basis for membership. As the UK Treasury has elaborated in its massive study of the issues, UK entry should be based on a careful cost/benefit analysis, irrespective of who seems to be doing better at the time. The statistics behind the arguments, moreover, are always in flux, so that even the most thorough assessment can rapidly get out of date. One such study wisely states that

*“the **no** campaign does not say ‘never’ to the euro”*<sup>24</sup>.

An important factor will be the likely expansion of the Euro area to include more EU Member States. There are already more EU countries using the Euro than countries retaining national currencies; and those outside the Euro area, apart from the Denmark and the UK, have no opt-outs – they are required by the Treaty to adopt the Euro on fulfilling the convergence criteria.

By around 2012, therefore, it is likely that a large majority of Member States will be in the area, even allowing for further expansion of the EU. The simple business argument for joining – that, in tendering for a contract in the Euro area, a firm based within it, having no exchange risk, enjoys a cost advantage

---

<sup>23</sup> OECD figures, December 2004

<sup>24</sup> *The economic case against the euro*, New Europe Research Trust, 2001.

over a firm which is not – will carry increasingly greater weight.

It will also increase the weight of the Euro Group (the once informal, but now formalised meetings of Euro area Finance Ministers<sup>25</sup>) in decision-making within the EU as a whole. At the same time, the international role of the Euro is also likely to have expanded. This will change the international monetary environment in which Sterling operates.

International developments are, indeed, crucial. Part of the case against Britain joining the Euro area rests on the past volatility of the €/£ exchange rate, given the pattern of our trade. An inveterate opponent of joining, Professor Patrick Minford, has observed that if Britain joins the Euro area

*“we thereby increase our exchange risk against the dollar as the euro swings around against it. If we remain outside, the pound can...‘go between’ the two, rather like someone sitting on the middle of a seesaw”*<sup>26</sup>.

But the volatility after the Euro’s creation will not necessarily continue (still less the volatility of the D-Mark against the Dollar from 1980-99 which Prof. Minford includes in his calculations). It has, in any case, been pointed out that the argument contains

*“an elementary error...If all EU countries had used one currency (the DM) since 1985, our trade-weighted exchange rate would have been much less volatile than was in fact the case... the coefficient of variation of its monthly value would have been 4% rather than 8%”*.<sup>27</sup>

Indeed, until its recent plunge, the Pound has been quite stable against the Euro – more so than against the Dollar.

---

<sup>25</sup> The Euro Group has tended to meet before the Finance Ministers of the EU as a whole (ECOFIN), and there are reasons to believe that many major decisions have been informally agreed by the Group in advance of ECOFIN discussions.

<sup>26</sup> Prof. P. Minford, *Should Britain Join the Euro?*, Institute of Economic Affairs, 2002.

<sup>27</sup> *Why Britain should join the euro*, Britain in Europe, October 2002.

Finally, it is by no means certain that the Fed and the ECB will always conduct policies of “benign neglect” towards their exchange rates. Discussions continue within the IMF and in other contexts – and indeed have been given a new urgency by the “credit crunch” and its consequences – for the creation of a new “international financial architecture”, within which the Dollar and the Euro might be linked, as indeed advocated by Robert Mundell himself<sup>28</sup>. That would be a giant step towards the world currency which he saw in his original paper as the ideal.

## Conclusions

*“When I first learned of the intention of the 1988 Hanover summit to set European monetary union in motion,”* Martin Wolf wrote in the *Financial Times* in 1998, *“I thought it insanely risky. I still think it risky. But it no longer looks insane.”*<sup>29</sup>

This personal observation accurately mirrored British opinion at the time. Since then the Euro has been introduced efficiently and on time; has weathered the fall of its parity against the Dollar between 1999 and 2001; and has now established itself as a stable currency, internally and on international markets.

It is true that, measured against many optimistic predictions during the 1990s, the effects of EMU in promoting economic growth have disappointed. A more relevant benchmark, however, is the probable situation had the chaotic financial environment of that period continued. It is worth remembering that powerful voices were then arguing that mobility of capital within the Single Market and internationally had resulted in dangerous instability, and that there would have to be a return to exchange controls. If the whole process of freeing up European and world markets had then been put into reverse, the cost in terms of lost growth and jobs would have been enormous.

Of course, the successful creation of the Euro area has not prevented critics from

---

<sup>28</sup> *Does the \$/€ rate need to be managed?*, Lecture in Luxembourg, 8 March 2000.

<sup>29</sup> *Financial Times*, May 5, 1998.

forecasting its eventual demise. Historians have observed that past experiments with currency unions have generally lasted only when accompanied by political union (e.g. 19<sup>th</sup>. Century Germany); and have tended to dissolve when the political framework has broken down (e.g. the Soviet Union). Many, both supporters and opponents of European integration, have therefore concluded that EMU can only survive if the Treaty objective of “ever-closer union” is vigorously pursued. For some, this has indeed been the purpose of the exercise – in 1950 the French economist Jacques Rueff famously stated that

*“l’Europe se fera par la monnaie, ou ne se fera pas”*<sup>30</sup>.

A study of history also shows, however, that

*“the one-to-one link between currencies and nation-states is a fairly recent development”*<sup>31</sup>;

and that political union sometimes precedes monetary union, and sometimes follows; but not always.

It is also arguable that the apparent past dependence of a currency on its political framework has been mainly due to the “politicisation” of money by governments, and what Adam Smith called the *“avarice and injustice of princes and sovereign states”*<sup>32</sup>. Where money has been in some measure autonomous or international – for example, has taken the form of gold – the system has worked satisfactorily in spite of changes in national political environments (see the quotation from Milton Friedman in the Box on page 3). The modern equivalent is the independence of Central Banks. Even if political union in Europe does not go much further than at present – as seems possible – there is no reason why the Euro should not continue to flourish as a, literally, international currency.

---

<sup>30</sup> See *L’Age de l’Inflation*, Paris: Payot, 1963.

<sup>31</sup> Christopher Johnson, *In with the Euro, out with the Pound*, Penguin 1996.

<sup>32</sup> *The Wealth of Nations*, Book 1, Chapter 4: “Of the Origin and Use of Money”. Adam Smith was noting the tendency for governments to renege on their debts through debasement of the currency, so *“abusing the confidence of their subjects”*.

Sceptics often raise the spectre of a slide towards economic “government from Brussels” and the harmonisation of taxation, citing as evidence the opinions of many French politicians who want to do just that. However, such opinions arise because those holding them both dislike the independence of “unelected” Central Banks, and fear competition from countries with more efficient tax systems. What they advocate is neither inherent in EMU, nor inevitable.

In the end, the success or failure of the Euro is likely to depend on how far the Euro area economies converge. But, as the UK Treasury observes, it is not necessary to have

*“complete convergence at all times. That would be an impossible standard, and one not met in existing and successful monetary unions”*<sup>33</sup>.

Inflation rates are slowly converging as economies with lower previous standards of living catch up, though this process will inevitably be prolonged as more countries of Central and Eastern Europe join the system

### **The Euro’s effective exchange rate, 1999-2008**



Source: EBB Bulletin, December 2008

In addition, as the ECB itself has pointed out,

*“there have been enduring differences in growth between euro area countries. As these differences largely appear to reflect structural factors, they must be addressed by appropriate national measures.”*<sup>34</sup>

<sup>33</sup> “UK membership of the single currency: an assessment of the five economic tests”, June 2003.

<sup>34</sup> Bulletin, May 2005.

The factors which will determine the fate of the Euro area, therefore, are much the same as those which will determine the fate of the EU economy as a whole. The necessary policies are also the same: completing the Single Market, particularly in the services sectors; and renewed progress in fulfilling the Lisbon Agenda to make the EU at least *one* of the most competitive economic areas within in the global economy.

\*

Finally, there is the special position of the UK. Opinion polls are still showing large majorities against joining the Euro area – although it is interesting to note differences in response depending on whether the question asked is about “adopting the Euro” or “giving up the Pound”. The Conservative shadow Foreign Secretary, writing in the *Daily Mail*, has even broken the golden political rule: “never say never”.

It is important to remember that, by opting out of the Single Currency, the UK has not thereby opted out of EMU as a whole. The Governor of the Bank of England, for example, already sits as a member of the European Central Bank’s General Council<sup>35</sup>. The UK is also bound by the three fiscal rules established by the Maastricht Treaty – no monetary financing of budget deficits, no privileged access to financial institutions, and “no bail-out” – and by the requirement to avoid excessive government deficits.

Nor, even outside the Euro area, can the UK opt out of its success or failure. On the contrary – the UK has the strongest of interests in seeing that the currency area forming its most important trading partner prospers. In consequence, the need to be “at the heart of Europe” pressing for policies to strengthen both the EU, and within it the Euro area, remains a no-brainer for any UK government.

<sup>35</sup> This comprises the President and Vice-President of the ECB itself, and the Governors of all 25 national central banks of EU Member States. It participates in the advisory and coordinating functions of the ECB, and, in particular, in preparations for new countries to join the Euro area.

## **Ben Patterson**

Ben Patterson was the Member of the European Parliament for Kent West between 1979 and 1994, and Vice-Chairman of its Economic and Monetary Affairs Committee between 1992 and 1994. From 1974 to 1979 he was Deputy Head of the European Parliament's London Information Office; and from 1994 to 2004 worked in Luxembourg for the Parliament's Research Directorate. During this period he was also a member of the Parliament's Monetary Union Task Force, and wrote a number of studies on the theory and development of monetary union.



203 Southbank House  
Black Prince Road  
London SE1 7SJ

*Telephone:* +44[0]20 3176 0543  
*e-mail:* [emoffice@euromove.org.uk](mailto:emoffice@euromove.org.uk)  
*web page:* <http://www.euromove.org.uk/>