Europe and the Euro: Doomed to Succeed
Barry Eichengreen

Europe's economic prospects tend to be painted in black and white. Optimists generalize from a resurgent Germany, suggesting that Europe, with its disciplined labor force and unparalleled ability to produce precision manufactures, is poised to become an export powerhouse. In contrast, pessimists generalizing from the experience of Italy, which has suffered a steep loss of competitiveness and labors under heavy debt and demographic burdens, conclude that European economic performance will continue to disappoint.

As is often the case when views are so polarized, the truth lies in between. Europe has skilled workers, sophisticated financial markets, and strong institutions. Along a number of these dimensions its endowment compares favorably with the United States. But it also has ageing populations, reflecting a combination of low fertility rates and immigration-unfriendly policies. Its taxes are high. The obstacles to start-ups – to founding the new firms that are the seedbeds of innovation – remain much higher than in America. In reality, then, the picture is mixed and will remain so for the foreseeable future.

The same is true of the euro. It is neither the solution to all of Europe's economic ills, as suggested by some of its champions, nor the fundamental obstacle to faster growth and wider stability, as claimed by its critics. The euro has stimulated cross border competition by rendering prices more transparent. It has also stimulated the integration and development of European securities markets. Last year, for the first time, more bonds were issued in euros than in dollars. Slowly but surely Europe's currency is taking

on a global role. The euro has also freed Europe from the eruptions of inflation that it suffered in the 1980s and the currency crises it experienced in the 1990s.

But the euro has also required difficult adjustments of the participating member states. The share of bank loans in total financing has declined from 74, 80, percent, and 75 percent in 1989 in France, Germany and Italy, respectively, to 42, 52, and 47 percent today due to competition from securities markets, partly reflecting the stimulus of the euro. European firms required to placate impatient investors must focus on the quarterly profit-and-loss statement. They are finding it hard to maintain expensive training programs for their workers and to undertake other investments whose payoff is delayed. Thus, the advent of the euro has entailed a wrenching adjustment for the entire European model.

In addition, giving over monetary policy to the ECB has meant a sharp fall in interest rates in Portugal, Spain and Italy. Housing markets have boomed. Excessive exuberance has spilled over to labor markets, where wages have soared. As a result competitiveness has suffered. These countries now face an extended period of slow growth and grinding deflation until their labor costs are brought back into line.

Does this mean that they will be tempted to abandon the euro and reintroduce their national currencies in an effort to restore their international competitiveness at a stroke? These disaster scenarios are standard fodder for euro-skeptical commentators. They sell newspapers. But a moment's reflection suggests that they are overblown. The reason is not so much the standard economic objection, namely that if a country like Italy abandoned the euro it would suffer high inflation, neutralizing any depreciation-induced improvement in competitiveness, and experience significantly increased debt-service

costs. In fact, if the defector buttressed the independence of its central bank and adopted a strong monetary anchor, like inflation targeting, it might avoid these adverse economic effects – just as the UK avoided them when it abandoned the ERM in 1992.

The real costs of exit are political. A country that withdrew from Europe's monetary union would be seen as unilaterally disregarding its commitments to other euro area members. By raising questions about the future of the monetary union itself, it would be making their lives more difficult. Such a country would not be welcomed in the meetings of member states where the European Union's future architecture is discussed and policy priorities are decided. Insofar as member states value their participation in these other political discussions, they would incur significant costs. My own assessment is that the high value that member states attach to their involvement in the larger European process would prevent them from abandoning the euro except under the most extreme circumstances. The participants will have to find a way to make their union work. In effect, the euro is doomed to succeed.

Thus, Europe's economic future is likely to be one of neither triumph nor tragedy. And while the euro is not likely to overtake the dollar as dominant international currency anytime soon, neither will the euro area collapse. Given Europe's turbulent history, this kind of boredom is not a bad thing.

Barry Eichengreen is George C. Pardee and Helen N. Pardee Professor of Economics at the University of California, Berkeley. His latest book is *The European Economic Since 1945* (Princeton University Press, 2006).