Growing Pains for the Euro

Adam S. Posen, coeditor of The Euro at Ten: The Next Global Currency?, *asserts that the euro has helped stabilize the European economy but is also falling short of its potential in the face of the global financial crisis.*

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Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest for Peterson Perspectives is Adam Posen, deputy director of the Institute and coeditor of a new book, *The Euro at Ten,* which Adam has edited with Jean Pisani-Ferry of Bruegel, the Institute's sister think tank in Brussels. Thanks for coming, Adam.

Adam S. Posen: Mais oui. Thanks.

Steve Weisman: The euro was established 10 years ago. On its 10th anniversary, we're in the midst of a global financial crisis. Has the euro, which was controversial when it was established, helped or hurt Europe and the world cope with the crisis?

Adam S. Posen: That's a really good question, Steve, because the euro as you say was not only controversial, it was totally new territory. The idea of a bunch of countries getting together, pooling their sovereignty to create a new currency rather than having a currency imposed when they get conquered or something, was very new and still hasn't been replicated elsewhere.

The short answer is, for the euro's own members and for the system of the world as a whole, the euro has been a good thing and has performed very well. Countries in the eurozone,particularly countries like Greece, Italy, Portugal, which would have seen their interest rates shoot through the roof and capital fleeing out of their countries, have had very little of that as members of the euro area. Their interest rates have gone up some but nothing like they would have if these countries had dropped out. By the same token, the major economies within Europe—Germany, France, and so on—are suffering less from competitive devaluations or depreciations of their neighbor countries and their closest trading partners because they're in the eurozone.

On a global perspective, it's a little less of a slam dunk. There has certainly been no harm from the euro, and it has been a story of relative stability. It probably helps maintain a general sense of price stability in the world. The reason I'm just being a little bit hesitant, and this is the theme of our new book, is that we feel the euro could play a much more important role, both regionally to help those European countries outside the euro area, particularly in crisis in Eastern Europe, and globally in terms of backing up and in some ways partnering or even rivaling a bit the dollar in global leadership. That's where we feel the euro is letting us down.

Steve Weisman: Before I ask you to amplify that, let's step back for a second. The euro was many years in the making in terms of discussion and it was established 10 years ago. What was the thinking behind it? What were its progenitors hoping to achieve?

Adam S. Posen: The progenitors were the top political leadership of Europe at the time—people like Helmut Schmidt and Helmut Kohl from Germany, Valéry Giscard d'Estaing and Francois Mitterrand from France, and various people leading the European Commission through the years.

They had in mind three very big goals. The first was part of the overall European project to bind the countries closer together and avoid any future prospect of war. This was seen as a next step and an attainable one. The second was very sensibly, purely economic: If you're going to have a free trade area, which the European Union at that point already had become, and try to deepen economic and financial integration, it makes sense to have one currency. And one can exaggerate that; one can certainly have integration without it. But there were and are economic benefits to not having to exchange money every time you're going across borders commercially or individually. The third motivation, which became very much apparent in the last major financial crisis to hit Europe in 1992 and 1995, was to keep countries that got into trouble—in those days, it was usually Italy or Belgium or Spain—from ending up having to drop out of the exchange rate mechanism in Europe and suddenly depreciate their currency.

That was a lose-lose, as I was trying to say at the start. Say Italy in 1992 and 1993 borrows too much, overheats, has to suddenly cut back on its spending, its currency goes through the floor, its interest rates go way up—Italy suffers a real loss of wealth. But at the same time, Germany, which say, was sending lots of Mercedes Benz into Italy, suddenly can't compete with Fiat because the Italian lira has moved 30 percent overnight. So one of the big victories for Europe was to have the euro stabilize these kinds of exchange rate changes and crises within the euro area.

Steve Weisman: Was it envisioned for the euro to eventually become such a strong currency that it could compete with the dollar on a global level? Or was that a dream then and is it still a dream now?

Adam S. Posen: I think it was an attainable dream, and it is becoming actually, in some ways, less attainable right now.

Steve Weisman: Why?

Adam S. Posen: Well, the dream to give credit where credit is due was not only advocated by some European officials but by some American economists, including our Institute's director, Fred Bergsten, was way out in the front with that. Richard Portes, who teaches at London Business School, also was way out in front with that. And they were very much against the tide of people like Martin Feldstein and others in London and the United States who were very skeptical toward the euro.

At face value, the euro area is the same size in GDP as the United States, roughly speaking. The euro area does have very large and deep financial markets, although the more you look in detail, there are still some things there that differentiate it from the United States. And the euro area has delivered price stability. They have a very low rate of inflation pretty consistently. So you put those three things together, on paper it looks like the euro should be at least a very clear second to the dollar in investors' portfolios, in government reserve holdings, in how much you invoice trade like oil or planes or things like that.

But what our research finds in this book—in particular in good chapters by Kristin Forbes and Linda Goldberg—is the fact that if you look under the hood a bit, there is a huge shortfall between what you would expect just based on size and how much the euro is used. So there's an awful lot of trade that's still invoiced in dollars, not in euros, even between countries that are not dollar countries. There are huge amounts of financial flows that come to the United States, and the depth of European assets and financial flows is not commensurate with the size.

Steve Weisman: And of course during the crisis, that flow to the dollar has accelerated.

Adam S. Posen: Exactly. Even though there is a strong case to be made and even stronger set of perceptions that this crisis was US-born and bred and really shows weaknesses in the United States, when there was a flight to quality, the money came into US treasury bills and US assets and the dollar. In fact, the dollar even appreciated against the euro in the midst of the crisis, not vice versa. Which doesn't say that the euro is weak, but it certainly shows you who's top dog in terms of safety and security perceptions.

Steve Weisman: Well, as you said at a conference on this book only today, April 23, this is not about who's got the biggest or best currency, it's about economic fundamentals. Should the United States be rooting for the euro to in effect compete with the dollar? Or is that something that we should be concerned about?

Adam S. Posen: We definitely should not be concerned about it, as you say. There's a tendency to get sort of macho about it, so if there was a brief run-up in the euro about a year and a half ago, and McDonald's started running commercials with people saying, I'm going to pay in euros instead of dollars because the dollar buys me more.

Steve Weisman: And some supermodels were reportedly demanding to be paid in euros.

Adam S. Posen: Gisele Bundchen and all that, yeah. That's all fine but that's really not what we're talking about. I mean both the euro and the dollar let their governments and their people borrow in their own currency. It's not like Argentina or Turkey, where you have to borrow in foreign money. Both the United States and the euro area get what's called seigniorage, which means the government issues a lot of paper, people outside the area use it, and they get some revenue for that. And neither of those are imperiled for the United States by the euro's success.

What is an issue is we do need something called monetary leadership, for want of a better term, in times of crisis. We need some set of governments or government willing to step up, provide liquidity to other countries, guide what the International Monetary Fund (IMF) does, and be willing to let its currency appreciate when there is fear and money rushes in. The economic historian Charles Kindleberger, whom others have since agreed with, pointed out part of the problem we had in the 1930s was that the British pound had weakened from that leadership role, but the dollar wasn't ready to take on that role. At least the American government wasn't ready to take on that role.

So what I and Jean Pisani-Ferry, who coedited the book with me, argue is that while the dollar is not by any means collapsed, it is weaker than it has been in terms of its global role, given the nature of the current crisis and given the relative decline and size of the dollar zone versus China and Europe. And it would be nice if the euro was able to punch in accordance with its weight and be another factor in sort of a bipolar or at least strong secondary factor of monetary leadership, and Europe is not doing that.

Steve Weisman: When you say you wish they exercised more leadership, give me a couple of examples.

Adam S. Posen: Let me give you two. The first is that some of the worst-hit countries in the current financial crisis are the emerging markets of Eastern Europe. Ukraine is obviously in terrible shape, but there are also countries that are members of the European Union but not yet members of the euro area, like Hungary or Latvia or Romania. And the euro area countries have sort of put up a lot of money and shoved it through the IMF to try to help the worst from happening in these countries, but they did very little to prevent them from getting into this trouble, and they've done very little to really ameliorate the effects of the crisis on these countries. And that's destabilizing. It takes up resources that could be used elsewhere, it leads to tensions within Eastern Europe, it leads to currency depression among emerging markets. It's just that they're not standing up for their neighbors and fellow members the way they should be.

Steve Weisman: But isn't this more a political problem than a monetary problem? The European leaders in the eurozone are nervous about imposing conditionality on their aid. Some were suggesting at the conference that you had today that they are standing behind the skirts of the IMF.

Adam S. Posen: Sure, and I can understand that. But I want to pick up on what you said about being political, not economic. A number of people who were skeptical about the euro would say, oh, it's a political project, it's not an economically viable project. And what I think recent experience shows us is that exactly the reverse is true. It works perfectly well on its own limited economic terms, but it is insufficiently political, insufficiently politically strong, insufficiently geopolitically strong and coherent to provide a greater role. And in my chapter in this book, that's the emphasis I put on it. Part of what has kept the euro from having a greater global role and thus contributing to global monetary stability is this defensive crouch the eurozone goes into. It says, well, we can't have any extra members come in because they might destabilize the currency; we can't issue any euro area debt on behalf of these poorer countries because that will escalate out of control. And those are narrowly speaking very reasonable short-sighted economic arguments. But the lack of political will to step up is kind of breathtaking.

Steve Weisman: Which countries are most nervous?

Adam S. Posen: I think almost everybody in the euro area deserves their share of this view. I mean, this is clearly a view that successive German governments feel very strongly about, that you do nothing to interfere with the Maastricht Treaty, the original treaty setting up the euro states, which has very strict budgetary and monetary rules. But the French are certainly on that wicket. The Austrians, even though they have a lot of bank loans, and Eastern Europe have stuck with that. The Belgians and the Dutch, and even some of the countries that in the past have benefited by euro entry like Spain or Italy, are very suspicious or worried about rapid Eastern European entry.

Steve Weisman: You and Jean Pisani-Ferry have recommendations, practical steps that the eurozone can take.

Adam S. Posen: The eurozone will survive in a sense domestically, in terms of providing stability for its own member-countries without doing much else. But we think there is a need to get the eurozone ready for global leadership and rectify the weaknesses that put the limit on global leadership that this crisis shows up.

What we have in mind is, first, talking about consolidating decision-making in financial matters in the euro area. The European Central Bank (ECB), actually did a very good job in responding flexibly and quickly to the crisis in the strict sense of issuing liquidity and moving interest rates, until recently. But on financial matters like these bank failures and dealing with Eastern European countries, it's all been very ad hoc and uncoordinated, and that's been a problem. The system, as Jean Pisani-Ferry puts it, was set up to preempt crises but therefore has nothing built in place to deal with crises. We've encouraged them to be more realistic and do that.

The second area would be talking about coordinating more or better, specifically in crisis response in the financial area. For example, we have issues with countries putting on deposit guarantees or wanting the parent companies of banks in Eastern Europe to bring home money. You want to be careful that you coordinate in some fashion so you don't make one country in Europe's crisis worse in order to protect another country. It also goes to the fact that in Europe, you do not have quite the depth of a continent-wide bond market the way we do in the United States for, say, US government bonds, which limits the ability for it to be a safe haven.

The third issue which we would talk about is representation and governance in the eurozone. There's a European system of central banks, which is all the national members, central banks of the eurozone plus the other EU members and…

Steve Weisman: The other members that are not in the eurozone.

Adam S. Posen: Exactly. Thank you for clarifying. There is reason to think that at least all the euro area member should be represented under one voice at the International Monetary Fund and in other global fora. And Marco Buti, who is director-general of economics and finance at the European Commission and spoke at our conference today, spoke about that and said we have too many voices and as a result less power, and the commission itself has come out in favor of this. We would support consolidating that kind of voice. There are also specific things like extending swap lines in euros to Eastern Europe the way the United States has done with dollars to some other emerging markets. But that gets into more technical [matters]. The broad point is more centralization, more coherence, more bravery on the international front, and a particular emphasis on increasing the financial flexibility of the eurozone's capabilities.

Steve Weisman: Finally, Adam, this volume comes out at the time of the annual meetings of the IMF and the World Bank, and the world's finance ministers and central bankers in Washington, and that's three or four weeks after the G-20 meeting. How have Europe and the United States done since the G-20 meeting in London to address these issues of leadership?

Adam S. Posen: As many of my colleagues have written for our blog at the Institute, RealTime Economic Issues Watch, we actually think by standards of past G-20, G-7, G-whatever meetings, they did pretty well. I think the UK leadership got the process going. I think the French and German governments, notably not the European Commission, not the euro area governments as a whole, but the French and German governments explicitly advanced a pretty good agenda on financial regulation, which the Americans signed on to. And of course, the biggest thing is, they mobilized a huge amount of resources for the IMF and [may] potentially change its role in a more constructive way. This does help Eastern Europe as much as anything.

The larger question, though, of leadership is a bit odd because we are hoping to continue the G-20 process. I think everybody sensible believes that's the way to go. They've created this thing called the Financial Stability Board, which is essentially the financial officials of the G-20 members, to keep track of what goes on in the world. But we're not seeing anything very systemic happening. We haven't really yet seen a change in governance structure at the IMF to represent the Asian and emerging markets. And we still have very disparate paths for countries in terms of the richer countries, how much they're responding to this crisis. In the end, that may not be the end of the world. But if things get worse, that's not the ideal place to be starting from.

Steve Weisman: Adam, thanks very much for taking time to talk about the new book. Congratulations on it and good luck with it.

Adam S. Posen: Thanks for having me, Steve.