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THE 'ECONOMIC' IMPLICATIONS OF THE EURO

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2009 was a year in which the 'economic' implications of the Euro were brought to light. Economics tells us that you cannot have it both ways. In other words, economics is a discipline that teaches the implications of 'trade-offs'. Some think economics is about making money but this is totally erroneous, unless they are thinking about how to make money in the face of trade-offs.

Trade-offs bite painfully in difficult times. When a household has enough income to buy both food and healthcare, it does not have to choose between the two. In contrast, when 'push comes to shove' and the budget is tight, the household must face a trade-off between the two. Trade-offs faced

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by policy-makers, entrepreneurs and central bankers are also more stringent in times of stress. Whether we like it or not, we live in exactly such times.

Central bankers face a trade-off when choosing between the monetary policy goals of domestic (price) stability and exchange rate stability. The EU Member States that adopted the euro chose exchange rate stability. Other Member States such as the United Kingdom and Sweden continue to choose not to do so. When the foreign exchange market is calm and domestic prices are stable, central bankers do not have to lose sleep over the choice between the two goals. However, situations can change rapidly. They can also be misjudged. Once prices and markets begin to misbehave, central bankers must make the right choice or face serious consequences. Another problem is that the choice that is optimal for one part of their jurisdiction may not be so for another part.

The current crisis was exacerbated by real estate bubbles in some Eurozone members, fuelled partly by the single monetary policy for the whole of the zone. Since the current crisis began, some Eurozone members have been suffering the cost of losing the exchange rate. Greece is a prominent example. Nevertheless, all members are feeling the strain of having only one monetary policy for the Eurozone and losing the exchange rate albeit to different degrees. This was to be expected. For an economy to recover stability after a shock, some variable has to adjust. If the price (exchange rate) does not adjust, quantity (income, employment) must.

Some people argue, with a certain amount of *schadenfreude* (satisfaction derived from the misfortunes of others) that the European single currency was a bad idea to begin with, because the Eurozone was not an Optimal Currency Area. Such people should be reminded that as early as in 1992, the European Commission published a book (*One Market, One Money*) in which the authors acknowledged that Europe was not an OCA. The costs of losing the exchange rate that we see today were not unanticipated.

Furthermore, you do not have to adopt a single currency to be burdened by the trade-off between exchange rate stability and monetary policy autonomy. Countries such as Latvia, Estonia and Lithuania, which have not yet adopted the euro but have joined ERM II (Exchange Rate Mechanism II) and pegged their

currencies to the euro, are also experiencing the harsh reality of this trade-off.

We should also recall that the monetary policy autonomy kept by countries such as the UK has not helped in the current crisis. We can argue over whether the UK truly has monetary policy autonomy, because the pound's exchange rate against the euro cannot be ignored. Even if a country has full monetary policy autonomy because it pays no attention to its exchange rate in deciding its monetary policy, though, monetary policy autonomy has its own costs and benefits. The country that comes closest to this description is the United States of America...and look what happened.

What happened took place because of a trade-off between yet another pair of monetary policy goals: price stability and (financial and/or real estate) market stability. To which of the two goals should monetary policy be devoted? When the economy is humming along nicely with stable prices and stable markets, it does not matter which of the two goals the central bank chooses. Famously, the former Fed Chairman Greenspan thought that the economy was in just such a state and maintained the 'Greenspan put'; the priority was on price stability and the bubbles were to be dealt with after they burst. We all know now the devastating consequences of this misjudgement.

Then, there is the trade-off between too much discipline and too little discipline on the part of members of a currency union. In general, for a currency union to survive, its core currency has to be issued by a country with an anti-inflationary monetary authority. To understand what happens if this is not the case, we need only to recall how the Bretton Woods system unravelled. However, if the centre country's anti-inflationary stance is too strong, then overall economic activity in the currency union suffers.

The country at the core of a currency union should also be a net lender not a net borrower, if being a heavy net borrower hurts the credibility of the key currency. Nonetheless, this does not ensure the longevity of the currency union. It is possible that many members at the periphery (as opposed to the centre) are net borrowers, i.e., that the peripheral countries' private sectors or public sectors or both are net borrowers. If the public borrowing in the periphery becomes too extensive, as it has in Greece, it threatens the currency union not from the centre

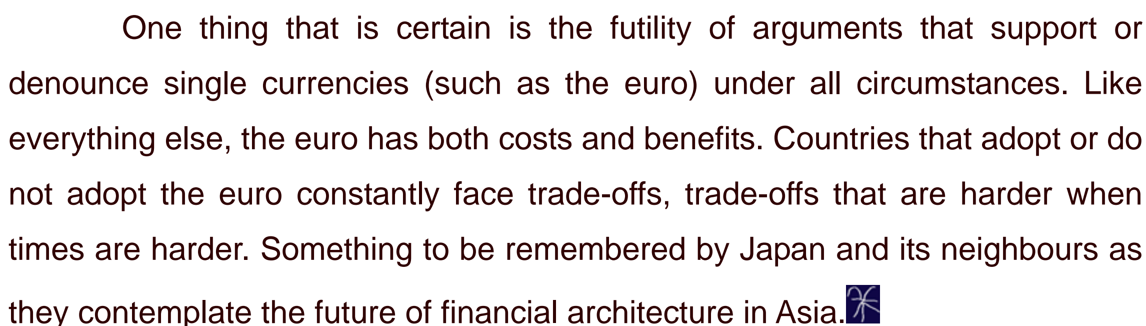
but from the periphery. The threat is more serious if the borrowing is from abroad. This is one reason why the Eurozone needs the Maastricht criteria on deficits and debt, as well as the Stability and Growth Pact, and why these pacts need to be effective. If private borrowing in the periphery becomes too great, then a financial/banking crisis could result, eventually involving currency crises, which would in any event trigger a public borrowing spree.

A currency union can be ‘too stable by half’. Stable exchange rates and budget discipline can bring about low interest rates. That boosts economic activity and encourages borrowing. This happened in Europe in the run-up to the current crisis and in East Asia in the run-up to the Asian crisis ten years earlier.

With all these trade-offs, it is easy to see why choosing macroeconomic policies that ensure stability is not an easy task. However, this is only half the story. There are all manner of trade-offs in the microeconomic aspects of policy. For instance, the trade-off in policies regarding banking regulation, if not recognised and handled correctly, will lead to financial crises. At the broadest level, if regulation is too tight, this will limit lending and hurt economic activity. If it is too lax, though, this will encourage activities that lead to crises.

The optimal choice depends on the economic, regulatory and systemic environment. It is a moving target. Add to this the fact that financial markets are by nature prone to instability, and we can conclude that the possibility of another crisis cannot be eliminated.

One thing that is certain is the futility of arguments that support or denounce single currencies (such as the euro) under all circumstances. Like everything else, the euro has both costs and benefits. Countries that adopt or do not adopt the euro constantly face trade-offs, trade-offs that are harder when times are harder. Something to be remembered by Japan and its neighbours as they contemplate the future of financial architecture in Asia.



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