Europe Can't Handle the Euro
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The euro's recent collapse certainly isn't what its creators had in mind. Since Europe introduced its single currency at the beginning of 1999, it has dropped nearly 20% relative to the dollar. It recently fell below the symbolically important value of $1.

When leaders of the 11 nations that agreed to combine their currencies gathered in January 1999, they predicted great things: the single currency would shift global portfolios to euro assets, depressing the value of the dollar relative to the euro, and the new eurozone would be a strong player in the global economy, reflecting the size of an integrated European market. Instead the euro plummeted, Europe's economy remains weak, and unemployment is more than twice the U.S. level.

The euro's sharp fall has actually helped strengthen aggregate demand in Europe by increasing net exports. But it is also a reminder that the currency union did not bring exchange-rate stability. While the exchange rates within the 11-country euro area are fixed, exchange rates with other currencies can vary substantially. For a German firm that uses oil or other resources priced in dollars, the sharp decline of the euro has meant a sharp increase in the cost of production and a corresponding loss of competitiveness.

The new European Central Bank gets high marks for the way it managed the initial establishment of the euro. But it has been less successful in explaining its monetary policy. Unlike Germany's Bundesbank, which always spoke of a target growth rate for money, or the Bank of England, with its explicit inflation target, the ECB has adopted a policy that appears to target both money growth and inflation. The resulting confusion about possible inconsistencies is compounded by the secrecy of the ECB's deliberations and the ECB board members' tendency to contradict one another in public.

The ECB will eventually be judged not by its words but by whether it achieves low inflation and does so without increasing cyclical unemployment. I am not optimistic about either part of this goal. Maintaining low inflation will depend on avoiding political pressure to overexpand demand. During the past two decades, Germany has set the standard with virtual price stability, and the other countries of Europe limited demand in order to bring down their inflation rates because a failure to do so meant the embarrassment of devaluing relative to the mark. That discipline will disappear when the mark is gone and each EMU country has a vote on monetary policy.

The ECB must make monetary policy for "Europe as a whole," which in practice means doing what is appropriate for Germany, France and Italy, the
eurozone's three largest countries. Last year demand conditions in those countries were relatively weak, while demand conditions in Spain and Ireland were very strong. That meant a monetary policy that was too expansionary for Spain and Ireland, causing a substantial acceleration of their inflation and threatening their competitiveness. Such disparities of demand conditions will undoubtedly persist in the future because European countries differ substantially in industrial composition and in a variety of economic policies.

It was lucky for the euro that in 1999 outlier countries like Spain and Ireland were enjoying very strong growth rather than high cyclical unemployment. But the time will come when the ECB will set a policy that is too tight for the outliers, leading to substantially higher unemployment than if they were free to set their own monetary policies. Even without discretionary monetary policies, the interest rates in countries with weak demand would naturally decline, and the external values of their currencies would fall, both acting as offsetting stabilizers of the countries' weak demand. But this will not be possible within the EMU, where a single interest rate and a single exchange rate prevail. Result: higher average cyclical unemployment.

Europeans look to the success of the American economy and mistakenly assume that our single-currency system should work equally well there. But the response to a cyclical fall in demand in a U.S. region is very different from the response in Europe. In the U.S., a fall in regional demand leads to lower wages, which help to maintain employment; to movements of labor to regions where demand is stronger; and to a net fiscal transfer from Washington (because lower regional income means lower federal tax liability). None of this happens in Europe, where wages are inflexible, mobility is severely limited by language and custom, and there are no significant fiscal transfers.

Most of today's high unemployment in Europe is not cyclical but structural, reflecting bad welfare policies, bad regulations and high taxes. The ability to solve these problems should be separate from the monetary arrangement. But the single currency will be a political impediment to reform. Politicians can now blame the ECB for high unemployment and complain that it is a powerful force beyond national control. Instead of seeking to make labor markets more flexible, European governments are talking more about "social wages," about mandatory 35-hour workweeks, and about rolling back even the small reductions in social benefits Germany achieved under Helmut Kohl's government. Worse yet, there are attempts to eliminate differences in labor practices and even differences in wages among the EMU countries.

This makes Europe even less suited to a single currency and exacerbates the structural problems that keep unemployment so high. Moreover, these policies reduce the international competitiveness of many European industries and encourage the adoption of protectionist policies to keep out non-European products. If labor standards and environmental regulations become acceptable subjects for international-trade discussion, it's easy to imagine Europeans arguing that they should not have to compete with American companies that don't give their employees European-level social benefits, have longer working hours, and are subject to less restrictive environmental regulations.

Some Europeans acknowledge these adverse economic effects of the euro but argue that it is important for European political union. Looking back on the wars that have devastated the Continent during the past century and a half, they reason that people who carry euros in their pockets will come to think of themselves as Europeans first, and that this will reduce the likelihood of conflict.

I think the opposite is more likely. The attempt to achieve Europewide policies will itself be a major source of discord within Europe. Forcing a single monetary policy on all of Europe will cause the countries that suffer what they regard as unnecessarily high unemployment to resent the actions of others. Attempts to force a Europewide tax system, especially if taxes are used to redistribute incomes among European countries, will compound the potential for conflict.

The Maastricht treaty that created the EMU makes no provision for a country to leave and return to its own currency. While a country might nevertheless unilaterally opt to leave, it would risk being denied all of the trade benefits of the single market, and it might face other forms of
retribution. EMU is meant to be a marriage made in heaven with no possibility of divorce.

One way for European governments to create greater unity is to have a common adversary. With the Soviet Union gone, I worry that Europe will come to see the U.S. in this role—as a politically convenient opponent that can be used to advance the agenda of political and economic unification despite the tensions that it creates among the countries of Europe.