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The euro at ten

Demonstrably durable

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Europe's single currency has been a haven in recent financial storms. But as capital markets become more discriminating, it no longer affords shelter from reform

Alamy

PAUL VOLCKER once likened global capital markets to a vast sea that cannot escape the occasional big storm. Mr Volcker, a former chairman of the Federal Reserve who is now an adviser to Barack Obama, counselled that when the waters got choppy, it was far safer to be on a big ship. A stately liner can sail serenely through turmoil that would capsize even the sturdiest small vessel.

Mr Volcker was speaking a few months after the collapse of the Thai baht set off the Asian financial crisis, and a few months before the launch of the euro, which celebrates its tenth anniversary on January 1st. A decade on, the euro has demonstrated the virtue of size in rough seas. As small economies were tossed by the financial storms that followed the collapse of Lehman Brothers in September, the currencies with global clout, such as the euro and the dollar, were the most stable.

In its first ten years the euro has come through several tests already. Claims that the currency zone would fall apart have proved groundless. Nor is the euro a soft currency, as some had feared. The European Central Bank's (ECB) common monetary policy has drawn on the traditions of its best constituent central bank, the Bundesbank—and has produced an even better record of low inflation.

From the standpoint of economic stability, the euro has been a success. If there is cause for disappointment it is that sound money and the price transparency afforded by a common currency have not fostered faster economic growth. The hope when the euro was launched was that countries stripped of the licence to cheapen their currencies would be forced to compete directly, and that competition would beget more flexible markets and higher productivity. Yet there has been little improvement in the euro area's underlying growth rate in the past ten years. Income per person has remained at around 70% of that in America.

Perhaps the euro has proved too safe a haven. Partly sheltered from the whims of fickle foreign capital,

member states have been under less pressure to shape up. If that is true, the blame may not lie entirely with the single currency. The run-up to currency union and most of the euro's first decade coincided with the Great Moderation, a period of economic stability and low inflation—and hence low interest rates—in the rich world. But investors who once underpriced risk are now charging heavily to bear it, which will affect companies and governments inside the euro's embrace as well as beyond it. As budgetary laxity and weak growth become costlier, reforms are more likely.

The crisis has another legacy: despite the weakness of the dollar in recent weeks, the euro may struggle to challenge the greenback as the world's main reserve currency. Lately, it is true, the euro has gained in value against the dollar—partly because the ECB seems reluctant to follow the Federal Reserve's path to zero interest rates. But the dollar held up better in the eye of the financial storms in October, when investors were most fearful. The American currency still has important advantages over the European newcomer.

Safety in numbers

The advantages of euro membership—and the perils to small European countries of being outside—were plain when the crisis was most severe. Last autumn capital drained from currencies that investors saw as risky. That included the paper of countries, such as Iceland, with bloated financial industries, as well as some eastern European states with current-account deficits, heavy public borrowing or (as in Hungary) a dangerous mix of both.

Euro-area countries with similar faults have been spared the currency crisis that plagued others. Eurocrats are quick to point out that Ireland's guarantee of bank deposits and debt would seem threadbare if it still managed its own currency: investors might have taken fright at the scale of the banking sector compared with GDP. Being part of a big club has made a currency run far less likely (though Ireland's membership of the euro is one reason it became a large financial centre in the first place). Belgium, with its big banks and huge public debt, has benefited from being an insider too. Spain would have struggled to fund its current-account deficit, the world's second-largest, outside the euro.

At the worst point, investors ran from all but four big global currencies: the dollar, the euro, the yen and the yuan. Doubts were even raised (and remain) about the wisdom of holding the British pound and the Swiss franc, which each account for a small share of global foreign-exchange reserves. For some, Britain and Switzerland are Iceland or Ireland writ large, but without Ireland's lifeboat—its membership of a large and liquid currency pool. Both countries have big banking industries with foreign-currency debts.

Leading figures in the European Commission have not been shy to play up the role of the euro as a haven. The commission's president, José Manuel Barroso, said on French radio that "some British politicians have already told me: 'If we had the euro, we would have been better off.'" Mr Barroso also claimed Britain was "closer than ever before" to joining the euro.

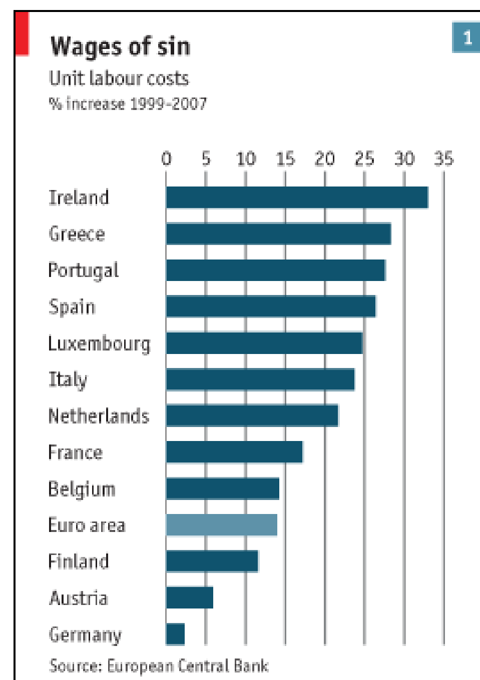
That is an overstatement. There are few signs yet that public or political opinion in Britain has shifted towards signing up to the euro. But the lessons of the crisis have not been lost on many other EU countries that have yet to join. The three Baltic countries have long been keen to adopt the euro, but have fallen foul of the low-inflation criterion for entry. Hungary abandoned its attempt to join when it became clear it would not meet the public-finance criteria for joining, which include a budget deficit below 3% of GDP. It is now said to be redoubling its entry efforts and plans to peg the forint to the euro in preparation. Poland's chilly attitude towards euro membership began to thaw after a €10 billion ($12.5 billion) credit line was offered by the ECB to help stabilise the zloty.

Denmark was forced to raise interest rates in October to keep its currency peg with the euro intact. After two votes against joining the euro, the government is mulling a third referendum. Polls suggest that this time the Danes would vote in favour. Even the sceptical Czechs seem less doubtful about the merits of membership of the currency club.

With its sound public finances, low inflation and stable exchange rate, Denmark would sail through the euro's entrance exam. Sweden could make the cut too, if it was minded to. But the rest would be hard pushed to join soon. It is unlikely that the rules for entry will be relaxed. Just as euro outsiders may now see advantages in being part of a global currency, insiders may take a different lesson from the crisis: that a less exclusive euro club, with laxer rules, would dim the currency's allure.

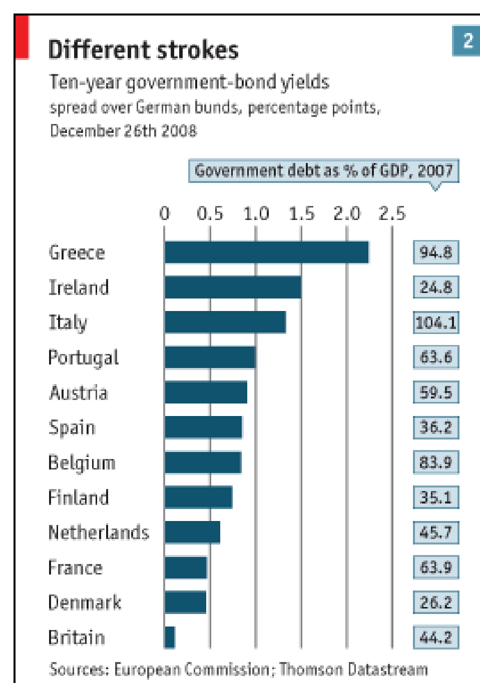
Haven or trap?

In fact, some existing members are struggling with the rigours of a currency union. When a country's wage costs rise too quickly, it can no longer recover lost competitiveness through a lower exchange rate. That is a concern because wages in some euro-area countries look dangerously out of whack. Unit labour costs in the zone rose by 14% between 1999 and 2007, according to a recent article in the ECB's *Monthly Bulletin*. But in Greece, Ireland, Italy, Portugal and Spain, they rose by 10-20 percentage points more (see chart 1). That makes it harder for firms in these countries to compete with rivals in the rest of the euro area.



This group is suffering badly in the downturn. Housing busts in Ireland and Spain have crushed domestic demand. Tax receipts that had been swollen by booms in consumer spending and housing have shrivelled. With unemployment rising too, public finances are worsening. Portugal has struggled to dig itself out of the rut it fell into when its convergence boom turned to bust in 2000. Greece, like Portugal and Spain, has a big current-account deficit. Italy has a smaller trade gap but, like Greece, has huge public debt. As the prospects for economic growth fade, investors are starting to demand far higher interest rates for holding their sovereign debt than for the safest German government bonds (see chart 2).

Although all the euro area's members, including super-competitive Germany, are troubled, recovery is likely to prove most difficult where wage growth has run far ahead of productivity gains. Firms will find it harder to dislodge cheaper imports from their home markets and will struggle to keep up with their euro-area peers abroad. The old remedy of a lower exchange rate is no longer available. For that reason "it is far from self-evident that it is better to be inside the euro than outside it," says Francesco Caselli, of the London School of Economics. In 1992, the last time Europe lived through such currency-market squalls, both Britain and Italy were forced to devalue their currencies against other EU nations. Neither country regretted it, says Mr Caselli.



Are Italy, Spain and the other countries struggling with high wage costs and low productivity eyeing Britain enviously, as its currency slumps and its relative wage costs fall with it? Or is Britain wishing it were, like Italy, safe inside the euro ark? Britain has been harder hit by the credit crunch: it had a huge housing boom that is turning to bust; it has a large financial sector, which is now shrinking fast; and its households are more indebted than even America's.

In other words, Britain is suffering from the very "asymmetric shock" that is so hard to adjust to within a currency union. In these circumstances Britain benefits from being able to cut interest rates and allow its currency to depreciate. The pound had looked dear on some measures anyway. And Britain has not been frozen out of capital markets: its government-bond yields are a bit lower than France's and much lower than Italy's.

Italy faces starker choices. A 2006 report from the Centre for European Reform, a London think-tank, concluded that Italy could follow three paths. It could continue to muddle through as the euro area's slowest-growing economy; it could introduce reforms to tackle its poor productivity and high labour costs; or it could leave the euro, default on its euro debts and devalue its currency. Two years on, Simon Tilford, the author of the report, reckons that with deep recession and ballooning budget deficits on the horizon, muddling through is no longer an option. He also thinks Italy's exit from the euro cannot be ruled out.

However, a break-up is improbable—and less likely than it was before the crisis. Marco Annunziata of UniCredit, an Italian bank, reckons that the lesson being drawn from the travails of Hungary and Iceland is that being outside the euro is costly. Some monetary-policy autonomy would be restored by leaving, but borrowing costs would go up. At a time when markets are clinging to the safest investments, Italy's high public debt and poor record of macroeconomic management would count heavily against it. The policy debate in Italy has become more pragmatic as the potential losses from being outside the euro loom larger, says Mr Annunziata. The world has changed since Argentina and Russia swiftly regained access to foreign capital after defaulting on debts. Investors are likely to be far less forgiving these days.

A catalyst for reform

The more bracing market conditions may renew hopes that the euro will be a catalyst for reform. The record so far is disappointing. Productivity growth has slowed from an already sluggish 1.6% a year before the euro's launch to 0.8% since. That isn't a wholly bad sign: perhaps healthy jobs growth temporarily depressed productivity because each new worker was less productive than the average. André Sapir, an economist at Bruegel, a Brussels think-tank, says there is some tentative evidence for this: countries with the worst productivity record, such as Spain and Italy, enjoyed rapid jobs growth.

That said, sluggish productivity also reflects a waning appetite for reform. A report by the European Commission on the euro's first decade concluded that members became less ambitious after 1999. That may partly reflect "reform fatigue", following the dramatic efforts made to qualify for the first wave of euro entry.

The protection the euro offered its members also worked against reform. Joining the euro meant that countries could carry on with old habits for longer. For countries such as Italy with huge public-debt burdens, the reduction in interest costs on joining the euro relieved pressure to trim budgets. Spain's consumption boom and ballooning current-account deficit continued unchecked because foreign lenders faced less currency risk.

Before the credit crisis started to brew, investors were almost as keen to own the public debt of profligate Italy as that of prudent Germany. At one time ten-year Italian government bonds yielded just 16 basis points (hundredths of a percentage point) more than the equivalent German bonds. Life within the euro area is no longer quite so cosy. The spread has risen to 140 basis points and may rise further as concerns about Italy's fragile public finances and faltering economy increase.

Challenging the dollar

The return of the bond-market "vigilantes" will put pressure on budgets, which may in turn spur wider reform. Fiscal laxity tends to fatten the government wage bill, setting a high benchmark for private pay deals that can cripple competitiveness. Scarcer credit may affect the private sector directly too. Recent research by economists at the commission found that incentives for reform are greatest when financial markets are working well. Capital will tend to flow to countries that have made most progress in freeing their economies.

The euro has proved itself a safe place for insiders at times of crisis. But how appealing has the currency been for outsiders? The euro held up far better than currencies backed by smaller, less diversified economies. The euro is attractive because of the currency zone's size, political stability and sound monetary policy. But in the eye of a storm that had its origins in America, the dollar rallied against the euro.

The dollar's attractions as a bolthole are partly a benefit of incumbency. The greenback accounts for around two-thirds of global currency reserves, compared with a quarter for the euro. Outside the EU, the bulk of cross-border sales are invoiced and settled in dollars. A third even of euro-area trade is still dollar-based. The greenback still dominates global currency transactions—which is a rough guide to its use as a "vehicle currency" for trade between smaller economies (see table 3).

For some observers, the euro cannot challenge the dollar's hegemony as long as it remains a currency without a state. The euro area cannot rival the liquidity offered by the market for American

Treasuries, which have a single issuer. The euro has 16 separate government bond markets. Bonds held as currency reserves are useful if they can be converted to cash quickly and cheaply. The market for German government bonds meets the requirement for liquidity but others fall short.

This liquidity problem is compounded by worries about the default risk of some euro-area sovereign bonds, says Stephen Jen, a currency analyst at Morgan Stanley. That markets now discriminate among euro-area credits is a good thing. But it also means investors see the euro's financial markets as fragmented, which undermines its appeal as a reserve currency. Doubts about the merits of holding euro reserves have been raised by poor co-ordination of policies—from deposit guarantees to bank bail-outs and fiscal packages—in response to the credit crisis.

Vehicle currencies 3

Foreign-exchange market turnover

% share of average daily turnover, April

	Dollar	Euro	Yen	Sterling
1992	82.0	39.6	23.4	13.6
1995	83.3	36.1*	24.1	9.4
1998	87.3	30.1	20.2	11.0
2001	90.3	37.6	22.7	13.2
2004	88.7	37.2	20.3	16.9
2007	86.3	37.0	16.5	15.0

Source: BIS *Predecessor currencies

The lesson that Asian central banks have taken from recent events, says Mr Jen, is that when their currencies come under pressure, they need liquid dollar securities: "It is only in bad times that the mettle of a reserve currency is tested and the dollar met that test better than the euro."

The euro may yet make further ground as a reserve currency—at the expense of the smaller European currencies, the pound and the Swiss franc, if not the dollar. The more important legacy for the euro may be within the currency zone itself. Its status as a haven in the financial storm has quietened voices that habitually blame the euro and the ECB for all economic ills. If that mood is sustained, politicians may look closer to home for solutions to the problems facing their economies. The newly discriminating capital markets may nudge them in the right direction.

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