Why the Euro is Essential to the Future of Europe: Part I – It's Not the Euro, Stupid!

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Theme: A sense of haplessness, together with a short-sighted desire to find a quick fix for economic problems, has prompted a growing number of European policy makers and commentators to focus their fear and confusion on a new target: the euro.

Summary: Recently, high-level officials in important European countries have begun to suggest that their economies should withdraw from the Economic and Monetary Union (EMU) and re-establish their national currencies. Unfortunately, these suggestions betray such a profound ignorance of the nature and role of the euro within the context of the European project, and of the structural realities of the world economy, that they are breathtakingly irresponsible.

Most European countries lost effective macroeconomic sovereignty long ago –long before the euro came into existence–. It therefore makes no sense to entertain fantasies that born-again national currencies in Europe could resolve economic problems through the recovery of a national macroeconomic sovereignty which, in real effective terms, was lost long ago.

The single currency and the ECB's common monetary policy are not part of Europe's problem, but rather an essential part of any answer to Europe's burgeoning economic challenges. However, the euro and the ECB are not sufficient by themselves to make the euro zone economy operate efficiently, nor are they sufficient, by themselves, to recapture for Europe a degree of collective macroeconomic policy sovereignty. As it now stands, EMU is also incapable of contributing to higher productivity growth and saving the European welfare state from complete destruction.

For the euro to successfully achieve all these goals, other supplemental policy reforms must be undertaken rapidly, before it is too late. Unfortunately, the most important of these policy reforms –labour market reform and more effective European economic governance and fiscal policy coordination– face stiff obstacles to their realisation.

Analysis: Introduction

The victory of the No vote on the EU Constitution in France and the Netherlands unleashed fresh waves of confusion and pessimism over the nature and direction of the European project. Not only is the Constitution's fate now uncertain, anxiety over Europe's economy is also beginning to reach fever pitch. Blame is being cast by nearly everyone at whatever target is at hand, and the scenario is becoming increasingly dangerous. A sense of haplessness, together with a politically-motivated desire to find a quick fix, has prompted a growing number of policy makers and commentators to focus their fear and confusion on a new target: the euro.

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In recent days there have been reports that high-level officials in important European countries have begun to suggest that their economies withdraw from the Economic and Monetary Union (EMU) and re-establish their national currencies. Roberto Maroni, the Italian Welfare Minister and a political ally of Berlusconi, has even called for a referendum on returning to the lira. Presumably, such a move is seen by some as a way to regain national economic sovereignty and put an end to their economies' stagnation and high unemployment. For reasons inexplicable to such people, the ECB simply will not respond appropriately, while the Stability and Growth Pact appears to them as an unreasonable restriction upon the use of fiscal policy to stimulate growth. According to such logic, renewed growth could be achieved either by engineering a depreciation of born-again national currencies to stimulate external demand, or by easing reborn national monetary policy to boost domestic demand. Unfortunately, these suggestions betray a profound ignorance of the nature and role of the euro within the context of the European project, and of the structural realities of the world economy.

Too much is at stake to allow such short-sighted visions to feed upon the growing level of fear and confusion now gripping populations across Europe.[1] Fortunately, European ministers, from Hans Eichel to Pedro Solbes, have calmly pointed out that there is no turning back on the euro –no turning back, that is, without precipitating severe financial crisis and the probable death of the European project–. Nevertheless, people are scared and confused. Therefore, we must go back to the basics of the euro and explain why it was created, what it is supposed to achieve for Europe and its peoples (and what it is not supposed to achieve), and what still must be done –and by whom– to allow the euro to truly fulfil its purpose. If we do not do this, and simply watch on as irrational and centrifugal forces tear away at the unity and coherence of the Euro Zone, we will all pay a price far more taxing than that which many Europeans misguidedly claim to be paying now as a result of adopting the euro in the first place. Whether we like it or not, we will ultimately find that if the euro is allowed to fall apart, a time will come –but only after experiencing much more economic pain and losing precious time– when we arrive at the conclusion that we need and want the euro again. But, by then, it might be too late.

The long and the short of it is simply that most European countries lost effective macroeconomic sovereignty long ago –long before the euro came into existence–. As such, it makes no sense at all to harbour fantasies that born-again national currencies in Europe could alone deal with economic problems through the recovery of a national macroeconomic sovereignty which, in real effective terms, has long been lost forever.

Back to Euro Basics

First, we must be clear in remembering that the euro was conceived to lend a degree of collective macroeconomic stability, flexibility (what one might call macroeconomic 'sovereignty') and potential growth to the economies of Europe that they would otherwise never be able to achieve on their own. Secondly, the euro also offered the possibility of maximising the benefits of Europe's single market by improving certain aspects of microeconomic efficiency: notably by raising the transparency (and thus the 'symmetry') of price information across the continent and eliminating a range of unnecessary transactions costs (like exchange rate commissions). The combined effect would be to allow the European economy to grow faster over time and to respond more efficiently and less painfully to international shocks in an increasingly globalised world economy. Finally, a possible indirect, but politically significant, effect of establishing the euro would be to create a new international currency with sufficient weight and attraction to eventually

garner for Europe some of the economic advantages and international political influence which the US has enjoyed *en solitaire* since World War II as a result of the dollar's central position in an international economy with no serious currency rivals.

To do this, however, would require individual European countries to cede their domestic sovereignty over national macroeconomic policy –that is to say, their governments' independent discretional capacity to *attempt* to improve the evolution of the national economy through the use of fiscal and monetary policy– and fuse it with that of their partners in European-wide policy-making institutions.[2] Furthermore, in order to consolidate these benefits, and to safeguard against internal strains that might become politically unsustainable in particular countries at particular moments, European economic agents –both capital and labour– would need to become both more mobile geographically (across internal national borders) and flexible (with respect to national factor market rigidities).

It is also important to remember that the introduction of the euro and the achievement of its objectives have never implied, by themselves, the necessity of reducing or eliminating the welfare state aspects of the European economic model. On the contrary, if the euro could reach its potential, and European product and factor markets could be made more flexible and efficient in order to facilitate this goal, the euro would actually make any future requirements to reform the welfare state that less severe and easier to achieve. Put another way, a *laissez faire* economic model (read: the Anglo-Saxon model) was never a prerequisite for a successful euro –although at least some modifications must be made to the excesses of the European model as it currently exists–.[3]

Recapturing the Macroeconomic Sovereignty that Europe Lost Long Ago
The most important conclusion to understand is that more real macroeconomic policy independence can be secured by a European economy with a single continental currency, a unified monetary policy and at least a set of highly coordinated national fiscal policies than any of Europe's individual member economies could achieve by operating their own national economic policymaking machineries. To grasp the reason why this is so requires not only a textbook comprehension of international economics (essential nonetheless), but also an understanding as to why the actual structure and characteristics of the international economy have an inconvenient tendency to produce results which typically diverge from those projected in the textbooks.

The concepts necessary for grasping this terrain include: (1) the nature of the chosen exchange rate regime; (2) the implications of the chosen exchange rate regime for the counter-cyclical effectiveness of discretional *national* fiscal and monetary policy; (3) the implications of economic size for the choice of exchange rate regime; and (4) the implications that (1), (2) and (3) have on the pragmatic reality of national macroeconomic 'sovereignty' –that is to say, under what circumstances is national macroeconomic policy effective, and therefore truly 'sovereign', and under what circumstances is the notion of such national economic sovereignty a dangerous delusion?–. Our contention is that, by the time the euro was adopted, individual European economies had already lost all, or much of, their real discretional macroeconomic policy autonomy. Of course, this was one of the key reasons why European leaders pushed to create the euro.

Fixed Exchange Rates and Monetary Policy

The most basic textbook cliché will tell us that under a fixed exchange rate regime –in which central banks constantly intervene in the currency market in order to maintain an established exchange rate target (or ‘parity’)– national economic policymakers must surrender their discretional ‘sovereignty’ over monetary policy. This is because monetary policy must keep its focus on maintaining the stability of the exchange rate –tightening policy and raising rates to attract short-term capital inflows and choke off imports to support a weakening currency, or loosening policy and lowering rates to stimulate capital outflows and boost imports to limit the strength of an appreciating currency–. Another way of expressing the reality of this loss of discretional monetary sovereignty would be to point out that, under fixed rates, over time monetary policy must produce roughly the same inflation rate as the currency or currencies to which a country’s currency is fixed, so as to maintain the economy’s level of competitiveness relative to that of its trading partners (ie, its ‘real effective exchange rate’). Only then might a country avoid the appearance of significant external deficits or surpluses which would cause the exchange rate to deviate from its fixed target.[4]

This means that monetary policy cannot be effectively used in a discretionary way to either stimulate domestic growth or limit domestic price inflation –independently of the exchange rate–. In fact, maintaining a fixed (or stable) exchange rate may require monetary policy to provoke a slowdown or deepen a recession to support an exchange rate, or import inflation and stimulate excessive growth to weaken a strengthening currency. Monetary policy cannot both keep the exchange rate fixed and pursue independent anti-cyclical macroeconomic objectives. Indeed, monetary policy may be forced into pro-cyclical behaviour –as in the case of the tight monetary policy in Spain in 1991 and 1992 which aggravated the slowdown and subsequent recession (a pro-cyclical policy that eventually provoked an abandonment of the original ERM parity and the first in a series of devaluations)–. The important thing to remember about monetary policy sovereignty is that it means the central bank has the power to avoid excessively low growth AND the power to restrain excessive inflation. If at any given time monetary policy cannot achieve either of these objectives, then it is not truly sovereign.

Fixed Exchange Rates and Fiscal Policy

On the other hand, the text book would also tell us that under a fixed exchange rate regime national economic policymakers continue to have at least limited sovereignty over fiscal policy, which in such circumstances does retain its discretional capacity to exert an independent impact on domestic growth and inflation. When the economy is operating below the level of full-employment potential output –exhibiting unnecessarily high levels of unemployment as proof–, expansive fiscal policy (higher spending or lower taxes) can stimulate growth in the short-run and reduce unemployment. When the economy is operating at, or near, full-employment potential output –with accelerating inflationary pressures providing the proof–, restrictive fiscal policy (lower spending or higher taxes) can contain overheating and limit excessive inflation.

This was the basic Keynesian scenario which potentially could have applied, more or less seamlessly, in Europe during the first phase of the post-war period. Nevertheless, while this conceptual framework provided the basic orientation for macroeconomic policy thinking in a post-war European world characterised by the Bretton Woods fixed exchange rate regime, a number of economic realities began to change over time which modified – and eventually neutered– the discretional sovereign nature of European national fiscal policies. Here we must move into the terrain of real world policy tendencies and real world

structural realities which force us to look beyond conventional text book dynamics –something which real world lay populations wrongly insist that economists rarely do–.

Fixed Exchange Rates in an Imperfect and Changing World

First, over the course of time, European policy makers slowly lost control over fiscal policy. Partly as a result of the necessity to experience a secular increase in government spending to create the welfare state, but also partly as a result of a lack of political discipline –induced by electoral politics– which allowed deficits to continue to widen even during times of strong economic growth, European economies began to build up significant quantities of public debt.[5] Initially, this lack of fiscal discipline did not impose a significantly high price on European economies, at least not until one of the underlying assumptions of the basic Keynesian scenario began to give way. The basic Keynesian model, in which fiscal policy could be used as a primary anti-cyclical tool, assumed not only fixed exchange rates but also closed capital markets, or at least highly regulated international capital markets. As soon as financial capital became free to come and go –as occurred, first gradually during the 1960s and 1970s, but then more clearly during the 1980s and 1990s– an 'external' market discipline could potentially be imposed on national fiscal policy. Investor sentiment with respect to the health and dynamism of the national economy –and with respect to the sustainability of the public debt that international investors might choose to finance– would become an increasingly influential factor on interest rates in the domestic economy and, by extension, on the costs of generating and servicing public debt.

In such a new scenario, not only would the discretional sovereignty of national fiscal policy to stimulate growth be partially limited by the level of potential output (and the appearance of inflationary pressures), but also by the perception of investors, now increasingly free to operate internationally and to shop for fiscal prudence, rewarding anti-cyclical fiscal competence and discipline with lower rates, and punishing fiscal incompetence and imprudence with higher rates. In an extreme case of completely open capital markets and a high level of previously generated public debt, 'the tyranny of the bond markets' can easily impose itself with a vengeance. Such were the characteristics of the European scenario during the heyday of the European Exchange Rate Mechanism (ERM) and the early phases of Economic and Monetary Union (EMU).

When, for example, Spain began to experience the monetary tightening induced by the interaction of the ERM with German reunification, Spanish fiscal policy began to loosen, in part to offset the contractionary effects imposed by the overriding goal of exchange rate stability. However, during 1991 and 1992 Spain was also completing its integration into the European capital markets and dismantling its last capital controls. Given the high levels of fiscal deficits being registered in Spain in the early 1990s, together with the rapid build-up in public debt, investors began to dump the peseta in anticipation of a decision by the Spanish authorities to forgo fiscal discipline in an attempt to fight high unemployment –and to appease a labour constituency incensed with the liberalising reforms required for European integration– and to eventually abandon the ERM exchange rate peg.[6] The forced devaluations of the peseta in 1992 and 1993 provided palpable evidence that, under fixed rates, with open capital markets and the market perception of an unsustainable build-up of debt, Spain had lost any real discretional fiscal policy autonomy. While Spain could carry on under the *delusion* of independent fiscal policy sovereignty, to do so while maintaining an EMU-inspired fixed exchange rate peg –even at a lower rate– would only induce more tyrannical market discipline, higher interest rates, higher unemployment and an economic

stagnation which could threaten to become chronic and embedded. That Finance Minister Pedro Solbes quickly reversed the fiscal policy course in 1994 and 1995 was a testimony to the fortunate fact that clarity with respect to national interests and the illusory nature of national fiscal policy sovereignty –crystallised by the intense economic pain of the recession– had been able to return to dominate Spanish policy.[7]

Of course, increasingly widespread recognition of this changing structural reality in the world economy –evident to many Europeans as early as the Bretton Woods period in the late 1960s– and its implication for the deterioration of national fiscal policy sovereignty –together with the complete lack of monetary sovereignty under fixed rates– was a significant aspect of the original inspiration to begin to move towards the creation of the euro in the first place. **Therefore, Lesson Number One is that with fixed exchange rates an economy has no monetary sovereignty (the textbook explanation) and, over time, due to typical policy excesses and changes in the realities of the world economy, it eventually loses any effective discretional fiscal policy autonomy (the real world addendum to the textbook).**

This lesson is particularly relevant to European economic reality under EMU –the ultimate limit in intra-European fixed exchange rate regimes–. With national monetary sovereignty now gone –fused into the collective European sovereignty of the ECB– the textbook suggests that there does remain at least the potential for discretional fiscal policy autonomy to be used at the national level to ease cyclical divergences between Euro Zone economies and to offset the internal impact of so-called 'asymmetric shocks'. However, with open capital markets and a nearly universal situation of relatively high public debt, this national discretional fiscal policy sovereignty is at best illusory because the international bond markets can still impose their tyranny through higher interest rates. This reality provided the point of departure for the attempt to adopt some form of European fiscal policy rules and some mechanism for fiscal policy coordination. The result was the adoption of the Stability and Growth Pact, however imperfect it has turned out to be. The important point here is that the impulse to establish something like the Stability and Growth Pact was not itself misguided, only that the Stability and Growth Pact as it exists now, even with the recent modifications, remains an incomplete mechanism and insufficient to achieve effective fiscal policy coordination in the Euro Zone. (For related analysis of the Stability and Growth Pact, see "The Future of the Stability and Growth Pact", Paul Isbell, 18/12/2002, http://www.realinstitutoelcano.org/analisis/178.asp, and "Europe's Difficult Moment, Spain's Tough Position", Paul Isbell, 30/9/2003, www.realinstitutoelcano.org/analisis/341.asp)

Much of the current confusion of recent years, however, stems from the paradoxical fact that the situation today is nearly the opposite of what was feared during the debates over the euro and the Maastricht Convergence Criteria. Back then, it was supposed that the loss of national monetary sovereignty required by the euro would potentially place certain countries with a tendency towards high unemployment or other economic weaknesses (like the so-called PIGS: Portugal, Italy, Greece and Spain) in a difficult position. If economic growth were to weaken more in these countries than in the dominant economies like Germany and France (the general, if erroneous, assumption at the time), the ECB would theoretically keep monetary policy in line with the continent-wide inflation rate, leaving the more vulnerable peripheral economies with little to do, short of increased deficit spending, to fight against recession and still higher unemployment.

However, given the market perception that the PIGS were precisely those economies with historic tendencies towards excessive deficits, the Stability and Growth Pact (an indefinite extension of the Maastricht deficit criterion) was created to limit the expected fiscal imprudence of such countries and the resulting negative market effects on interest rates across the Euro Zone –even in countries exhibiting fiscal prudence–. This, of course, placed a limit on the last remaining autonomous macroeconomic policy tool available to national governments. The irony of all of this, however, has been that since the inception of the euro –and particularly since the last world slowdown– growth and unemployment have fared far worse in the core economies of Europe than on the periphery, while the Stability and Growth Pact's deficit limit has been breached even more frequently by these core European economies. It is now some of these core economies where anti-euro sentiment and pressures have become the most noticeable.[8]

An even greater irony has been that Spain has actually experienced a 'positive asymmetric shock' –the opposite of what many imagined would happen–. Given Spain's higher inflation rate, relative to that in the core European economies like Germany and France, real interest rates have been significantly lower in Spain than in the rest of Europe for years. This has become particularly noticeable since the ECB began to lower rates in 2001. Now real short term interest rates in Spain are below negative one percent. This has meant that since the inception of the euro –when Spain lost its formal monetary policy sovereignty– but particularly since the 2001 slowdown- the monetary policy imposed on Spain from the ECB has been excessively loose, feeding consumption, borrowing and growth. This positive asymmetric shock –the opposite of what Germany has been experiencing– has not only accounted for the positive growth differential which Spain has registered with respect to the Euro Zone average, but also for the steady build-up of Spanish macroeconomic disequilibria, including the increase in household debt, the potential bubble in the housing market, and the widening external deficit. For better or for worse, Spain chose not to offset this monetary looseness by using its still autonomous tool of even tighter fiscal policy (the Stability and Growth Pact places a much harder limit on excessive deficits than it does on the generation of fiscal surpluses). For better or for worse, Spain now faces a potential correction stemming from the future adjustment of its imbalances. When this will come, nobody knows for sure, but it is unlikely that it might be avoided when and if ECB rates eventually rise again sometime in the future.

Flexible Exchange Rates and Macroeconomic Policy Sovereignty

Under a flexible exchange rate regime, -presumably what a country like Italy would return to after leaving the euro- the textbook would tell us that a national economy regains monetary policy autonomy, but loses fiscal policy sovereignty. This is because monetary policy is no longer required to hold vigil over the exchange rate, which instead fluctuates freely according to supply and demand in the currency market. The domestic interest rate policy of the central bank can focus on managing domestic demand, exerting a countercyclical influence on growth and inflation. Fiscal policy, on the other hand, is increasingly less effective at exerting an independent influence on domestic demand, due to the upward pressure on interest rates generated by the resulting competition with private sector agents for the limited financial resources that the government now needs in order to finance the higher levels of deficit spending implied by a looser fiscal policy. This potentially negative, offsetting impact on growth stemming from the effect of higher interest rates on domestic economic investment and consumption –sometimes called the 'crowding out' effect– is especially restrictive the closer the economy is to potential output and the more inflationary is any particular loosening of fiscal policy.

Yet again, we must move away from the strict textbook interpretation to incorporate real world policy tendencies and real world economic structures. First, even ignoring the historic tendency towards 'political' fiscal expediency and debt build-up, the increasingly competitive nature of national legislatures has slowed down the budgetary process, making fiscal policy an extremely slow and blunt tool for managing the economy in a countercyclical fashion. This is one reason why most contemporary Keynesians have argued that the daily front-line macroeconomic weapon against weak growth and excessive inflation must be monetary policy, wielded by an independent and technocratic central bank. Fiscal policy, given its unwieldiness and impractical nature as an anti-cyclical tool, should focus primarily on generating enough income to finance essential state activities (and possibly on helping cushion internal regional disparities), and should only be used against the cycle in an extreme case of depression when monetary policy loses its bite and begins to push on the proverbial string. While it is true that during the Great Depression most policy makers did not understand that in such extreme circumstances fiscal expansion was probably the only policy that might have ended the depression earlier, today many (particularly on the Left) still do not understand that Keynes advocated active fiscal expansion in the 1930s not because such a policy is always the optimal one for stimulating growth, but only because by the early 1930s the situation was already too far gone to be remedied by any other policy option.

Second, the crowding out effect mentioned above has tended to be deactivated by the opening of capital markets, which implies a potentially much larger pool of finance from which government deficits can be financed. In reality, the movement from closed national capital markets to regulated capital markets, and then to totally open capital markets, frees both domestic investors and the domestic government from the possibility of being held hostage by the other.

On the one hand, the limit imposed by potential output on national deficit spending through the phenomenon of 'crowding out' is considerably weakened with open capital markets. The government now faces a much larger pool of world savings to draw upon when going to the bond market to finance deficit spending. If the economy in question possesses financial markets which are sufficiently deep and broad, then the government's potential to use fiscal policy as an independent discretional policy tool might be maintained, particularly if it has a reputation in the markets for an astute use of fiscal policy (meaning one that typically has not contributed to excessive inflationary pressures). This might be the case of a relatively large and dynamic economy which has captured the faith of the markets (eg, the United States today).

On the other hand, the limit facing domestic investors in closed, or regulated, capital markets is also loosened. Before the complete opening of capital markets, domestic investors had only limited capacity to channel domestic savings abroad. In this situation, they were more or less held captive to domestic fiscal policy. While they could eschew the domestic bond market for other domestic financial markets, like the stock market, their capacity to maximise their returns without investing in domestic government paper was clearly limited by certain domestic and foreign regulations on capital flows. With open capital markets, however, such domestic investors can now join the army of international investors searching for the perceived highest and safest returns globally. This capacity allows domestic investors to leverage upon the strength of the international investment community to impose discipline on their domestic government's fiscal policy, particularly

when the investment community perceives a history of fiscal abuse and the potential for it to quickly re-emerge.

This makes the history of deficit spending and debt build-up in an individual national economy –and more importantly, the perceptions of the market in this regard, particularly with respect to their possible re-emergence– extremely important in determining the likely degree of discretional fiscal policy autonomy that a national economy might be able to wield under a regime of flexible exchange rates with a national currency. The case of Italy is interesting in this regard, particularly given the recent suggestions that Italy might withdraw from the EMU.

Given Italian debt levels, and the market memory of the 'fudging' of the Maastricht Criteria to allow Italy into the euro as a founding member (ie, allowing Italy to impose an extraordinary 'euro tax' in order to meet the 3% deficit threshold in 1997), market discipline would likely be re-imposed on any born-again lira, effectively stripping Italy of any perceived fiscal policy autonomy.[9] The most likely result would be a return of inflation, high interest rates and economic stagnation, particularly should the international economic environment continue to be characterised by higher and higher oil prices.[10] Of course, one might argue that perhaps this time around Italy would exhibit more prudent fiscal policy than it has historically. If this were to be the case, and markets were to grant Italy even more fiscal credence than we could reasonably expect, then Italy might be able to rely on a flexible exchange rate and discretional anti-cyclical monetary policy to help stimulate and rein in domestic demand when appropriate.

But just as we have demonstrated above that fiscal policy sovereignty under fixed exchange rates eventually has turned out to be a mirage, given changes in the structure and behaviour of the world economy, a national currency (like a born-again lira) under flexible exchange rates will also discover that even its supposed discretional monetary policy sovereignty is also highly limited and extremely complicated by the national economy's insertion in the international marketplace for goods and capital. Unlike the case of Japan, the UK, and the US (three of the largest economies in the world), most countries are highly exposed to international trade, measured as a percentage of national GDP. A flexible exchange rate imposes very little domestic costs on the US or Japan (in terms of domestic price volatility or swings in the impact of external demand on GDP growth –both of which would complicate the execution of monetary policy–) because imports or exports as a percentage of GDP tend to be 15% or below, given the enormous size of the internal markets in these countries. However, across Europe –indeed, across most of the rest of the world– exports or imports as a percentage of national GDPs tend to be well over 30% (and sometimes much higher). Therefore, a depreciation of a national European currency could be expected to 'import' at least twice as much inflationary pressure (via higher domestic currency-invoiced import prices) as the equivalent depreciation of the US dollar.

This difference in vulnerability to the volatility of the exchange rate between the US and individual European economies tends to be even more pronounced given that the large, open and dynamic market of the US tends to be perceived as a priority for world exporters (particularly in the absence of an efficient, unified single European market), inducing them to absorb much of the effects of a weakening dollar in the form of lower profit margins –instead of risking the loss of US market share by passing on the negative effects of a weaker dollar on export income to US consumers in the form of higher import prices–. In other words, the so-called 'pass-through' to domestic prices of the dollar's exchange rate

fluctuations tends to be lower than for individual European economies operating with their own national currencies.[11] This relative vulnerability would be particularly pronounced in individual European countries lacking market credibility in the realms of inflation and deficit control.[12]

This means that discretional monetary policy would be more complicated for individual European economies than for the US's Federal Reserve, simply because the US economy is structurally the largest in the world, while even the larger European economies are dwarfed in size by the US. As a result, in a world with US predominance –but without a sufficiently large and efficient EMU– money supply growth and interest rates would tend (and in the pre-EMU past have tended) to be more volatile for individual European countries than for the US. As a result, individual European central banks would be handcuffed to a very large degree relative to their colleagues at the US Fed. This heightened impact of exchange rate volatility, under open capital markets, on the domestic level of output and prices, not only makes effective monetary policy all the more challenging for individual countries, it also makes individual European countries –particularly those whose reputation for price stability and fiscal orthodoxy remain under question– vulnerable to financial market and exchange rate crises, like those of the emerging markets.[13]

Lesson Number Two, therefore, is that for most economies –not large and developed enough to dominate the world economy as does the US currently– even flexible exchange rates offer only limited and increasingly ineffective macroeconomic policy sovereignty, to say nothing of no real fiscal policy autonomy at all. Furthermore, this lesson has been clear to most relatively small economies, whether developed or developing, for decades –meaning nearly all world economies with the noticeable exceptions of the US, Japan and the UK–. When the supposed macroeconomic policy sovereignty under flexible rates is exposed for what it is –ineffectual and ultimately illusory– and this realisation is stacked up next to the reality of the increased GDP and price volatility implied by flexible rates, it is no wonder that most countries also would prefer some form of stable exchange rates.[14] Indeed most countries have tried to resist the trend towards purely floating exchange rates. European countries have undertaken a decades-long project to ultimately move beyond internal European fixed rates to a currency unification, while developing and emerging economies long held fast to some form of fixed rates –at least until the emerging markets crisis– and even now demonstrate a clear 'fear of floating', adopting a formal regime of flexible rates but continuing to quietly intervene so as to smooth out their exchange rate fluctuations.

If we take to heart both lessons number one and number two, it becomes quite easy to see why Europeans created the euro. It was a response, consistent with the other aspects of European integration, to particular structural trends in the world economy associated with globalisation –namely open capital markets and increasing integration in international goods and services markets–. It was a politically-willed structural change of the European economy designed to create a market and monetary space roughly equivalent to that of the US.

This brings us to **Lesson Number Three: only by creating a continental European economy roughly similar in size and attraction to that of the US, could Europeans regain at least some *collective* macroeconomic policy sovereignty and thus overturn**

the guiding maxim that international financial markets have now come to believe in almost as an article of faith: that the Fed runs the monetary policy of the world.

Conclusion: Talk of withdrawing from the Euro Zone is dangerous and misguided, not only for any individual country considering such a possibility, but also for the rest of the EMU partners that remain within the Zone. Withdrawal from EMU not only implies a likely currency and financial crisis for the country in question (like Italy, for example), but more importantly any return to a national currency offers only the mirage of macroeconomic policy autonomy. As the Euro Zone shrinks in the aftermath of any hypothetical desertions, remaining Euro Zone members would exercise even less autonomy than they now collectively possess. Not even Germany, France or the UK could remain immune, however, to the instability that would result from a crack-up of the euro, even if they remained outside a reduced euro area, and operated their own national flexible exchange rate regimes. Because the bulk of their trade is with current members of the EMU, the resulting exchange rate instability would impose severe complications on the operation of their supposedly autonomous monetary policy, ultimately limiting their growth potential, a situation which would last indefinitely into the future. Nevertheless, if pressure continues to strain the Euro Zone, the stronger and more credible economies might feel at least one incentive to abandon the euro themselves. If Italy and other weak economies like Greece and Portugal were to face crippling euro-denominated debt burdens as a result of the probable depreciations of their born-again currencies, more credible economies would face the prospect of lower euro-denominated debt burdens should their born-again currencies *appreciate* against the euro.

It is clear that the single currency and the ECB's common monetary policy are not part of Europe's problem –as more and more are now attempting to claim– but rather they form an essential part of any answer to Europe's burgeoning economic challenges. However, it is also clear that the euro and the ECB are not sufficient by themselves to make the Euro Zone economy operate efficiently and at its potential, nor are they sufficient to, by themselves, recapture for Europe a degree of collective macroeconomic policy sovereignty. Finally, EMU, as it now stands, is also incapable of contributing to higher productivity growth and saving the European welfare state from complete destruction. For the euro to successfully achieve all these goals, certain other supplemental policy reforms must be undertaken rapidly, before it is too late. Unfortunately, the most important of these policy reforms –labour market reform and more effective European economic governance and fiscal policy coordination– face stiff obstacles to their realisation.

In the end, the political battle lines over these reforms roughly correspond to those that formed during the European Constitutional Convention and in the most recent popular referendums on the Constitution in France and the Netherlands. The role these policy reforms will play in the future success or failure of the euro –and in the future success of Europe as an effective model in the international system– will be dealt with in the forthcoming Part II of this analysis.

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[1] A poll taken in May by the Forsa organisation for *Stern* magazine found that 56% of Germans preferred returning to the Deutsche mark. The danger is that imprudent talk by public officials around Europe might ignite a latent –if profoundly misguided– antagonism towards the euro.

[2] In this paper, the terms macroeconomic sovereignty, macroeconomic independence and macroeconomic autonomy mean the same thing and can be used interchangeably in nearly all cases.
[33] The key features of the European economic model –and those that could be saved in the long run– include national health services, unemployment insurance, national pension plans (even if revised to be capable of surviving European ageing processes), public investment in transport and communications infrastructure, regional redistribution and rural (re)development. Explicit protection of labour, however, should not be considered a key feature of the future revised European model. As we will see below, freer factor (read: labour) and goods markets are a key prerequisite to preserving the European model in the long run.
[4] In the very short run, under fixed exchange rates, it might be possible to avoid changing monetary policy to defend the exchange rate. This would be done by central bank currency intervention and subsequent sterilisation. However, there is a short-term limit to such practices. In the case of defending a weak currency, the limit is set by the quantity of foreign exchange reserves the central bank has at its disposal for currency intervention. In the case of defending against the appreciation of a strengthening currency, the limit is set by the central bank's quantity of domestic paper assets to sell for the purposes of sterilising the inflationary impact of its accumulation of foreign currency reserves. China is a case in point of the latter limit. Efforts to keep the yuan pegged at 8.28 to the dollar require accumulation of dollar reserves and then sterilisation of such currency intervention to avoid importing inflation. But China has been forced to allow some inflationary pressures –either in terms of increased consumer prices or in terms of higher domestic asset prices– thus severely limiting what we would call true monetary sovereignty. Furthermore, even this short-term capacity to keep rates fixed and maintain the previous 'autonomous' trajectory of monetary policy will be eclipsed under open capital markets and potentially large capital flows.
[5] At the time of the Maastricht Treaty, European Union countries tended to exhibit levels of public debt ranging from around 60% of GDP to 120% of GDP –far higher than the levels of Brazil and Argentina during the tumultuous years of 1997-2002–. Today the EU-25 has an overall public debt level of 63.8% of GDP, while the Euro Zone's public debt level is 71.3% of GDP.
[6] By 1993 Spanish unemployment had reached 24%.
[7] Of course, this is not the complete story. Some nuances are called for, so as to avoid the impression that the previous Spanish Finance Minister, Carlos Solchaga, might be cast as an incompetent, held hostage by the special interests of trade unions and their outmoded conceptions of progressive macroeconomic policy, or that his successor, Pedro Solbes, might appear too simplistically as the courageous genius who put fiscal policy back on a disciplined track, thus paving the way for the Partido Popular's triumph in eventually eliminating Spain's historic fiscal deficits. Solchaga faced the difficult challenge of managing economic policy at a time when Spain was simultaneously facing the imperative to begin the privatisation of state firms, integrate into European and global capital markets, incorporate the peseta into the ERM and begin to commit Spain to the exigencies of the coming EMU as imposed in the form of the Maastricht Treaty's Convergence Criteria. As all of this was happening, and while economic growth remained strong, Solchaga faced a potential outright social rebellion led by the trade unions, evident in the calling of the General Strike of December 1988. To handle these social contradictions caused by European integration, Solchaga used the fiscal policy tool. Then, as a world slowdown combined with the macroeconomic pressures produced by German reunification and the requirements of ERM to bring about the early 1990s recession, Solchaga used what he perceived as the last vestiges of fiscal policy autonomy to try to ameliorate the worst of the economic pain. It was a high stakes gamble that in the end did not pay off completely. The only open questions are whether by the early 1990s Spain still had any real discretional fiscal policy autonomy at all, and whether or not the electoral politics of late 1992 and 1993 influenced Spanish fiscal policy. Solbes, on the other hand, did have world recovery working in his favour, at least by 1995, along with a growing consensus in Spain –by then infamously labelled as one of the PIGS (Portugal, Italy, Greece and Spain) by the British financial press– to meet the Maastricht criteria at any cost.
[8] Italy is an interesting case, as it is often included in discussions of the core European economies –given its economic size and weight– but it is also referred to as one of the peripheral PIGS on account of its tendency to fiscal profligacy. While the Stability and Growth Pact was pushed by Germany to contain the potential damage to the euro from fiscal abuses by the PIGS, most of these economies (Italy, Greece and Portugal) have fallen into breach with the Pact only after repeated breaches by the core economies of Germany and France. Spain, on the other hand, has experienced its most disciplined fiscal policy ever during recent years, even while maintaining a growth rate far above the EMU average. Further nuances, however, will be applied to the Spanish case below.
[9] Already the spread between Italian government bonds and the German bund has opened up to around 20 basis points, even with Italy inside the EMU, as Italy's budget deficit continues to widen. While Italy's public debt level has declined recently, it was still above 105% of GDP at the end of 2004, second only to Greece's 110%. Italy's entry into EMU reduced the spread, until recently, between Italian and German bonds

to around 5 basis points, effectively making Italian debt cheaper to finance, allowing Italy some margin to reduce its deficit and buying it time to make other reforms which would strengthen EMU –like labour market reform, among others–. Unfortunately, not much reform has occurred.

[10] Italy –or any other European country that chose to withdrawal from the euro– would also face another potential disaster. A depreciating born-again lira would face a crippling public debt burden, as all Italian public debt is now denominated in euros. Furthermore, any attempt to impose a shift to lira-denomination would more than likely invite the wrath of the markets, effectively isolating Italy from international capital (as in the case of the breakdown of Argentina's peso-dollar 'convertibility').

[11] Some studies show that the creation of the euro lowers the exchange rate pass-through to levels similar to those experienced by the US dollar. See Michael B. Devereux, Charles Engel and Cedric Tille, 'Exchange Rate Pass-Through and the Welfare Effects of the Euro', NBER Working Paper nr. 7382, *http://www.nber.org/papers/W7382*

[12] Indeed, relatively small size combines with lack of market credibility in terms of inflation and deficit control to produce a scenario in which flexible exchange rates produce no monetary sovereignty at all. For a discussion of the impact of the inflationary environment and central bank credibility on reducing the level of exchange rate pass-through levels, see Jeannine Bailliu and Eiji Fujii, 'Exchange Rate Pass-Through and the Inflation Environment in Industrialised Countries: An Empirical Investigation', Bank of Canada Working Paper 2004-21, *http://www.bankofcanada.ca/publications/working.papers/2004/wp04-21.pdf*

[13] Although nearly all of the emerging market crises occurred in the context of an attempt to defend some kind of fixed exchange rate –as in the European cases of Spain, Italy and the UK during the ERM crises of 1992-93- the case of Brazil in 2002 showed that even an economy (larger than most European economies) with a flexible exchange rate can experience the ferocious market discipline of the investor community. Brazil only narrowly escaped a crisis-induced debt default in 2002 and 2003, and probably only because of significant IMF support, the imposition of strict orthodox fiscal and monetary discipline even in the face of recession (ie, a surrendering of fiscal and monetary policy autonomy, at least in the short run), and significant progress towards structural reforms (ie, tax and social security reforms). On the other hand, we can only assume that had Spain not belonged to the EMU, it would have experienced significant pressure from the international capital markets –perhaps even a run on the peseta– during the long build-up and denouement of the Argentine crisis.

[14] The increased exchange rate, GDP, price and interest rate volatility implied by flexible rates for relatively small economies would also likely depress investment levels and lower potential output growth, thus limiting the benefits of a supposedly sovereign monetary policy.