Why Germans Love The Euro

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And why the "Club Med" remains less enthralled.

Eight years after the euro was introduced in 1999, European policymakers and economic commentators are drawing divergent conclusions concerning the merits of the common currency. What is most striking lately about views offered in speeches and press articles analyzing experiences with the euro: The more an individual euro-area country has profited from the euro in terms of increased monetary stability and lower interest rates, the more critical the judgments on the benefits of the euro become—a somewhat perverse outcome.

Countries like Italy, Greece, and Portugal—which never experienced such low inflation rates over an extended period of time in their modern history and which enjoyed huge windfall profits when their interest rates dropped close to the German level at entry into European Monetary Union—have squandered these benefits. Instead of investing the interest payments their budgets were spared into economic reform, most of the savings went into consumption. Without reforms, the growth of their production potential dropped relative to the other euro-area members, an outcome for which the euro is made responsible.

In France, on the other hand, dissatisfaction with the euro seems to be mainly of a political nature. French policymakers appear to have problems in coming to terms with the political independence of the European Central Bank. One element of disillusionment in France concerning the euro, however, is similar to that prevailing in the countries of the Club Med: the recognition that the initial advantages the euro provided relative to the other euro area members have disappeared.

Contrary those in the Club Med, German policymakers are, almost without exception, full of praise for the euro. Yet the common currency has been more of a mixed blessing for Germany.

In terms of its internal stability, the euro has been without doubt a success. The average annual rate of inflation during the eight-year existence of the euro, measured as the increase in the ECB's "harmonized index of consumer prices," was 2.05 percent—even lower than the average German inflation rate during the preceding eight years (2.25 percent). In assessing that outcome, however, one needs to take into account that the Eurosystem was lucky, operating in an environment of worldwide falling

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inflation rates. In relative terms, the comparison favors the deutschmark. The bonus in terms of lower inflation Germany enjoyed in relation to other countries in the pre-EMU era was higher than the bonus the euro area experienced since 1999 in relation to the rest of the world.

The outcome is less positive when assessing the euro's role for economic growth. Notwithstanding the tranquilizers offered routinely by the ECB and the EU Commission, stressing that the growth and inflation differentials among euro-area members have remained stable and that the conjunctural cycles have become more synchronized since entry into EMU, the fact remains that the euro area has a considerable way to go in forming an optimal currency area. Despite frequent official declarations to the contrary, a monetary policy which results in relatively low real interest rates for the high-inflation members of the eurozone and in relatively high real interest rates for the low-inflation members causes economic costs, in particular in the form of losses in growth and employment.

The reference to the United States, always made by European policymakers and central bankers in that context, misses important differences. The U.S. economy is much more able to adapt to changing economic circumstances, the U.S. labor force is more mobile, and fiscal policy in the United States absorbs economic shocks to a higher degree than in the euro area. Also, inflation differentials between regions appear to exist for much shorter periods of the time in the United States than in the eurozone. Under such circumstances, regional economic divergences in the United States are less costly than in the eurozone.

The economic costs of the euro borne by Germany became particularly visible during the early years of EMU, when high real interest rates brought Germany close to deflation and contributed to dismal growth performance during that period. Economic policymakers and central bankers in Germany have been trying to explain that away by pointing out that the so-called "real interest rate channel" has been neutralized over time by the "real exchange rate channel" (that is, a gain in competitiveness through sub-euro area average inflation). However, whereas the former phenomenon was a direct result of the euro, the latter has little to do with EMU. The German gain in competitiveness relative to the rest of the eurozone has been rather the consequence of the particular social and economic preferences in Germany. Just as in the pre-EMU era, Germany has been accumulating competitive advantages *vis-à-vis* the traditional soft-currency countries in Europe.

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For a few years following the start of EMU, this process was concealed. German unification had lowered the productivity of the enlarged German economy compared to former West Germany. It took several years of sub-euro area average inflation to absorb this misalignment. Once this was completed, Germany has started again to build up competitive gains compared to other euro area members, laying the ground for economic imbalances and political tensions in the eurozone. Contrary to the past, other euro area members can't compensate anymore for faster wage growth, lower productivity growth, or both in their countries through exchange rate adjustments.

Given the way the "real exchange rate channel" has operated since the beginning of EMU, it's a surprise that euro-area representatives still consider the absence of (nominal) exchange rate flexibility within the eurozone an advantage. In fact, it is a handicap. Under the common currency regime, nominal exchange rate movements have been substituted with real exchange rate movements. Prior to EMU, nominal exchange rates among EU countries carried the burden of adjustment, compensating for differences in national price and cost developments. Within EMU, real exchange rate movements can be corrected only by changes in domestic prices and wages, meaning economic policies have to adjust in order to prevent real exchange rates from moving too far out of line. Obviously, such an adjustment mechanism imposes much higher demands on policymakers. The German case also shows that such adjustments, if they can be made to get off the ground, take a damagingly long time before showing results.

During the run-up to the Maastricht Treaty, some economists had claimed that potential growth losses for individual euro area member countries resulting from a uniform monetary policy would be compensated for by intensified trade among euro-area members as a result of lower transaction costs, higher price transparency, and absence of exchange rate risks. However, for Germany no major effects of that nature can be discerned. While it is true that German trade with euro area countries increased substantially since 1999, trade with East Asia and Eastern European countries, for instance, increased much more strongly, leaving the share of German trade with its EMU partners more or less unchanged

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since the beginning of EMU. Even in 2006, when the euro area had largely closed the growth gap with its main industrial competitors, trade with third countries grew more dynamically than with the euro area. The available evidence suggests that the growth in intra-European trade was more a result of globalization and its European equivalent, the Single Market, with reduced communication costs and other advantages, than of the common currency. The fast integration of the East European countries into the Single Market indicates that no common currency is needed for successful trade integration.

The above analysis leaves out aspects such as the increased (in comparison to the deutschmark) international role of the euro and the integration of European financial markets that may have some positive but unquantifiable economic consequences. It also neglects certain political effects assigned to EMU. Some observers have raised the question, for instance, whether European markets would have remained as open to German exports as they were in the past in the absence of EMU. Such factors are subject to speculation.

In conclusion, EMU has been economically less costly to Germany than many had feared in 1999. While the price stability record of the euro is similar to that of the deutschmark, Germany suffered some growth losses in the initial phase of EMU due to an unnecessarily restrictive monetary policy. It is doubtful whether these losses were fully matched by positive trade effects deriving from the euro or by the integration of European financial markets.

The usual reply of German policymakers and central bankers confronted with that finding is that the euro must not be faulted, but rather policymakers of other euro-area countries who did not adjust their economies sufficiently to the requirements of EMU. They are right in as far as the pre-1999 convergence process was, indeed, a one-time effort undertaken by candidate countries endeavoring to qualify for EMU membership. These efforts were not upheld once EMU was established.

But should policymakers be surprised? The assumption underlying EMU that national economic policies would not be determined anymore by the deeply ingrained social preferences prevailing in individual countries, but by the needs of the currency regime, was optimistic at best. After all, the Bundesbank had always claimed that a monetary union would not be viable in the longer run without political union. The decision to go ahead without political union supports the view that EMU has been primarily a political project destined to foster European integration—a political project which comes, however, at a price. ◆