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Here Comes the Euro

Despite broad popular opposition, Europe's political leaders seem united in their determination to introduce a common currency, the euro, over the next three years. Whether this unprecedented abrogation of individual and national sovereignty will succeed as hoped no one knows. At this time it may most usefully be understood as the risky legacy of Europe's failed Fabian politics.

On the first weekend of this month, the members of the European Union (EU) met to start the implementation of a plan for a common currency, the euro, in an new Economic and Monetary Union (EMU). The process begins with an agreement to fix the exchange rates among the currencies of 11 of the 15 members of the Union, and the naming of the officials of the new European Central Bank (ECB). At the end of next month, the cross exchange rates of the 11 existing national currencies and the new euro will be fixed, and at year end the rates will be finalized so that one euro will equal one ECU (a unit of account now defined as a weighted "basket" of EU national currencies). At that time, banks will begin to accept euro deposits, existing financial contracts, e.g., bonds, will be re-denominated in euros, and securities trading will be in euros. Three years later, the ECB will issue euro notes and coins, all bank deposits will be converted to euros, and the existing paper notes and coins of the 11 national currencies will cease to be legal tender 6 months later.

Will This Really Happen?

Skeptics have long questioned the will and ability of the countries of Europe to forge a common currency, inasmuch as the move means giving up some measure of each country's national identity.

As recently as a year ago, it appeared that only a minority of the EU members would meet the qualifications set by the 1991 Maastricht treaty for participation in the new currency. As it happened, a combination of budget stringency, some creative accounting, and an uptick in economic activity have enabled all EU members but Greece to qualify (the other three EU countries who are not participating at this time — Great Britain, Denmark and Sweden — are doing so voluntarily).

The politicians now describe the process as "irreversible," yet some observers believe it remains vulnerable through the balance of 1998 at least. "Pegged" currencies are the stuff of speculators' dreams, and if imbalances become apparent during the next 7 months, unprecedented cooperation among the separate central banks may be required before the ECB begins to function (at which point the individual currencies will simply become sub-sets of the euro).

Nevertheless, it appears that the politicians, who have staked their reputations and prestige on the success of this venture, are likely to find the will to maintain the agreement. For, as discussed below, the move to a common currency is far more political than economic.

Economists are Divided

Some economists believe that the common currency will provide the key to solving Europe's economic problems. There will be undeniable advantages — lower transaction costs and less risk for transactions and contracts among the participating countries; but, given the current absence of exchange or capital controls and the availability of well-developed hedging instruments, these advantages are easily overrated.

Nevertheless, the optimists believe that, as Professor Robert Mundell of Columbia has written, a "well-run monetary union ... will be of enormous benefit to the people of Europe and to the rest of the world, including the U.S." Beyond the simplification of payment mechanisms, most economists expect the euro to facilitate competition within enlarged markets that could encourage needed changes to lower costs and increase efficiency. For example, it appears likely to foster a consolidation of banking and exchange trading that will reduce capital costs by increasing the role of the money and capital markets and reducing European businesses' reliance on bank loans.

In any event, the desire for economic integration, of which a common currency is only a part, clearly has been modeled on the "continent-wide" economy of the United States. Much of the economists' debate has focused on comparison with the U.S. economy, specifically the effects of a "one size fits all" monetary policy on disparate national economies. Euro interest rates are expected to be equal throughout the EMU and the concern is that the common interest rate may not be best for particular countries or regions.

On one hand, the economies of Europe are more alike (in terms of industrial diversification, the importance of agriculture, etc.) than the regions of the United States. On the other hand, the introduction of the euro could encourage more specialization, and the EMU lacks regional "stabilizers" (such as Federal unemployment payments) to transfer incomes from leading to lagging regions. Moreover, because of the barriers of language and tradition, European workers are far less inclined than workers in the United States to re-locate to where the jobs are. Indeed the rigidity of European labor markets is likely to remain the foremost problem there.

Some economists hope that, once governments are denied competitive devaluation as a policy tool, they will be forced to deal with the barriers to flexible employment that are the main villains in Europe's recent record of high unemployment and low growth. However, it remains to be seen whether the European politicians and electorate will be willing to give up social programs, the taxes needed to pay for them, or the labor regulations that together make idleness attractive to the unemployed and new hires expensive for employers. In any event, it does not seem likely that Europeans will soon move as easily, say, from Dresden to Dublin as Americans move from, say, Detroit to Dallas.

In short, simply adopting a common currency will accomplish little directly to ensure a harmony of fiscal, welfare and

The Euro: An Overview

The Treaty

The *Maastricht Treaty* set the stage for monetary union. It was agreed to by the heads of government of the member countries of the European Union in 1991 and subsequently ratified by their parliaments or by voters in national referenda. The treaty requires the member countries to join in a monetary union (establishing a single currency and a supranational central bank) by no later than 1999 if they meet specified economic and fiscal criteria. Britain and Denmark, however, negotiated clauses that permit them to remain outside the monetary union if they choose.

Key Institutions

The *European Union* (EU) began as an economic association of six countries in 1957 and now has fifteen members. Many more countries have applied for membership, including Turkey, Cyprus, Malta, Hungary, Poland, Romania, Slovakia, Latvia, Estonia, Lithuania, and Bulgaria.

The *European Monetary Institute* (EMI) is the forerunner to the new European central bank. In operation since 1994, it is in charge of laying the groundwork for monetary union, and once the new central bank begins operating next year the EMI will be dissolved. It is run by a Council that is composed of a president, plus the central bank governors of the fifteen European Union member countries. The EMI is responsible for deciding the legal, organizational, and regulatory foundations of the new central banking system. It also tries to strengthen the coordination of monetary policies among member countries' central banks, although its policy recommendations are nonbinding. Each member of the EMI Council gets one vote and, depending on the issue, decisions are made by a simple majority, a two-thirds majority, or a unanimous vote.

The *European Central Bank* (ECB) is the new supranational central bank that will be in charge of the euro and will set a common monetary policy for the euro countries. It will be located in Frankfort, Germany, and is structured after the Bundesbank, Germany's central bank. The ECB will be managed by an Executive Council composed of a president plus up to five other people, each of whom will be appointed for eight-year terms. Day-to-day monetary policy will be set by a larger group, the Governing Council, which will consist of the Executive Board plus the central bank governors of the eleven euro member countries. The Governing Council will operate on the principal of one-man, one-vote, thus Germany will have the same voting power as Italy or Ireland. Most issues will be decided by simple majority. This council will be supplemented by a larger group, the General Council, which will comprise the ECB president and vice president plus the central bank governors of all fifteen EU countries. The General Council will coordinate monetary and exchange-rate policy between the euro countries and the other EU countries.

The *European System of Central Banks* (ESCB) is a new system that will consist of the European Central Bank plus the central banks of the fifteen EU countries. Its structure is comparable to the U.S. Federal Reserve Bank System.

regulatory policies, and even less to encourage the geographic mobility of labor. Therefore, some economists expect intense conflicts to develop, especially if jobs and capital flow to low tax, low regulation countries at the expense of countries that wish to maintain their welfare states and privileged workers.

Professor Martin Feldstein of Harvard, believes that the EMU "will be judged not on its impact on inflation and unemployment, but by its effect on peace and conflict within Europe and the world." The Maastricht treaty contains no provisions for a member of the EMU to withdraw: the common currency is intended to be permanent." Citing the precedent of the American Civil War (the U.S. Constitution was silent on the question of secession), Feldstein finds this ominous.

But the Politicians are United

Although economists believe that the euro could produce another European renaissance or another Armageddon (and everything in between), the political leaders of Europe (excepting the British, Danes, and Swedes) are all for it. So too are the business and financial elites.

This is all the more remarkable, given that polls indicate that European electorates are inclined to be skeptical of, or even hostile to, the notion of a common currency. Given that half of Europe's bankers could be in another line of work in a few years, their unanimity in favor of the euro is equally remarkable. It is widely believed that the defeat of the Gaulist government by the Socialists in France last year reflected dissatisfaction with the "austerity" steps taken to ensure French participation in the EMU. It is similarly asserted that the Social Democrats are likely to replace the Christian Democrats in Germany for analogous reasons. Yet the French and German socialists have also endorsed the euro.

Why, then, are the politicians — especially the leaders of France and Germany — who have been the leaders in pushing for the euro (and without whose participation it would not be even a possibility) so determined? They seem to believe that a common currency and economic integration will further the cause of political integration that will ensure peace and stability in the next century (cautions, such as Professor Feldstein's, notwithstanding). Prime Minister Kohl, it has been suggested, having presided over the re-unification of Germany, and having served longer than Bismarck, may wish to be remembered as the man who unified Europe.

On the other hand, the French, and others who have a "soft" currency tradition, have found that they cannot maintain an independent monetary policy and stable exchange rates when capital movements are free. For example, President Mitterand had to abandon much of his socialist and inflationist agenda in the early 1980s after the franc fell out of the "snake" (a regime for fixing European exchange rates). In other words, for the past decade at least, the finance ministers of the EU have found that their domestic monetary policies have been dictated by the Bundesbank. The notion that the "soft money" countries may expect more "leverage" over the euro has been reinforced by the last minute flap over how soon a "hard money" Dutchman could be replaced by a Frenchman as president of the new ECB.

Hard or Soft?

As the foregoing indicates, the move to a common currency may be more about politics than economics. Just as economists are in disagreement about the long-term consequences of the euro, there is little agreement among financial analysts regarding the euro's prospects against the dollar.

Some believe that the euro will appreciate because the euro, which will begin its existence as a pure fiat currency, will have to be managed with price stability as

its only goal (this is explicitly called for by the Maastricht treaty) initially, at least, so that it can gain credibility in the markets. If such credibility can be gained and maintained, it may happen the euro will begin to displace the dollar as a reserve currency, and in illicit and "off the books" trading. A shift to the euro and out of the dollar by non-Europeans (eventually up to $1 trillion in official reserves and in euro currency used hand-to-hand outside the EMU, by some estimates) could serve to boost the euro against the dollar. The combined gold reserves that will devolve to the ECB exceed the gold holdings of the United States.

There are, however, many unanswered questions regarding the operations of the ECB. Foremost among these is how its assets will be deployed. In addition to gold, the ECB will presumably continue to hold dollars as well as the euro-denominated debt of the EMU member governments. How the latter will be apportioned among the EMU members remains to be seen — it could become another major point of contention. Members are supposed to keep their fiscal deficits below 3 percent of GDP, but there are no explicit penalties for failing to do so. Presumably, governments that cannot finance their deficits with the ECB would have to take their lumps in the bond market — in the same fashion as profligate U.S. cities and states — paying premium rates to secure financing. Few analysts expect the ECB to sell significant amounts of its gold. To do so could depress the price of this important reserve asset.

If the ECB reduces its dollar reserves, it could depress the dollar against the euro. But appreciation of the euro against the dollar could shrink the markets of European exporters and make dollar-priced goods more competitive in the EU. A "strong" euro in competition with the dollar could be expected to generate vehement protests. Moreover, any shift out of the dollar and toward the euro as a world reserve currency could take a long time. The last time the dominant reserve currency changed, Sterling remained important in global finance long after Britain assumed a relatively minor role in world affairs.

In the final analysis, as with any fiat currency, the question of whether the euro will be "hard" or "soft," *i.e.,* the degree to which it retains its purchasing power over time, will reflect politics. Our guess, and it can only be a guess, is that the inflationists will eventually gain the upper hand in the management of the ECB, and that its long-term record will be closer to the overall European record than to the record of the Bundesbank over the past 4 decades. Given huge pension obligations, powerful unions, and the demanding electorates of Europe, there may be many, even in Germany, who would not mind seeing the purchasing power of their debts whittled away.

The same applies to the fiat dollar. With low unemployment and robust growth, the United States now seems to be in a better position to maintain the value of its currency. But this is a political, not an economic, judgment. Alan Greenspan will not be around forever, and conditions could change. As long as the value of a currency is determined by the actions of a small group (rather than by the interaction of all producers and consumers in the market place, which is what happens when currencies are defined as and freely convertible into precious metals), that group can be expected to abuse its power sooner or later.

The Failure of Democratic Socialism

In different perspective, the euro experiment seems broadly symptomatic of the failure of European political institutions to promote the reforms that market economies demand. To a

The Euro: Timetable

May 1-3, 1998

The fifteen member countries of the European Union (EU) announced which countries will participate in the Economic and Monetary Union (EMU) and the euro. As expected, there will be eleven members when the EMU begins on January 1, 1999: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain. Britain, Denmark, and Sweden have chosen not to join yet, and Greece did not meet the economic and fiscal criteria.

The EU countries also took further steps toward creating a European Central Bank (ECB). They chose a president for the new bank, Willem F. Duisenberg, a former head of the Netherlands' central bank who currently heads the European Monetary Institute, the predecessor to the ECB. The president is supposed to serve an eight-year term, but because the French prefer their own candidate over Duisenberg, they forced a compromise: Duisenberg agreed to step down after just four years to allow Jean-Claude Trichet, president of the French central bank, to replace him. This is widely regarded as a "fudge" that raises doubts about whether the ECB will operate as the politically independent institution its supporters envision.

They also announced the fixed exchange rates at which participating member nations' currencies will trade with each other. These rates may be adjusted when "irrevocable" conversion rates are set next January. Production of euro notes and coins is set to begin before the end of the year.

January 1, 1999

A transition period that will last up to three years begins. On January 1, participating member states will announce "irrevocable" fixed conversion rates between their currencies and the euro. During the transition period, the euro will be a legal currency but will be used largely as an accounting unit; euro notes and coins will not be issued until later. National currencies and coins remain the only legal tender for cash transactions, but increasingly they will trade as fractions of the euro.

The banking, financial, and foreign exchange markets are required to begin conducting business in the euro. Retailers and other industries are free to convert some or all of their operations to euros, and have the option of carrying out noncash transactions in euros. Use of the euro among the general public remains optional, and only time will tell how rapidly it will be accepted.

Member countries begin to denominate new government debt in euros. The European Central Bank begins to operate, conducting a single monetary and exchange-rate policy for all member countries.

January 1, 2002 (at the latest)

Euro notes and coins begin to circulate. All businesses are required to begin conducting business in euros. The national currencies and coins of member countries begin to be withdrawn.

July 1, 2002 (at the latest)

The national currencies and coins of EMU member currencies lose legal tender status. The euro becomes the only legal currency in these countries. All transactions, accounts, debts, and liabilities must be denominated in euros.

far greater extent than in the United States, European democracy has been overwhelmed by the special interest politics of Keynesian and other variants of Fabian economics that have dominated political thought on the subcontinent for the past half century. Once governments succeed, as most European ones have, in making clients of nearly all their citizens, few if any genuine statesmen can survive the electoral process: any who try to rescind government "benefits" are thrown out of office. Hence, the current enthusiasm for a resort to an unelected and unaccountable supranational authority that, it is thought, might indirectly compel needed structural reforms throughout Europe — and so pave the way for European political union.

It goes without saying that such authority, if exercised diligently, could plausibly be far more effective in promoting needed reforms than might be obtained through the contentious and unreliable democratic process. If the introduction and administration of the euro by authorities unaccountable to the European people succeeds in promoting the dismantling of special privilege and the ascendancy of genuinely free markets, it would constitute a revolution in European affairs of incalculable benefit — and could stimulate the resurgence of democratic capitalism throughout the subcontinent. That is the bet that the European elites today seem willing, nay eager, to take. It also goes without saying, however, that there can be a far darker side to such authority.

Who Has the Power?

Treaties (like fiat currencies) are simply pieces of paper that are most readily subverted when the power to enforce them is called into question. It may be obvious, but it has been mostly ignored in the debate over European monetary union that governments and their agencies must ultimately rely on the use of force (or its threat) to compel compliance with their laws and dictates. That is why they maintain armies, police forces, and any other variety of armed agents — Gestapo, KGB, Red Guards, IRS, or whatever. The bland visage of the bureaucrat belies the fact that, at bottom, his authority derives from the barrel of a gun.

In the United States, the Legal Tender Acts and related legislative and executive orders are empowered by the U.S. Government's vast enforcement apparatus. The dollar is this nation's sole legal tender not necessarily because state governments or independent banks have no wish to issue their own currency. Indeed, a bewildering variety of state and private banks' notes circulated freely as currency at one time. They do not today because any state that issued its own currency soon would find armed federal forces at the statehouse door (the outcome of the American Civil War largely determined how questions of states' rights in this country would be settled — *i.e.*, by force).

Thus, although the U.S. Federal Reserve Banks nominally are private banks and the Federal Reserve Board of Governors nominally apolitical, the central banking system in the United States operates under broad federal mandate. If necessary, it can summon the force of federal authority at will. While many may doubt its wisdom, few would question its power to enforce even unpopular or wrongheaded policy, and the financial markets both here and abroad literally dance to its tune.

The same cannot be said of the new European Central Bank. Rather, it would seem that very little can go wrong and a great deal must go right if the original provisions of the Maastricht Treaty are to be honored.

Until and unless genuine European political unification occurs, the ECB will lack the power the U.S. Federal Reserve tacitly commands. Acquiescence in the as-yet-unknown policies of the ECB will therefore depend on voluntary compliance. Such compliance would seem in turn to rely ultimately on popular sentiment — at least as long as the EMU member countries retain some modicum of sovereignty.

Despite the elites' attempts to circumvent the popular will, the success or failure of the euro must finally depend on the European people. In view of the high stakes involved, one can only hope that — however painful the adjustment and whichever way the euro goes — civility prevails in whatever disputes arise. The euro experiment seems a bit like the family dinner to which both sets of in-laws have been invited. Despite the resentments and jealousies that always threaten to disrupt the party, duty requires that one show up and hope for the best. With the euro, however, the dinner never ends. That is why many of those who are broadly sympathetic with its goals nevertheless regard it as a very risky high-stakes gamble. ❑

The Drug Runner Special?

Although paper euros will not be circulated until the year 2002, their designs have been approved. The largest denomination note (pictured above) is expected to be worth roughly 5 times the U.S. $100 bill, the largest now available. This means that $1 million in currency, which now fills a suitcase, could be carried in a lady's handbag of moderately generous dimensions. We are not aware of any official explanation of why such a large bill is needed and it would appear to be a pure play for modern-day "seigniorage." Currency used outside its area of issue has no effect on demand or prices in that area, and, like all circulating paper currency, it amounts to an interest-free loan to its issuer.

PRICE OF GOLD

	1996	*1997*	*—— 1998 ——*	
	May 9	*May 8*	*Apr. 30*	*May 7*
Final fixing in London	$392.70	$343.75	$310.70	$298.10

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