Five Years of the Euro: Successes and New Challenges

Europe embarked upon monetary union much the way Columbus set out across the Atlantic in 1492—full of hope but without a map.

Nothing like economic and monetary union (EMU) had ever been tried before its launch in 1999. Eleven countries—with a hodgepodge of languages, cultures and customs—tied their economic futures to a common central bank and single currency, the euro. Greece joined in 2001, expanding the euro zone to 310 million people in 12 nations.

After five years voyaging into the unknown, the European Union (EU) may not have discovered a new world of prosperity, but it at least proved wrong the pessimists who doomed EMU even before its launch. Bank of France Governor Christian Noyer summed up what many had predicted for EMU: It will never happen. If it does happen, it will be a disaster.

EMU has confounded those expectations by establishing itself without any major breakdowns—in iffy times for the global economy. The European Central Bank (ECB) has built a reputation as an independent, credible monetary authority. And the euro ranks as the world's second most important international currency, after the dollar.

Perhaps most important, the new monetary arrangement has achieved its primary goals—macroeconomic stability and, more specifically, low inflation. The ECB has defined price stability as consumer inflation of less than 2 percent. And as Chart 1 shows, EMU has largely delivered on that mandate. Tame inflation has given most member countries both short- and long-term interest rates lower than they would otherwise have had.

Monetary union has not been as successful in stimulating the economies of continental Europe. Chart 2 shows that the euro area has grown more slowly than the United States for much of the past five years, with most of the poor performance arising from structural rigidities in product and labor markets. The first five years of the euro also saw instability in the currency's value. In 1999 and 2000, the euro fell against the dollar, reaching a low of 82 cents in October 2000. After 2002, the currency rose, peaking at $1.28 in February 2004. Various explanations, including higher U.S. productivity, do not fully account for the exchange rate swings, which are no worse than the dollar's earlier ups and downs against the German mark and Japanese yen.

Twelve of the 25 EU member states currently participate in EMU, whose framework was established by the Maastricht Treaty of 1991. Some are not participants because they choose not to be. Denmark and the United Kingdom, for example, negotiated opt-out clauses to the treaty, which obliges EU members to adopt the single currency when they meet the qualifying criteria. Others are not yet members because they only joined the EU earlier this year. (See map on page 15.)

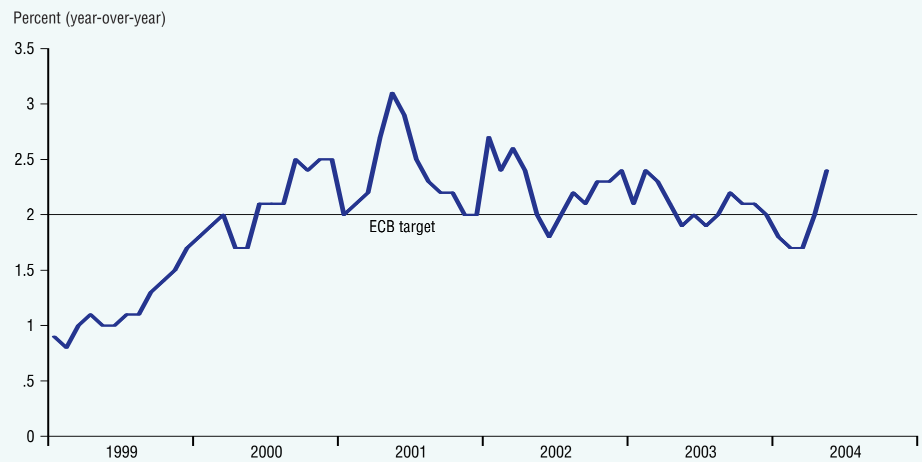
Economists and European central bankers recently gathered at the Federal Reserve Bank of Dallas to assess the first five years of the euro. Presentations focused on the currency's international role, its impact on global financial markets, the lessons learned and the challenges ahead. This article draws on conference presentations to review EMU from the perspectives of various countries.[1]

Fringe Players: Ireland and Portugal

EMU gets its ballast from core heavyweights France and Germany, but the single currency involved leaps of faith for Ireland and Portugal, two smaller countries on the EU's periphery. They could have stayed out, like Britain, Sweden and Denmark, but chose to join, becoming integral parts of the European economy.

Chart 1

Inflation Under EMU



SOURCE: Statistical Office of the European Communities.

Chart 2

Economic Growth in the United States and Euro Area

*Seasonally adjusted, annualized rate.

SOURCES: Office of the European Communities; U.S. Bureau of Economic Analysis.

Fundamental to EMU's success in Portugal has been widespread recognition that long-term changes have been made to the economy.

In its first five years under EMU, Ireland achieved one of its primary goals—closing the credibility gap that saddled its economy with borrowing costs above Germany's. Had it not entered EMU, Ireland would almost certainly have ended up with higher interest rates than it has. They would have choked off the nation's 1990s growth spurt, a boom captured in the description of Ireland as the "Celtic Tiger."

In other ways, EMU membership hasn't turned out as expected. Perhaps most significant, Irish inflation accelerated following EMU's launch, rather than retreating to the euro zone average. This was partly due to the Irish market's heavy reliance on British retailers, whose pricing decisions reflect economic conditions outside EMU. With interest rates lower, the Irish saw the EU's biggest building boom, marked by double-digit increases in housing prices and rising construction costs.

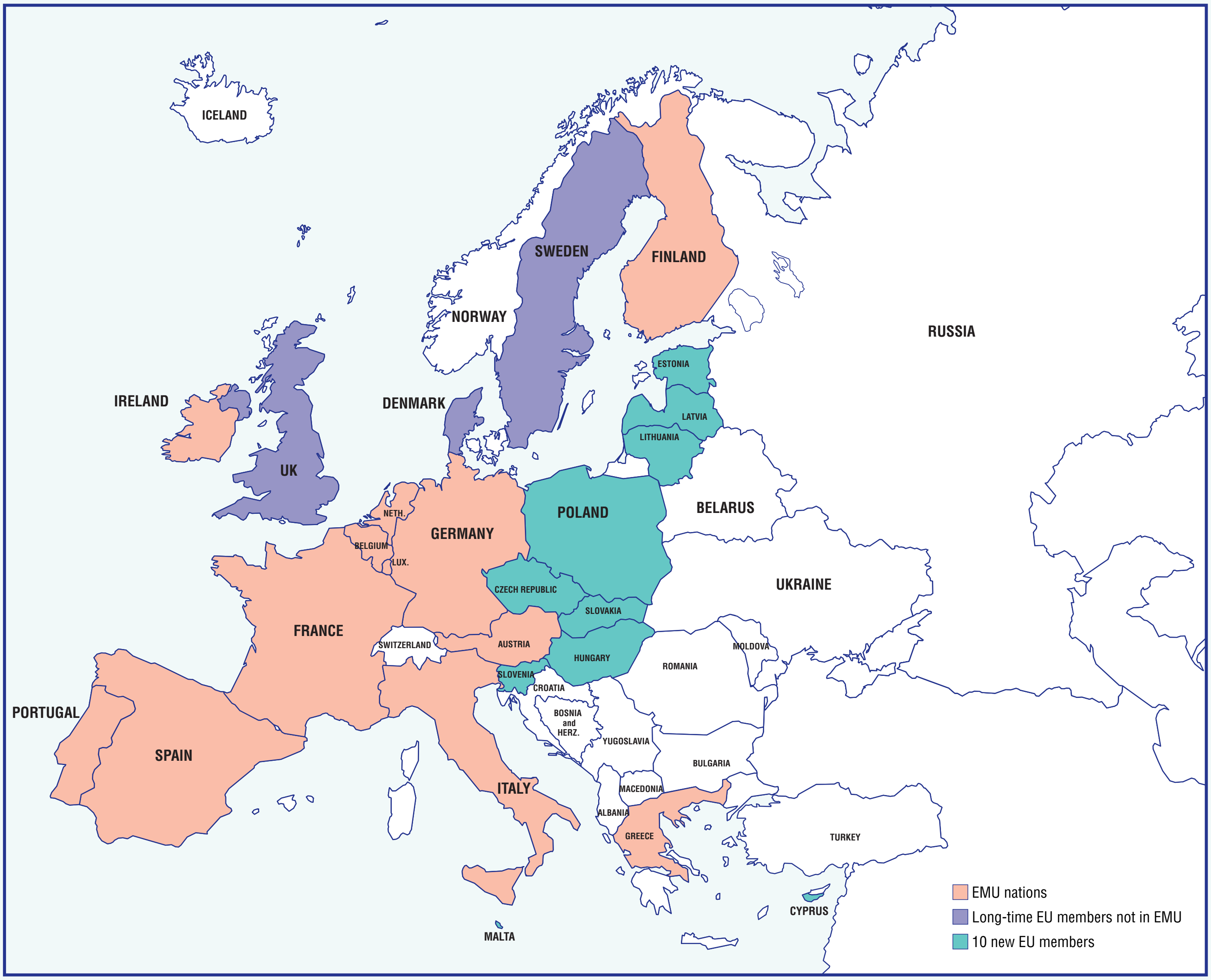
As an EMU member, Ireland can no longer rely on monetary policy to cool inflation, leaving the budget as the primary lever for keeping excess demand from driving up prices. EMU membership requires adherence to the so-called Stability and Growth Pact, which limits governments' ability to run budget deficits. Like several other EU nations, Ireland has run afoul of the pact's guidelines in recent years. The country's expansionary fiscal policy helped stoke the fires under wages and asset prices.

Entering EMU, Portugal received the same credibility boost Ireland did, bringing greater stability and lower interest rates. Consumers' incomes, firms' cash flows and the state's fiscal operations are all in euros, the same currency those agents are borrowing and lending in the domestic and foreign markets.

Operating in euros provides Portugal with certainty in its economic relations with the rest of the world. With a national currency, jitters about trade imbalances and central bank reserves fed into exchange rate and interest rate panics, causing problems for Portugal's solvent as well as its insolvent. When it comes to creditworthiness, families, firms and government entities are now judged on their own merits, not by conjectures about the national economy. By giving Portuguese companies greater access to international finance and removing exchange rate risks, the single currency created a surge in overseas investment for a nation once isolated economically.

Fundamental to EMU's success in Portugal has been widespread recognition that long-term changes have been made to the economy. This allowed nominal and real interest rates to fall to the EU average. Families and firms could then borrow more without assuming higher debt service. Households' total

Europe 5 Years Into Monetary Union



credit increased from 46.4 percent of GDP in 1996 to 103.7 percent in 2002. At the same time, borrowing by nonfinancial companies rose from 53.7 percent to 92.1 percent of GDP.

As in Ireland, EMU has raised questions about whether falling interest rates, coupled with budget deficits, have produced too much of a good thing. The signs are there—current account deficits, inflation above the EU average, rising asset prices. A more benign view of these developments is that they reflect market-led responses to the transition to EMU that will unwind without causing many problems.

On the Sidelines: Great Britain and Sweden

While Ireland and Portugal joined EMU, two other nations on Europe's fringes geographically opted out, retaining control of their own monetary policies and keeping their own currencies.

Some British euroskeptics believe the United Kingdom will never join the euro zone. Indeed, the UK Independence Party, which favors withdrawal from the EU, gained ground in recent European Parliament elections.

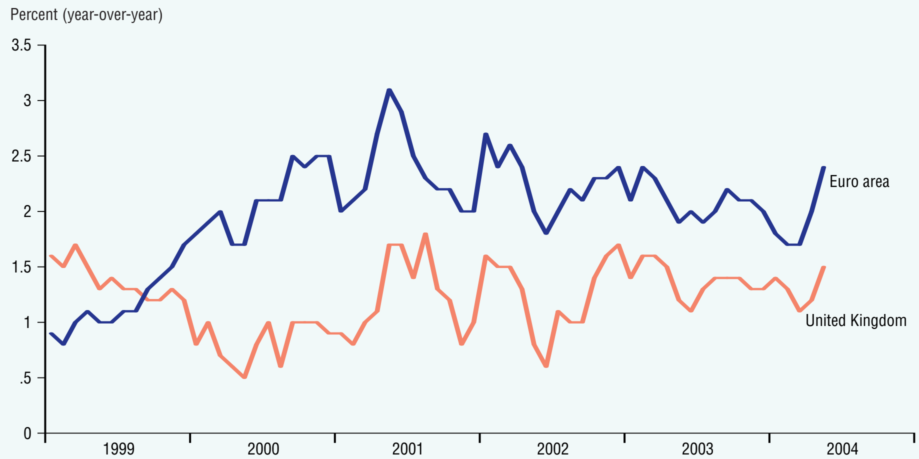
In its latest assessment of EMU membership, issued in 2003, the British government notes potential advances in growth, trade and incoming investment, as well as a boost for financial services. But the government continues to worry that UK business cycles aren't in sync with the EU's and that EMU rules lack the flexibility needed to respond to the British economy's ups and downs.

While the EMU nations spent the 1990s preparing for the euro, the UK enjoyed a decade of steady growth with tame inflation. Britain's economy continued to outperform the euro area's during the past five years, as Charts 3 and 4 show.

Economic models suggested that signing onto EMU would have made for a far bumpier ride, three-quarters of it

Chart 3

Inflation in the United Kingdom and Euro Area



SOURCE: Statistical Office of the European Communities.

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tied to the exchange rate of the euro and dollar. The last thing many skeptics wanted was to risk the UK's stability. Joining the euro zone, moreover, would not produce other tangible gains. Lower transaction costs for changing money would be offset by the cost of switching from pounds to euros. Fluctuating exchange rates would remain a risk, given Britain's trade patterns. The country divvies up its trade between the blocs dominated by the euro and the dollar. Joining EMU would eliminate risks with the former but increase them against the latter.

Whereas Britain long opposed entering EMU, Sweden's political elite wanted the country to join. Swedish voters rejected the idea in a September 2003 referendum, unpersuaded that potential gains from adopting the euro would outweigh the loss of independence in monetary policy and the risk of economic shocks. Charts 5 and 6 compare Sweden's inflation and growth with those of the euro area as a whole.

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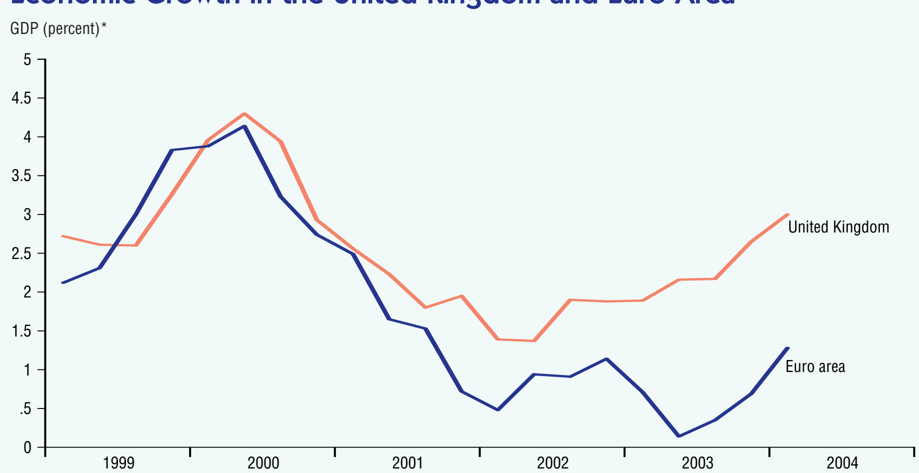
Chart 4

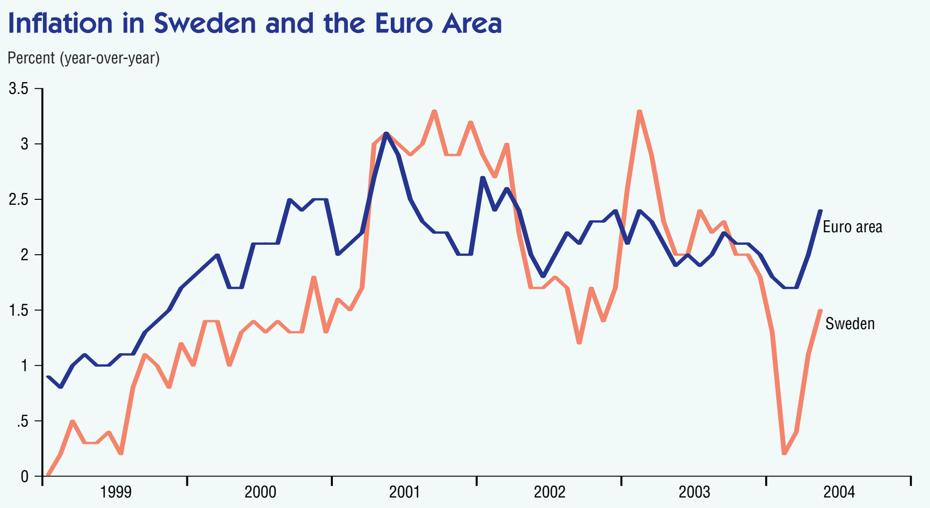
Economic Growth in the United Kingdom and Euro Area



*Seasonally adjusted, annualized rate.

SOURCE: Statistical Office of the European Communities.

Chart 5



SOURCE: Statistical Office of the European Communities.

The evidence suggests that joining the euro zone might increase trade by 10 to 15 percent. Gains from lower transactions costs are small. Like Britain, Sweden would face exchange rate risks even inside EMU because of its significant trade with countries outside the euro zone. Joining EMU might produce lower inflation, cheaper credit and stable exchange rates, but they can also be achieved with sound domestic policies.

The big risk in joining EMU lies in vulnerability to Europe-wide policies that aren't appropriate for an individual country's economic conditions. Countries with higher inflation need tighter money—but may get the opposite. Countries trying to climb out of sluggish spots need looser policies—but may get the opposite. If Sweden's economy were to fall out of step with the rest of Europe, the common interest and exchange rate would have a destabilizing effect.

Outside EMU, Sweden can use both monetary and fiscal policies to manage its economy. Inside, fiscal policy becomes the primary lever, and government spending isn't always a good substitute for monetary policy.

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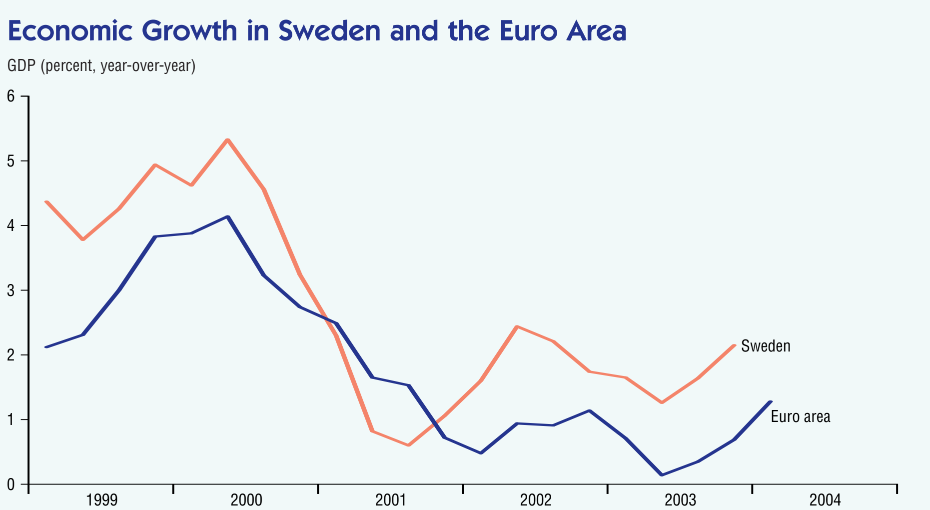
Chart 6



SOURCE: Statistical Office of the European Communities.

Table 1

European Union Newcomers Will Have to Work for EMU Entry

	Inflation rate (May 2004)	Long-term interest rate (2004:1)	Fiscal deficit (2002)	Public debt (2002)
Cyprus	1.2%	4.71%	**–3.5%**	58.6%
Czech Republic	2.6	4.24	**–3.9**	27.1
Estonia	**3.7**	4.94	1.3	5.8
Hungary	**7.8**	**7.17**	**–9.2**	56.3
Latvia	**6.1**	4.95	–2.0	22.7
Lithuania	1.0	5.16	–3.0	15.2
Malta	2.4	4.91	**–6.2**	**66.4**
Poland	**3.5**	5.96	**–4.1**	41.8
Slovakia	**8.2**	5.01	**–7.2**	42.6
Slovenia	**3.9**	6.14	**–2.6**	28.3
Target	2.7	6.27	–3.0	60

NOTES: Boldface numbers indicate areas in which countries do not meet the target. Fiscal deficit and public debt are as a percentage of GDP. Inflation and interest rate targets change with underlying economic conditions; those shown are for early 2004.

SOURCES: Statistical Office of the European Communities; Malta National Statistics Office.

Knocking on the Door: New EU Members

The EU's recent expansion brought into the fold 10 countries, most of which were part of the communist bloc only 13 or 14 years ago. So even before they've grown comfortable with capitalism, they face another round of restructuring tied to joining EMU.

These newcomers can't opt out of monetary union, so key issues boil down to timing and preparation. Some economists recommend entry into the euro zone as soon as possible to capture the benefits of price stability and lower interest rates. The newcomers are already integrated with the rest of Europe, making them vulnerable to the shocks and credibility premiums that once bedeviled two other small nations, Ireland and Portugal. Euro enthusiasts see national currencies as a luxury these 10 countries can no longer afford.

Joining will depend on meeting EMU entry criteria. As Table 1 shows, all the newcomers have work to do. The biggest hurdles are getting inflation to a target within 1.5 percentage points of the EU's three best performers and reducing fiscal deficits to 3 percent of GDP. Only Hungary fails to meet the standard for long-term interest rates, a target that is within 2 percentage points of the EU members with the lowest inflation. Only Malta has a public debt above the threshold of 60 percent of GDP.

Rigid adherence to the targets may be unwise when it comes to the 10 newcomers. These standards were developed for established market economies, not countries in transition. Flexibility aimed at hastening entry could spare these countries some hard times. The EU might, for example, alter the target inflation rate from the average of the three best performers to the euro zone average. In any case, experience suggests prices stabilize quickly after entry. Getting the fiscal house in order should be the primary concern, and all the newcomers, save the Czech Republic, expect to do that by next year.

The goal is to bring the 10 newcomers into EMU between 2007 and 2010, but no dates have been fixed. As early as 2005, each country will enter a transitional phase in which the national currency is fixed against the euro. A minimum of two years later, the countries will fully adopt the euro. The strategies of the newly admitted countries put Estonia, Latvia, Lithuania and Slovenia into transition in 2007. Poland, Hungary and Slovakia may enter in 2008 or 2009; the Czech Republic may be ready in 2009 or 2010.

Incorporation of the new states will be among the important tasks facing EMU now that it has established the euro zone. In its first five years, EMU did not fall prey to pessimists' worst fears, and it kept inflation under wraps. Ireland and Portugal did benefit from lower interest rates, but EMU failed to ignite growth in the larger member nations. Economic disparities and impediments still plague the EU, and the structural reforms to address them haven't been achieved.

Perhaps most important, the EU will continue to wrestle with the inherent contradictions between a centralized monetary policy and decentralized fiscal policies. Before the 2001 recession, nations did not get their budgets into cyclical balance, and they ran into trouble when times turned tougher. Germany's and France's deficits now exceed the limit of 3 percent of GDP. The deficits aren't as large as in previous downturns, but EMU's only leverage under the Stability and Growth Pact amounts to peer pressure, which hasn't worked. The real danger of deficits lies in overheating the economy, creating bubbles that will cause job losses and falling asset prices when they burst.

Past attempts at currency unions eventually faltered because of their failure to enforce fiscal discipline. How EMU handles fiscal policy might be just as important as how it directs the continent's monetary affairs.

—Richard Alm

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Notes

[1] "Five Years of the Euro: Successes and New Challenges" was held May 14–16, 2004. The conference was organized by the Dallas Fed and the University of Texas at Austin and sponsored by the Commission of the European Communities. Information on participants and their presentations can be found at www.dallasfed.org/news/research/2004/04euro.html.