The World's Newest Currency

JANUARY 1 MARKED the formal launch of Economic and Monetary Union (EMU) in Europe as 11 nations of the European Union (EU) merged their currencies into a new single currency, the euro, and ceded sovereignty over monetary policy to a new supranational institution, the European Central Bank (ECB). The 11-nation entity that shares this new currency is similar in size (economically) to the United States, automatically making the euro the world's second most important currency after the dollar.

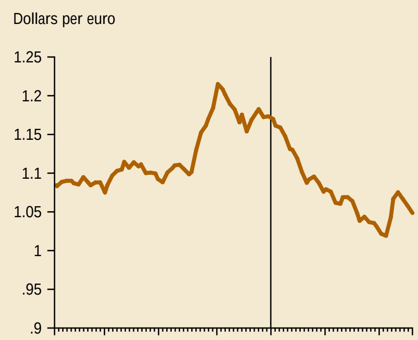
The launch of the euro and the creation of the ECB to manage it are part of the longer-term process of European integration that began shortly after World War II. The euro's creation eliminates all exchange rate risk between the participating nations and will further deepen the single market in goods and services that has existed since 1992. By ceding sovereignty over monetary policy to the ECB, individual countries can no longer tailor their monetary policies to domestic economic conditions, but must instead accept the policy set by the ECB on the basis of economic conditions in the euro area as a whole.

It is too early to say for sure whether EMU will succeed and whether the euro will be a strong currency. Many economists have raised serious doubts about the wisdom of EMU and have argued that the project is doomed to fail sooner or later. Periods of boom in some countries that are accompanied by periods of recession in others, in conjunction with limited labor mobility, will create strains that will test the new institutions. The skeptics point to historical evidence that monetary unions that are not accompanied by political unions invariably fail. The optimists point to the important role shared currencies play in building a common political identity and note that EMU differs in many important respects from earlier attempts at monetary union.

The fact that EMU membership goes hand in hand with access to the single market makes the costs of seceding from the monetary union quite high. Also, the creation of a single institution (the ECB) to manage the new currency, and the accountability of the ECB to the European Parliament, should enhance the legitimacy and durability of EMU.

It is also too soon to tell whether the euro will prove to be a strong currency and a worthy successor to the perennially strong Deutsche mark. Insofar as it is possible to design a currency to be strong, the euro has a lot going for it. Current conventional wisdom holds that central bank independence is a key prerequisite of a strong currency. The ECB is probably the most independent central bank in the world, and it has an unambiguous mandate for the pursuit of price stability. The ECB is only obliged to support the other policies of the EU to the extent that this support does not compromise its primary objective of price stability. But the ECB will be entering uncharted territory when it comes to building a constituency for its policies across national borders. The ability of Deutsche Bundesbank to pursue an independent monetary policy was due in no small part to the popular support it enjoyed among the German electorate.

Chart 1
Dollar–Euro Exchange Rate



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Much was made earlier this year of the euro's steady fall against the dollar on foreign exchange markets (*Chart 1*). To some this was a sign of inherent weakness in the new currency. However, a number of factors should be considered before reading too much into short-term movements in the dollar–euro exchange rate. First, at least part of the decline was simply an unwinding of the appreciation of the legacy currencies against the dollar in the latter half of 1998. As relative growth prospects in the United States and the EU shifted, so too did the exchange rate. Second, uncertainty about the direction of economic policy in Germany, the euro area's largest economy, and confusion about the ECB's attitude toward exchange rate developments detracted from market confidence in the first months of the new currency's existence.

The exchange rate has been more stable in the past couple of months, as the outlook for growth in Europe has improved. There is growing evidence that the slowdown in economic activity in Europe that began late last year has come to an end and that the continent is poised for faster growth in the coming year. Both Germany and Italy show signs of an upturn in economic activity, while the countries on the periphery (Finland, Ireland, Spain and Portugal) continue to grow rapidly. The ECB's first real test will occur when it comes time to raise interest rates to stave off incipient inflation.

—Mark A. Wynne

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