Euro Birthday Blues

By Desmond Lachman

As its twentieth anniversary approaches, was the currency fatally flawed from the start?

Twenty years ago, on January 1, 1999, the euro was launched with the highest of political and economic expectations. Today, its twentieth anniversary is being commemorated amid deep disappointment at its economic and political results, both dismal.

This has to raise questions anew as to whether the euro might have been fatally flawed from the start. It also has to raise doubts as to whether the euro is likely to survive the next global economic downturn.

HIGH HOPES

The euro's architects had high hopes that its launch would substantially improve Europe's economic prospects. By minimizing transactions costs, it was hoped that the introduction of a single currency would promote intra-European trade. It was also hoped that by increasing competition among member states, the euro would force countries in the eurozone's periphery to radically reform their sclerotic economies.

Beyond providing economic advantages, the euro's architects hoped that it would promote deeper European political integration and institution building. They also hoped that it would constitute a challenge to the U.S. dollar's dominance as the world's international reserve currency.

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Smile, everyone: In December 2018, the EU Council tweeted, "Happy (early) birthday, Euro! Almost twenty years ago, the common currency was born."

DISAPPOINTING ECONOMIC RESULTS

It would be an understatement to say that the euro has not delivered on its economic promises, especially since the 2008 Lehman crisis. Whereas over the past decade the U.S. economy has grown by some 15 percent, the overall eurozone economy has barely recovered its pre-crisis 2008 peak level.

Meanwhile, far from narrowing the economic disparity between the eurozone's prosperous north and its sclerotic south, those disparities have increased. As an example, while Germany's economy is now some 10 percent above its pre-2008 crisis peak, the Italian economy remains around 5 percent below that peak. This is not to mention the Greek economy which is barely recovering from an economic depression that has been worse in both severity and duration than that experienced by the United States in the 1930s.

The euro has also failed to deliver on its founders' lofty hopes that it would in time supplant the U.S. dollar as the world's international reserve currency. In reflection of the euro's poor economic and political performance as well as of the eurozone sovereign debt crisis, twenty years after its launch, the euro constitutes only 20 percent of the world's international reserves. That is a level little changed from that prevailing at its launch.

INCREASED POLITICAL DISUNITY

As to the hope that the euro project might have promoted political unity and harmony, it would seem that it has done just the opposite. Those countries in the eurozone's economic periphery deeply resent the austerity

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that has been imposed on them by the prosperous north in general and by Germany in particular. They blame that austerity for their poor economic performance and their high unemployment levels. At the same time, those countries in the prosperous north have grown increasingly resentful of having had to bail out a European economic periphery that they believe has been too slow to reform its errant economic ways.

More disturbing yet, especially since 2008, Europe's poor economic performance has undermined public confidence in Europe's political elite, thereby contributing to a wave of populism across the continent.

A recent example of this populist trend has been the coming to power of the Five Star Movement and The League in Italy as well as the presentation by that government of an expansive budget that has put it on a collision course with its European partners. Other examples have been the rise of the Yellow Vest movement in France, the plunge in French President Emmanuel Macron's poll ratings, and the fact that in the first round of last year's French presidential elections, around 50 percent of the votes were cast for candidates on the extreme left and the extreme right of the political spectrum.

Equally troubling for the euro's longer-run outlook have been recent German political developments that have to cast serious doubt on that country's continued willingness to bail out as needed countries in the eurozone periphery. With the rise of the Alternative für Deutschland party and with the rightward shift in the Christian Democratic Party, Angela Merkel, who was so central to keeping the euro together during the eurozone sovereign debt crisis, would now seem to be a spent political force.

The fundamental flaws in the euro have been papered over by the European Central Bank.

FUNDAMENTAL FLAWS

In the run-up to the euro's 1999 launch, American economists like Milton Friedman and Martin Feldstein presciently warned of the great risks of attempting economic union before attaining political union. They also noted that the eurozone was not an optimum currency area, especially in the sense that it lacked the labor mobility, the wage flexibility, or the centralized fiscal authority to make it work.

Over the past decade, the eurozone's experience has also underlined the inevitable tensions that would rise from locking together in a monetary union a country like Italy that is characterized by a poor productivity record with a productivity powerhouse like Germany. Without the ability within the euro to regain competitiveness through currency devaluation, Italy was bound to progressively lose competitiveness to Germany. That in turn was bound to result in highly disparate economic performance between those two countries.

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The fundamental flaws in the euro currency arrangement, which became all too apparent during the eurozone sovereign debt crisis, have been papered over to date by the forceful action of the European Central Bank. In mid-2012, at the peak of the crisis, the ECB declared that it would do "whatever it takes" to keep the euro from failing. It backed up this statement by action, first by the introduction of an Outright Monetary Transaction program and then by a massive round of quantitative easing that saw a US$3 trillion expansion in the size of the ECB's balance sheet.

THE NEED TO REFORM

Sadly, the eurozone has been very slow to make those institutional changes to the euro's architecture that might have placed the single currency on a sound long-run footing. These shortcomings are most apparent in the failure to complete the eurozone's banking union by establishing a common deposit insurance scheme, in the absence of a fiscal union with a common eurozone

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budget, and in the failure to enhance the eurozone's crisis-fighting instruments for the contingency that a large eurozone country such as Italy might face another sovereign debt crisis.

More serious yet has been the failure of a number of countries in the eurozone periphery, and most disturbingly Italy, to take advantage of a favorable global economic and liquidity environment to reform their economies or to reduce their excessively high public debt levels. This leaves those economies very vulnerable to another round of the sovereign debt crisis in the event of a global economic recession. This would seem to be particularly the case now that the ECB has ended its bond-buying program and now that German political resistance is growing to any future bailout programs for countries in the eurozone periphery.

In 1999, had the euro's architects known as we know today how troubling the eurozone's economic and political performance would have been over the subsequent two decades, it is doubtful whether they would have launched the single currency. With the eurozone's populist trend firmly in place, with the world economy slowing, and with the coming to an end of the era of ultra-easy global liquidity, there is strong reason to doubt whether the euro will make it in its present form to its next ten-year anniversary. ◆

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