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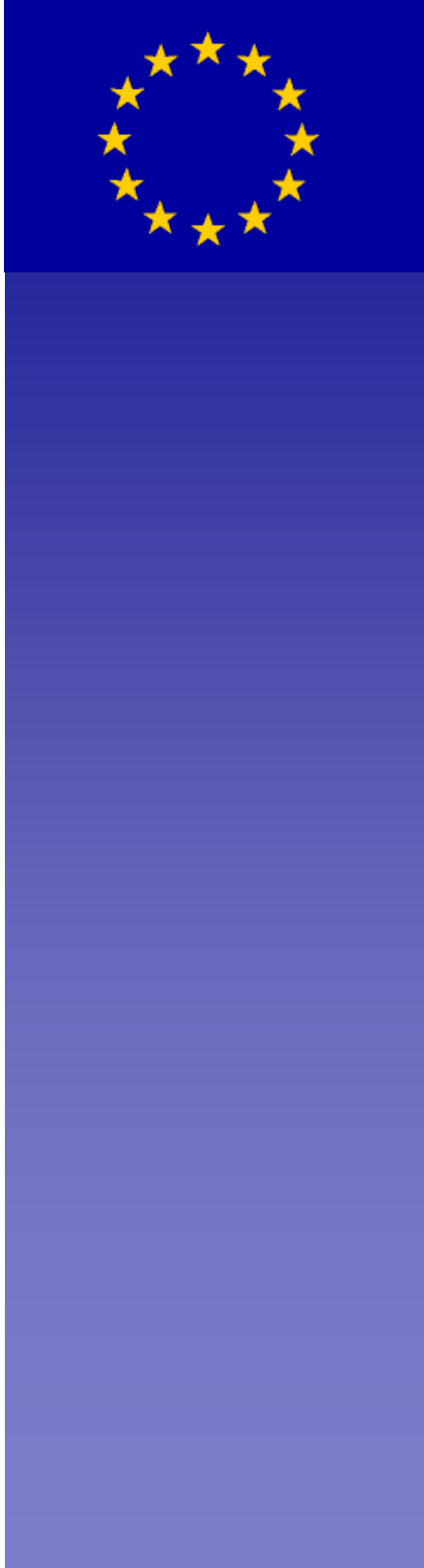
The Euro: The Economic Stabilizer of the Eurozone

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The Euro: The Economic Stabilizer of the Eurozone

María Lorca^{*}

“Great Powers have great currencies”¹

Introduction

A monetary union is a group of states which share a single, or common, currency. An economic and monetary union (EMU), like the Eurozone, is characterized not only by a single currency, but also by a single market, as well as by a common economic and monetary policy.

According to Cohen², a monetary union represents the complete abandonment of all separate national currencies, and the full centralization of the monetary authority in a single joint institution, normally, a central bank. In theory, there are two possibilities for a monetary union. The first one is a situation where currencies may continue to be issued by individual governments, but tied together in an exchange-rate union. The second is to have member-states' money replaced not by a joint currency, but rather by the money of a larger partner—an arrangement generically labelled “dollarization” after the United States dollar, the currency most widely used for this purpose.

In the EMU³ member states give up their currencies and seigniorage revenues⁴ in favour of a common currency—the euro—following conversion between the former national currencies and the euro.

The Introduction of the Euro: a Historical Overview

There were three stages⁵ to the economic and monetary union in Europe: the 1969 Den Haag summit and Werner Report; the 1979 European Monetary System and the ECU, and the 1989 Single European Act and the “Delors Report”. In terms of historical monetary union among European countries, there have also been several unsuccessful attempts. According to Bartel⁶, there were four major attempts: the Austro-German monetary union (1857-1866); the Latin

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¹ Robert Mundell, “EMU and the International Monetary System: A Transatlantic Perspective”, Working Paper 13, Vienna: Austria National Bank, pp 10

² Benjamín Cohen, “Life at the Top: International Currencies in the Twenty-First Century”, Princeton Essays in International Economics, No. 221 <http://eh.net/encyclopedia/article/cohen.monetary.unions>

³ like the Eurozone composed of 13 of the 27 member states of the European Union

⁴ Enrique Alberola, and Luís Molina, “Fiscal Discipline and Exchange Rate Regimes. A Case For Currency Boards?”, Banco de España, Documento de Trabajo n. 0006, <http://ssrm.com/abstract=981345>

⁵ European Commission, Economic and Financial Affaire, “EMU: A Historical Documentation,” http://ec.europa.eu/economy_finance/emu_history/history/part_a_2.htm

⁶ Robert J. Bartel, “International Monetary Unions: The XIXth Century Experience.” *Journal of European Economic History* 3, no. 3 (1974): 689-704

Monetary Union (1965-1878) among France, Belgium, Italy, and Switzerland; the Scandinavian Monetary Union (1875-1917) among Denmark, Norway and Sweden; and a final one between Belgium, Luxemburg in 1921.

There is an important difference between those four unsuccessful monetary unions and the EMU represented by the Eurozone. While those pioneer monetary unions rested on the value of gold and silver, the Eurozone rests on two pillars⁷: the economic union and the monetary union. On the one hand, the monetary union is based on the existence of the euro as a common currency, and the implementation of a common monetary policy supervised by a Central Bank—the European Central Bank (ECB). On the other hand, the economic union has the Stability and Growth Pact (SGP) as a major instrument, which is based on the implementation of specific fiscal and monetary requirements among EMU member states with the goal of maintaining fiscal and monetary stability.

In April 1989, the Delors Report delineated a plan to introduce the Economic and Monetary Union as well as the final introduction of the euro in three well-structured stages:

Stage one, from July 1990 to December 1993, brought about the first of the “four freedoms”: the liberalization of capital movements. The Treaty of Maastricht (1992), which entered into force in November 1993, established a number of economic convergence criteria that member countries, which planned to adopt the euro, needed to meet. These criteria concerned the inflation rate⁸, public finances⁹, interest rates¹⁰ and exchange rate stability¹¹. Those EU member states, that planned to enter the third stage of European Monetary Union (EMU) and adopt the euro as a common currency, must comply with these monetary and fiscal requirements. In 1999, twelve¹² out of fifteen EU countries decided to enter the third stage and adopt the euro. Of those twelve, all but Greece were able to meet the economic targets established by the convergence criteria and, in 1998, these eleven EU member-states brought the Eurozone into existence with the official launch of the on 1 January 1999. Greece was not able to meet the convergence criteria to join in 1998 but qualified in 2000 and was admitted on 1 January 2001. Denmark, Sweden and United Kingdom have so far not adopted the euro. Slovenia joined the EU in 2004 together with nine other countries, and it has been the only country of those new EU members that was able to achieve the convergence criteria, and qualified in 2006 to adopt the euro in January 2006. In 2007, Rumania and Bulgaria joined the EU, and both are still working towards reaching the criteria necessary to adopt the euro.

In stage two, from January 1994 to December 1998, a new exchange rate mechanism (ERM II) was set up to provide stability between the euro and the national currencies of those countries that were not yet part of the eurozone. Additionally, on 1 June 1998, the European Central Bank (ECB) was created, and in December 1998 the conversion rates between the 11 participating national currencies¹³ and the euro were established. Finally, the European Council decided at the Amsterdam meeting to adopt the Stability and Growth Pact, designed to ensure budgetary discipline after the creation of the euro.

In stage three from January 1999 until today, the euro currency became a reality, and the single monetary policy was introduced under the authority of the European Central Bank.

⁷ Subdirección General de Asuntos Económicos y Financieros de la Unión Europea, “El Pacto de estabilidad y crecimiento,” *Boletín Económico de ICE N. 2905*, Del 16 al 28 de Febrero de 2007.

⁸ Inflation rate: No more than 1.5 percentage points higher than the 3 best-performing member states of the EU

⁹ The ratio of the annual government deficit to gross domestic product (GDP) must not exceed 3% at the end of the preceding fiscal year

¹⁰ The nominal long-term interest rate must not be more than 2 percentage points higher than the 3 best-performing member states

¹¹ Applicant countries should have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for 2 consecutive years and should not have devaluated its currency during the period.

¹² Belgium, Germany, Spain, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, and Finland

¹³ Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal, and Finland

Nevertheless, euro notes and coins were not introduced until January 2002 to provide a three-year transition period. However, the national currencies legally ceased to exist on December 31, 1998.

One of the most important consequences of the EMU was the establishment of the Stability and Growth Pact (SGP). The SGP is nowadays one of the most important policies for the Directorate General for Economic and Financial Affairs because "(t)he Stability and Growth Pact (SGP) is the answer to concerns on the continuation of budgetary discipline in Economic and Monetary Union (EMU)."¹⁴ The SGP has to be respected by all EMU countries, but it is of special importance to those countries that have adopted the euro. Its main purpose is to enforce in those countries that have entered the EMU, and especially those that have adopted the euro, a clear set of economic measures to prevent their governments from maintaining loose fiscal policies at the expense of other euro-area countries. By respecting those levels, countries are expected to maintain a balanced budget (or even a surplus), which will ensure some margin for maneuvering in the event of a negative shock. Furthermore, a study by Guillermo de la Dehesa, Chairman of the CEPR and the OBCE, has shown that "not only [is] the SGP ... a necessary condition for the ECB's proper functioning and credibility, but it also tends to avoid pro-cyclical behaviour and, in the medium term, some structural fiscal rigidities, such as a high level of taxes and excessive volatility ... which reduce competitiveness."¹⁵ Hence, countries complying with the SGP requirements are assured to have a healthy economy. These requirements are:

- To maintain an annual government deficit no higher than 3% of GDP
- A gross government debt to GDP lower than 60%

In fact, the Treaty of Amsterdam definitively explains that the SGP has several well developed elements which need to be respected at the threat of penalties for those EU countries which do not comply with these requirements¹⁶:

- EU countries have to commit themselves to "medium-term" budgets that are "close to balance or in surplus".
- EU countries have to submit annual programs specifying medium term budgetary objectives; so, there will be a track record for the Council or the public to examine when assessing a country's compliance with the terms in the Pact.
- Countries in the Euro-zone that run "excessive deficits" will be subject to financial penalties.
- Deficits are "excessive" if they exceed 3% of GDP, unless they occur under "exceptional" circumstances.

However, the SGP has also been strongly criticized for being insufficiently flexible.¹⁷ Romano Prodi even stated once: "I know very well that the stability pact is stupid, like all decisions which are rigid."¹⁸ Hence, in March 2005, the EU Council relaxed the rules to respond to these criticisms and to make the pact more enforceable and flexible.¹⁹ This reform in the SGP was necessary²⁰ particularly since the pact had lost all credibility when it proved not to be enforceable against big countries such as France and Germany, which, ironically, were the

¹⁴European Commission for Economic and Monetary affairs. The Stability and Growth Pact. http://europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htm

¹⁵ Guillermo de la Dehesa, "Fiscal Policy as an Stabilizer of Business Cycle Fluctuations in the Euro-Area", December 2001. <http://www.europarl.europa.eu/comparl/econ/pdf/emu/speeches/20011218/deladehesa.pdf>

¹⁶ Resolution of the European Council on the Stability and Growth Pact. <http://www.eurotreaties.com/stabilitygrowth.pdf>

¹⁷ Razin, Assaff and Efraim Sadka. The Stability and Growth Pact as an Impediment to Privatizing Social Security. The NBER Webpage. 2 October 2005. <http://papers.nber.org/papers/w9278.pdf>.

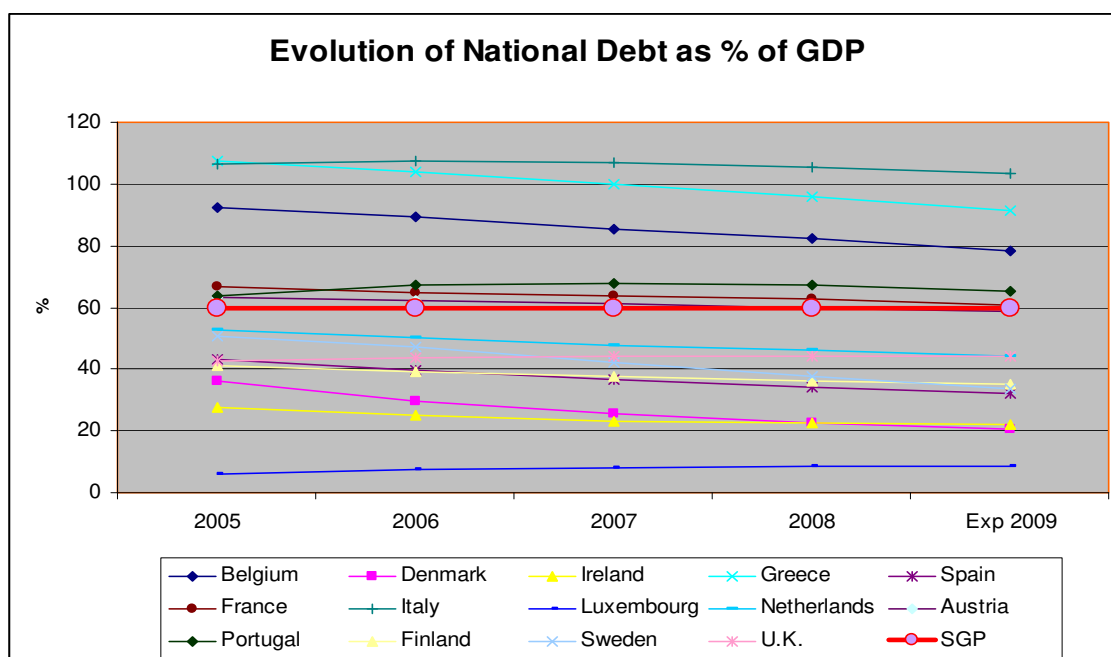
¹⁸Michael Keane. EU Stability and Growth Pact: Prodi Speaks Out. <http://archives.econ.utah.edu/archives/a-list/2002w42/msg00111.htm>. 4 October 2005

¹⁹ Kopits and Symansky in "Fiscal Policy Rules," published as Occasional Paper 168 in the IMF a set of benchmarks that were considered to be the "ideal fiscal rules".

²⁰ According to Professor Franz-Christoph Zeitler, Member of the Executive Board of the Deutsche Bundesbank, almost half of the countries in the euro area had either exceeded or were in danger of exceeding the 3% deficit ceiling specified by the Treaty.

biggest promoter of the SGP when it was created.²¹ Those in charge of the reform always kept in mind that they had to make the pact more flexible, though it was never meant to relax its standards. The main reason for the flexibility was that when the member states joined the EMU, each had a different economic "culture" and different economic cycle. After making the tremendous effort needed to meet the EMU's requirements to join, most countries suffered a series of economic imbalances. Hence these countries needed subsequently some flexibility to deal with these economic imbalances following the convergence effort.

The European Commission has stated that in comparison to previous years, the overall conditions of public finances have improved significantly in 2006, especially in the euro area. In fact, the Commission published a communication in which it explained that the current overall improvement of public finances is due to the reform of the Stability and Growth Pact (SGP) in 2005. This communication explains that "countries with an excessive deficit have made substantial progress, and based on current plans all but two of these countries will have brought the deficit below the 3% GDP by the end of 2008"²² (see appendix 3). With respect to maintaining a gross government debt to GDP 60%, the table below shows the evolution.



Source: This graph has been elaborated by the author. The data used for this graph can be found in Eurostat (http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1090,30070682,1090_33076576&_dad=portal&_schema=PORTAL) and has been graphed using Microsoft Excel

The Eurosceptics

Like a patient who can't resist scratching a scab, eurosceptics have since 1992 been constantly forecasting the demise of the euro. Yet they have been so far persistently wrong both about the future of the euro and the eurozone and its end.

Euroscepticism is the term used to describe those that oppose the process of European integration. Although, this group was first found in the U.K. as those who were sceptical of the

²¹ Katinka Barysch, *A Pact for Stability and Growth*. The CER Website. October 2003. The Centre for European Reforms. 6 October 2005. http://www.cer.org.uk/pdf/policybrief_stabilityandgrowth_oct03.pdf

²² European Commission, "Public Finances in EMU – 2007," Economic and Financial Affairs, http://ec.europa.eu/economy_finance/publications/european_economy/public_finances2007_en.htm

U.K. joining the European Economic Community (EEC), it encompass now all those who are ultimately against the EU per se, the Constitution, or just the euro. Even in the European Parliament those voices have coalesced to form the "Independent/Democracy Group of the European Parliament."²³

Currently, eurosceptics tend to focus on two main issues. Their major concern is economic: some eurosceptics argue against the feasibility of the EMU and the euro as a solid common currency, based on a lack of accountability in the implementation of the SGP and the slow pace of fundamental structural reforms needed to solve some fundamental economic problems, which they refer to as "eurosclerosis". Additionally this lack of economic coherence leads to the second problem for eurosceptics: the insufficient and incomplete integration, which is essential for the EU in order to act as a unitary actor. As Anselmo Callejas wrote:

lo más importante sea quizás su deficiente integración, pues para hacer uso debidamente de su enorme masa crítica, Europa tiene que actuar como un equipo. Sin embargo, esto se va haciendo cada vez más difícil pues la identidad europea la está disolviendo el despertar de unos nacionalismos que se arrastran detrás de unos míopes instintos egoístas-proteccionistas frente a los desafíos de la globalización.²⁴

Historically, politics and nationalism have impeded the path towards a common currency; in fact, Stuard Mill wrote in 1848 "... So much of barbarism, however, still remains in the transactions of most civilized nations that almost all independent countries choose to assert their nationality by having to their own inconvenience and that of their neighbours, a peculiar currency of their own."²⁵

Fortunately, according to the latest Eurobarometer the support for membership of the European Union and eurozone is at its highest in over a decade, i.e. since 1994 when in the autumn of that year support among the twelve member states reached at 58%. The latest Eurobarometer has reported that a tangible majority of 57% of EU citizens think that their country's membership of the European Union is a good thing. (...) We note significant minority opposition in the UK (30%), Austria (25%), Finland and Sweden (both 24%) as well as France (21%).²⁶

In terms of predictions about the euro, most eurosceptics have forecast that the euro would never challenge the US dollar's dominant role first as an international currency, and then as an official reserve currency. Charles Wyplosz²⁷ states that the EMU and the euro are "the hidden agenda of Europe's long-planned adoption of a single currency" with the sole purpose to challenge the economic supremacy of the US and the dollar. In his opinion, the euro will only dominate in what he calls the "euro-time zone" which for him "this is the euro's turf".²⁸ In fact, Mundell believes that there were not only economic incentives for the creation of the euro, but also four very important political ones: "(1) fear of invasion by the Soviet Union; (2) the need to bury Franco-German enmity; (3) emulation and jealousy of the United States; and (4) desire to increase or restore Europe's power".²⁹ For Cohen, "the euro will of course dominate monetary relations within the European region and may even extend its influence to some neighbouring

²³ The Independence/ Democracy Group in the European Parliament
<http://indemgroup.eu/16/>

²⁴ Anselmo Calleja, "Europa, mucho ruido..." *Cinco Días*, February 16, 2006.

²⁵ John Stuart Mill, *Principles of political Economy*, Vol. 2, New York, 1894, pp. 176

²⁶ European Commission, "Eurobarometer 67, Public Opinion in the European Union," Publication June 2007, http://ec.europa.eu/public_opinion/archives/eb/eb67/eb_67_first_en.pdf

²⁷ Charles Wyplosz, "An International Role for the Euro?," in Jean Dermine and Pierre Hillion, eds., **European Capital Markets with a Single Currency**. Oxford: Oxford University Press, 1999, pp 76

²⁸ Wyplosz, 1999, 89

²⁹ Robert Mundell, "The significance of the Euro In The International Monetary System," Speech for the Henry George Lecture series at the Pace University, New York, February 26, 2002, pp 6.

areas. ... But elsewhere, for the foreseeable future, Europe's new money is fated to remain a distant second to the greenback."³⁰

However, in 2007 the euro is considered without doubt an international currency, e.g. "in December (2006) the currency came of age by overtaking the US dollar in terms of the value of notes in circulation."³¹ The Euro has been proven to successfully develop a solid financial market. Hence it is eroding some of the advantages, which historically supported the hegemony of the US-dollar as a reserve currency. In fact, according to Walter, the euro has become a reserve currency itself despite its weakness between 1999 and 2001. He explains that theory and

long-term experience with the dollar as a reserve currency shows that there is a long-term correlation between the development of the exchange rate and the dollar's use as international reserve currency. ... But the euro did not follow the simple rule that a weak exchange rate automatically means losing ground as a reserve currency. Even when the euro was weak between 1999 and 2001, its share as a reserve currency increased from 17.9% to almost 20%.³²

Hence it appears that Jacque Delors's endlessly quoted premonition of "le petit euro deviendra grand" has become a reality despite eurosceptics' warnings – or preferences – to the contrary.

In terms of the economic performance of the eurozone, statistics published by the European Union, the International Monetary Fund, the World Bank, the OECD, and most independent research centres continue to show that far from disappearing as a political and economic block, the eurozone has perfectly integrated politically; and economically. It has also accelerated impressively from 0.5% in March 2002 to 3.2% in March 2007. Furthermore, 2006 has been a stellar year for the economy of the eurozone as it grew at the same rate as the U.S., and in fact even faster than Britain. Nevertheless, the eurozone still has a long way to go to lock in these gains.

	Real GDP YoY (June,2007)	CPI YoY (August, 2007)	Unemployment Rate	Central Bank Rate	Current Account Balance
Australia	4,30%	2,10%	4,30%	6,50%	-15.998,00
Canada	2,50%	1,70%	6%	4,50%	8,36
China	11,90%	6,50%	N.A.	3,87%	249.866,01
Germany	2,50%	2%	9%	4%	-720,00
France	1,30%	1,20%	8%	4%	-2,20
UK	3%	1,80%	5,40%	5,75%	-12,20
Italy	1,80%	1,60%	6,03%	4%	896,00
Japan	1,60%	0%	3,60%	0,50%	1.855,00
US	1,90%	2%	4,60%	4,75%	-190,79
India	9,30%	6,80%	N.A.	6%	2.563,00
Brazil	5,44%	4,10%	N.A.	11,25%	-717,00
Spain	4%	2,20%	N.A.	4%	-9.723,20

Source: Eurostat

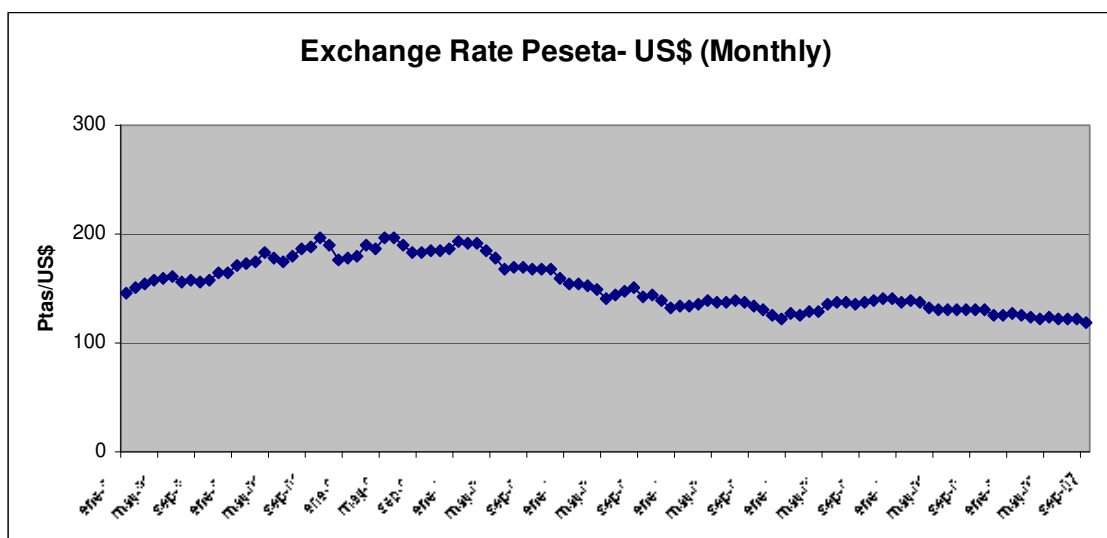
³⁰ Benjamin J. Cohen, "Global Currency Rivalry: Can the Euro Ever Challenge the Dollar?," *Global and International Studies Program*, (University of California, Santa Barbara), Year 2003, Paper 8, <http://www.polsci.ucsb.edu/faculty/cohen>

³¹ Ralph Atkins, "A Coming of Age for the European Currency", *Financial Times*, Thursday December 28, 2006.

³² Walter, 2005, 6

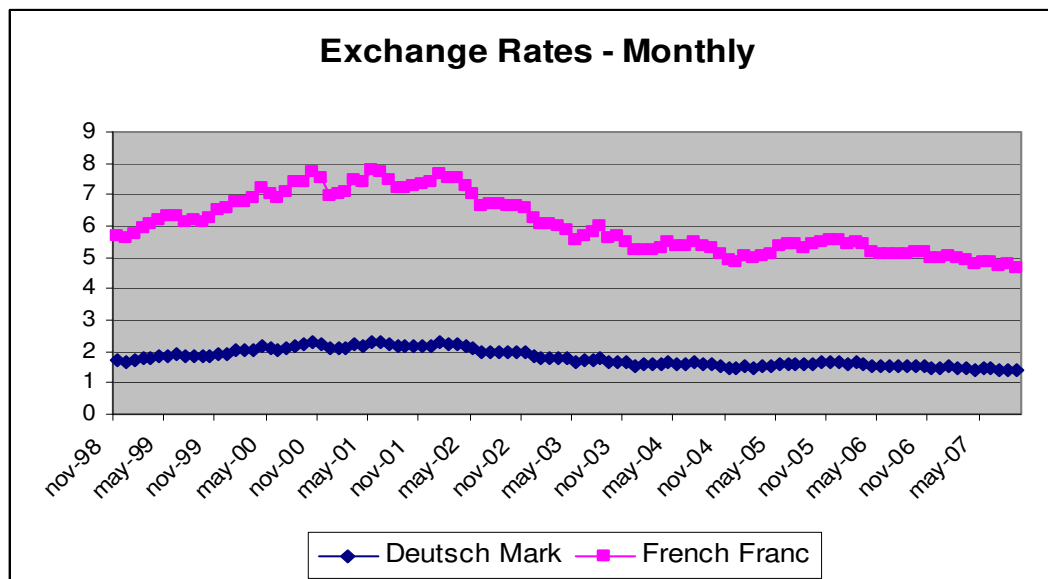
Euro-sceptics appear to have misinterpreted leading and coincident economic indicators which pointed to a strong cyclical improvement in the eurozone economy: unprecedented GDP growth, robust business confidence, strong exports, improvement in the unemployment rate, rapid money growth with low interest rates, and a strong currency (see appendix 1). By comparison, foreign exchange data-vendors still have available most cross-rates that existed before the euro. Those graphs clearly show that were the eurozone cease to exist, and countries had to take back their own currency, the foreign exchange behaviour of their currencies would be that which they had while using the euro. There are two reasons behind the continuity of the foreign exchange cross-rates. On the one hand, continuous reports forecasting the demise of the Eurozone and the end of the euro by the euro-sceptics. On the other hand, the Eurozone is a political commitment in favour of economic integration. However, the economy and the market have a tendency to lag behind political initiatives and since there have been many unsuccessful attempts at monetary union, the currency markets have integrated but maintained an open gateway. These are the reason why some currencies maintain their daily cross-rates with the dollar (see appendix 2).

The graph for the Spanish Peseta shows that if on September 2007 the Peseta would have been re-adopted, its actual level would have been 118.05 pesetas per US\$, or 238 peseta per sterling pound (see appendix 2). This exchange rate would be very negative for Spain, showing that the euro is the best thing that has ever happened not only to Spain, but to all European Countries.



Source: This graph has been elaborated by the author. The data used for this graph was provided by eSignal (www.esignal.com) and the data collected has been graphed using Microsoft Excel.

A further example is, were the Deutsche Mark and the French Franc in circulation, their rate against the US\$ would be DM1,3877US\$ and FRF4,6542US\$ respectively.



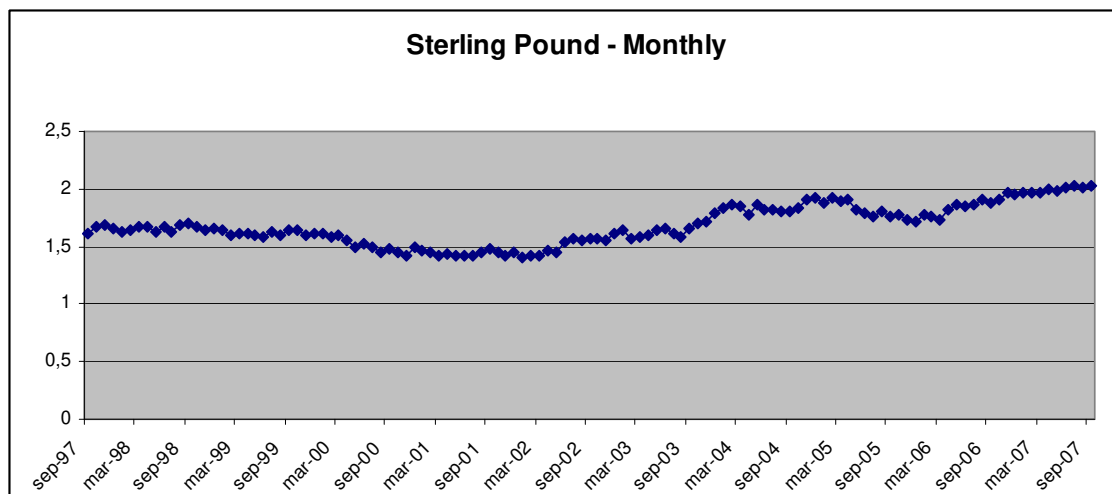
Source: This graph has been elaborated by the author. The data used for this graph was provided by eSignal (www.esignal.com) and the data collected has been graphed using Microsoft Excel

One interesting graph is that of the Sterling Pound. The UK has been reluctant since the beginning to adopt the euro for two main reasons: On the one hand, there is a political reason such as Stuart Mill realized that a national currency is a badge of independence and a symbol of liberty and sovereignty. According to Mundell, there is always a

tendency for the dominant country to reject a world currency. The basic fear is that a global currency represents a threat to the position of its own currency. The counterpart of the conjecture is that actual or potential rivals try to pursue international monetary reforms to clip the wings of the dominant power and to redistribute power.³³

On the other hand, there was an economic reason. According to Sir Edgard George, governor of the Bank of England from 1993 to June 2003, it was very difficult for the pound to join the euro in 1999, given the value of the pound to the Deutsch Mark. He told BBC in an interview titled "George Rules Out Euro Entry" on June 12, 2001 that "the only way out of the dilemma were if the euro strengthened against the dollar, as then the pound might be able to fall against the euro while also strengthening against the dollar." However, it seems that his wish is becoming true, as the euro is strengthening against the dollar, and the pound is weakening against the euro as shown in the graph below.

³³ Robert Mundel, "The International Monetary System and the Case for a World Economy," Léon Kozminski Academy of Entrepreneurship and Management (WSPiZ) and TIGER, Distinguished Lecture Series n. 12, Warsaw, 23 October 2003, p.4



Source: This graph has been elaborated by the author. The data used for this graph was provided by eSignal (www.esignal.com) and the data has been graphed using Microsoft Excel

Eurosceptics' negative economic forecasts may eventually become true. However, this would not mean the end of the euro currency or the demise of the eurozone. They are proclaiming that the overvalued euro, the political situation, the rising taxes and tight monetary policy will definitely push the eurozone into recession. Countries like Germany, Italy, Spain, Portugal and Greece are predicted to not be able to ride out a recession, because they have not made the necessary structural reforms to go through difficult times as they believe that eurosclerosis is still continuing despite proven economic improvements.

However, in a global and free-market economy there will always be economic turbulences triggered by internal and/or external shocks in one particular area of the economy, which will eventually spill-over and affect other economic areas. Nevertheless, we cannot think that the Eurozone is going to suffer a major economic set-back because only very rigid economic systems or with highly interventional governments are affected by internal and/or external shocks. For this reason Almunia declared that "la turbulencia de los mercados no afectará al crecimiento de la eurozone en 2007, pero sí podría hacerlo en 'unas décimas' en 2008, aunque en 'cualquier caso, la economía europea está asentada."³⁴ Indeed, Almunia has stated that the recent turmoil in the financial markets, i.e. the "sub-prime turmoil", although not expected to significantly affect eurozone economic growth in 2007, has negatively affected its projected economic growth and he has therefore cut growth expectations.³⁵ Yet these cuts are small³⁶ as Almunia is confident that "eurozone growth remains supported by sound fundamentals and a continuing favorable global environment."³⁷

³⁴ C. Molina, "El PIB de la UE se puede resentir en 2008 por la crisis hipotecaria," *Cinco Días*, 4 de Septiembre de 2007.

<http://www.cinco dias.com/articulo/economia/PIB/UE/puede/resentir/2008/crisis/hipotecaria/cdsedi/20070904cdsdi/4/Tes/> (accessed on Tuesday Sept. 4th, 2007).

³⁵ Tony Barber and Ralph Atkins, "Eurozone Still on Track After Global Turmoil," *Financial Times*, Sept. 5, 2007.

³⁶ the forecasted economic growth in 2007 is now expected to be 2.5% in the euro area—this is only 0.1 percentage point less than in his spring forecast.

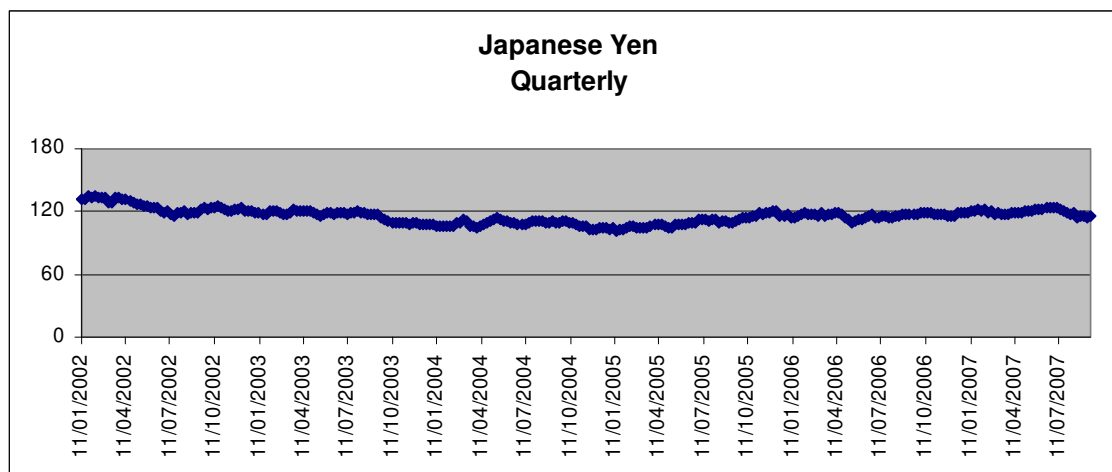
³⁷ Commission for the Economic and Financial Affairs, "Interim Forecast 2007"

http://ec.europa.eu/economy_finance/news/hotissues/2007/forecast_0907/main_en.htm

The euro and Its Influence on the Economy of the Eurozone

Economic theory explains that the economic situation of a country is represented by the strength of its currency.³⁸ In fact, in the 19th century during the Pax Britannica, the strength of the Sterling was the embodiment of Britain's global hegemonic political and economic power. However, since the 1980's, due to the deregulation of currencies and financial markets, and the effects of globalization, currency strength *now* seems to convey little information about the economic health of a country, and almost nothing at all about a country's competitive position in global trade.

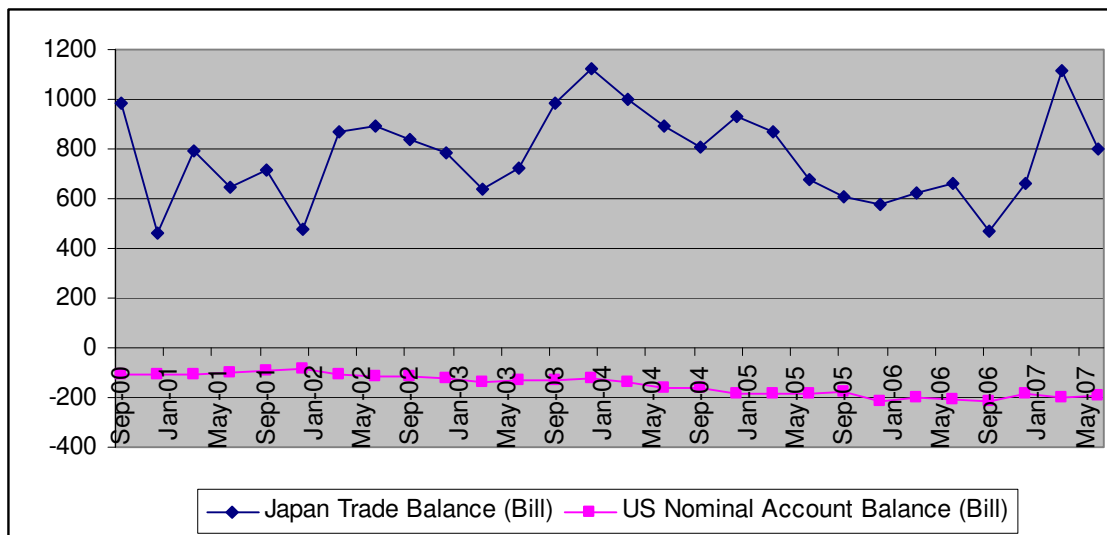
In fact, it seems that lately the relationship between trade balance and foreign exchange rate is no longer an accurate indicator of a country economic performance. For instance, on one hand, the Yen has been even weaker than the US dollar for the past three years.



Source: This graph has been elaborated by the author. The data used for this graph was provided by eSignal (www.esignal.com) and graphed using Microsoft Excel

And yet, Japan is the world's greater creditor nation, and enjoys the biggest trade surplus the world has ever seen, while, on the other hand, we have a falling US dollar reflecting the huge US's trade deficit.

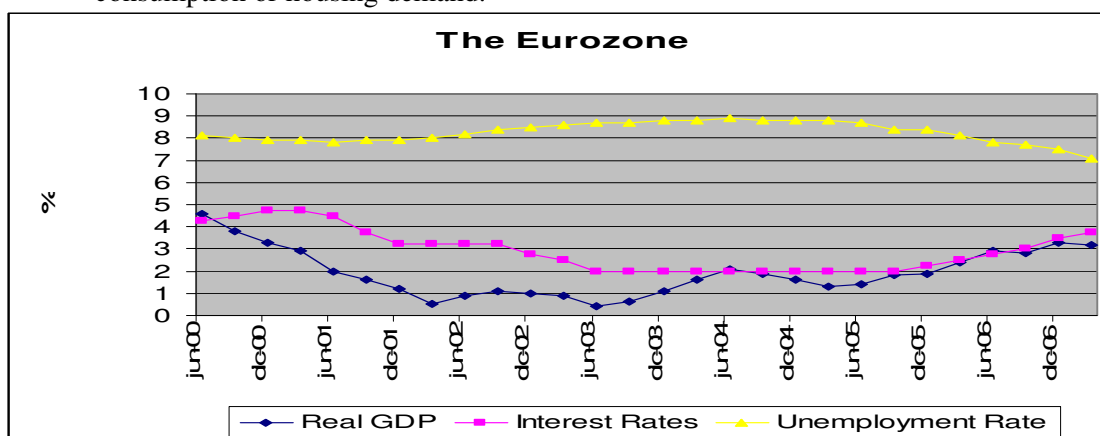
³⁸ Helmut Frisch, "The Euro and Its Consequences: What Makes a Currency Strong?," *Atlantic Economic Journal*, Vol.31, No. 1, (March 03).



Source: This graph has been elaborated by the author. The data used for this graph can be found in Eurostat (http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1090,30070682,1090_33076576&dad=portal&schema=PORTAL) and the data has been graphed using Microsoft Excel

Furthermore, there is another important economic tenet that is not holding true when analysing the economic behaviour of the eurozone: the idea that when a currency rises above a historically established level, two particular outcomes are to follow³⁹ (graph 2):

- A country with a rising currency experiences a sharp reduction in net exports and corporate investment, but 12 month after the currency movement takes place.
- Hence, it brings a significant reduction in economic growth and employment, unless the drag from net exports and investment is offset by some expansionary force like a reduction in interests rates or taxes (expansionary policies) aiming at stimulating consumption or housing demand.



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In analyzing these graphs we can see how the eurozone is witnessing an increase in the Euro against the US dollar, and yet exports are growing like never before. Its economic growth is the envy of other countries, and unemployment is reaching its lowest levels - all without any

³⁹ Paul Krugman and Robin Wells, *Macroeconomics*. New York: Worth Publishers, 2006.

expansionary monetary or fiscal policies! On the contrary, the eurozone is under tight contractionary fiscal and monetary policies, with the ECB raising interest rates and governments increasing taxes.

Therefore, following the "Optimum Currency Area" theory, developed by R. Mundell, the euro can now be considered an optimum currency for the eurozone area. The "Optimum Currency Area"-theory explains that a currency can be considered to be "optimum" for an area when

monetary and fiscal policy and flexible external exchange rate can be used to give the best resolution of three (sometimes conflicting) objectives: (1) the maintenance of full employment; (2) the maintenance of balanced international payments; (3) the maintenance of a stable internal average price level.⁴⁰

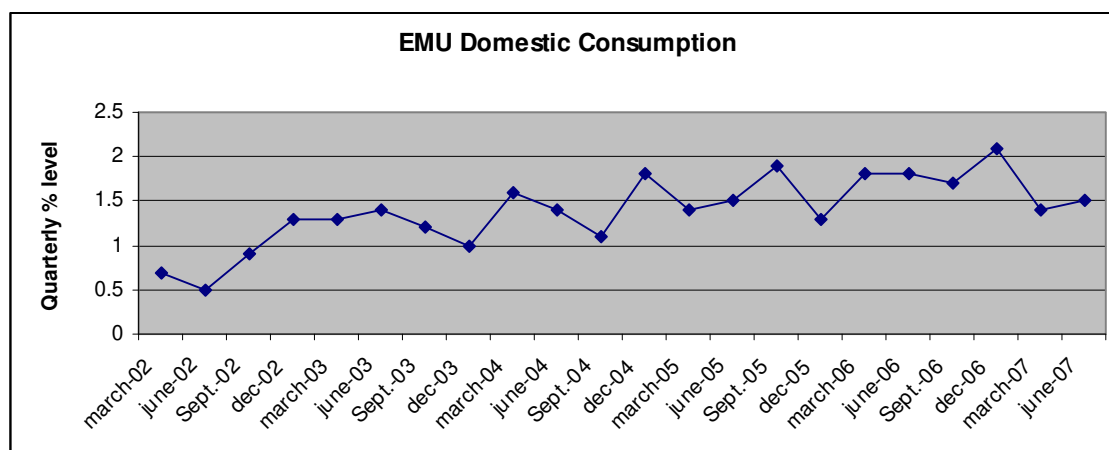
An important debate taking place today between economists, scholars and politicians is to explain the current level of the euro. Some are claiming that the foreign exchange rate of \$US/€ witnessed for the past 2 years and the current strength of the euro is not due to the eurozone's economic fundamentals, but is "made in the USA." The US-authorities have been "interested" in maintaining a low US dollar rate against the euro and other major currencies in order to help reduce the huge US trade deficit and even to finance the Iraq War. Hence, if America's trade deficit explains why the dollar is so weak, trade imbalance cannot explain the strength of the euro. In fact, this is an issue that worries Spanish's Economic Minister Solbes. He has recently stated that he is "not happy with the excessive volatility of the euro. It makes it very difficult for companies and households to plan ahead and to adapt."⁴¹ He acknowledges that the rate of the euro is "relatively high", but stated that a strong currency has helped curb import costs and contain inflation. Hence, the current exchange rate between the euro and the US dollar seems to be beneficial for both the US and the Eurozone.

Additionally, the graph below shows that eurozone exports have lately not been very sensitive to exchange rates. According to economic theory⁴² there ought to be an inverse correlation between exports and exchange rates: when the exchange rate is high, export are supposed to be low. However, this time around this rule of thumb is not properly applying either. Finally, economic theory states that when a country is experiencing tight monetary and fiscal policies, domestic demand tends to decrease. And, as the graph below shows, this is the only economic tenet that is working in the eurozone: internal consumption is slowing due to major tax increases in most of the countries, and a ferocious monetary policy by the European Central Bank (graph 4).

⁴⁰ Ronald I. Mackinnon, "Optimum Currency Areas," *The American Economic Review*, Vol. 53, No. 4 (Sep., 1963), pp. 717-725.

⁴¹ Leslie Crawford, Mark Mulligan and Frederick Stüdemann, "Spain Is Braced For Pain As Germany Slows Down," *The Financial Times*, September 28, 2007, <http://www.ft.com/cms/s/0/aa819d8c-6d5e-11dc-ab19-0000779fd2ac.html>

⁴² Paul Krugman and Robin Wells, *Macroeconomics*. New York: Worth Publishers, 2006.



Source: This graph has been elaborated by the author. The data used for this graph can be found in Eurostat (http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1090_33070682_1090_33076576&_dad=portal&_schema=PORTAL) and graphed with Microsoft Excel

This signals that in the current world of globalization there seems to be an inconsistency between the theory that currencies are driven by trade performance, and the empirical experience of the past decade, since it appears now that trade balances are almost irrelevant to currency levels. If exchange rates were still driven by trade as they were in the 1970's, then the only tradable currency going up against the dollar would be the yen, since Japan has by far the world's largest trade surplus. However, the yen has been the only currency that has not been rising against the dollar this year.

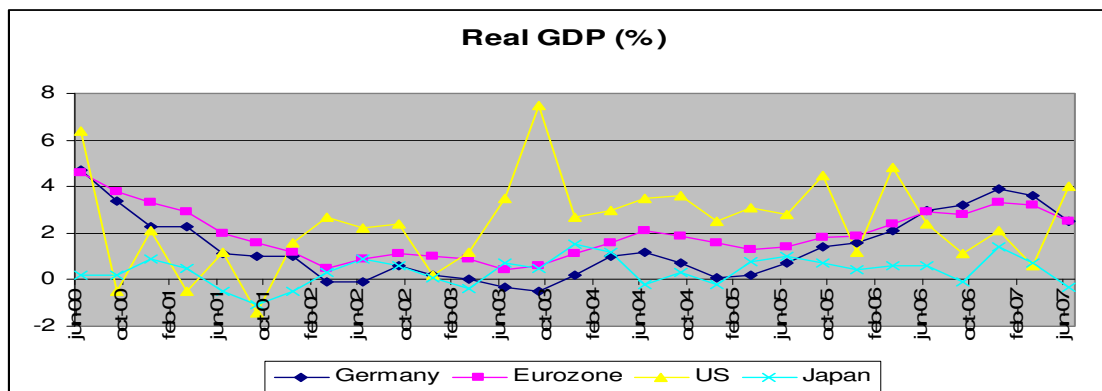
Therefore, the real mystery of today's eurozone growth does not seem to be about consumers and their apparent invulnerability to higher interest rates and taxes because consumers are responding as expected to these monetary and fiscal policies: they are tightening their belts, and retailers are preparing for a severe shock as tax hikes begin to be felt this year in Italy and Germany, and the building bubble burst in Spain and Portugal. The real mystery is how export growth in the eurozone was so spectacularly strong, given that the world economy is not growing at a significant pace, and that the rising euro was making exports increasingly uncompetitive against U.S., China and Japan, while the domestic demand was decreasing in most of the eurozone countries due to both fiscal and monetary policies tightening. However, the last IMF report states that economic fundamentals, both in the large industrial economies and in most major emerging economies, remain strong. De Rato explains that "despite some slowing in the second quarter of 2007, growth in the euro area and in Japan was expected to continue at a solid rate of around 2.5 percent, and major emerging markets like China and India will grow at close to or above double digit rates, thereby increasing their contributions to global growth."⁴³

The Euro as a Stabilizer: Some Examples

Since the introduction of the euro as a common currency, the financial and economic situation of the countries in the eurozone has improved substantially. The economic situation in the eurozone, characterized by economic growth where most of its members are enjoying a positive trade balance despite a strong euro, while internal demand is declining due to tax increases and high interests rates, helps control the inflation rate. All this means that the euro has become a stabilizing factor in the eurozone due to the economic and fiscal efforts which countries have to undertake in order to qualify for the euro, and the SGP which keeps them under surveillance.

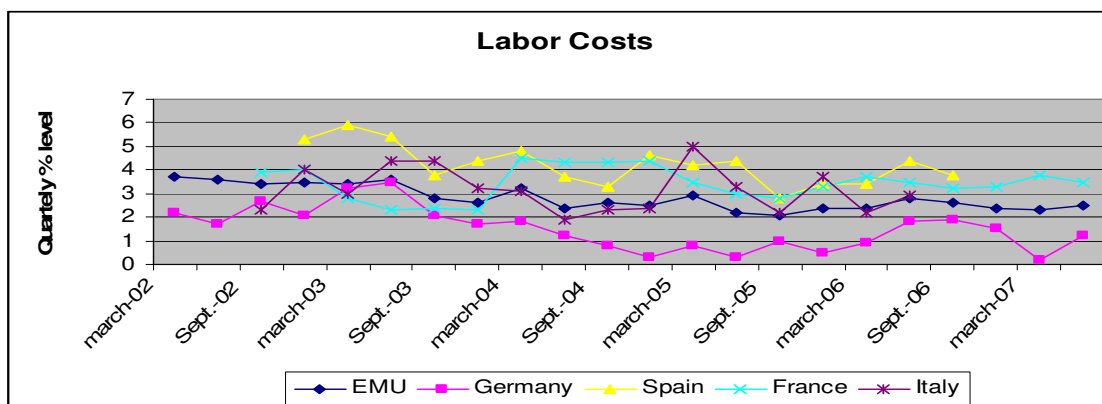
⁴³ Rodrigo de Rato, "IMF Survey: World Growth Solid Amid Market Fears," International Monetary Fund, August 23, 2007, <http://www.imf.org/external/pubs/ft/survey/so/2007/NEW0823A.htm> (accessed on Sept., 1st, 2007)

For example, the economy of Germany has gone through worrying times and was believed to be in the brink of recession, yet rose from the ashes like the Phoenix. Germany has become one of the faster-growing economies among the G7-countries and among most of the EU and Eurozone, expanding by 3.7% in 2006, compared with a growth rate of 3.4% in the US, and 3% in the UK, and 2.5% in the eurozone (graph 5).



Source: This graph has been elaborated by the author. The data used for this graph can be found in Eurostat (http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1090,30070682,1090_33076576&_dad=portal&_schema=PORTAL) and the data has been graphed using Microsoft Excel

This unexpected economic behaviour in Germany may be attributed to labor and fiscal reforms despite tougher management disciplines, and to larger tax increases for consumers, aimed at cutting the budget deficits without an easing of monetary policy. In fact, Germany has undergone a mayor labor market reform, which has led to important labor cost reductions (graph 6).



Source: This graph has been elaborated by the author. The data used for this graph can be found in Eurostat (http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1090,30070682,1090_33076576&_dad=portal&_schema=PORTAL) and graphed with Microsoft Excel

Italy also has experienced unprecedented growth despite Prodi's introduction of some of the biggest tax increases in the country's history. Finally, it appears also that Brussels is

succeeding in its efforts to prevent major tax cuts in France, and Spain and Italy where the fiscal pressure has increased the most last year.⁴⁴

In the case of these countries, taxes have been raised while the ECB has not changed the course of the monetary policy. In fact, Trichet has stated that the ECB's decision on the interest rate will depend on whether calm returns to financial markets, as well as its assessment of the outlook of the eurozone economy as a whole, since certain economic indicators have pointed to some weakening of the eurozone growth.⁴⁵

This seems to prove that the inverse correlation between taxes and interest rates is no longer working in eurozone countries. In fact, it proves that interest rates can be managed by a supranational institution—the ECB—independently of fiscal idiosyncrasy within each national economy, i.e. through the effect of (rising) taxes in a country. However, this behaviour defies another major macroeconomic theory: governments that in periods of economic stagnation impose tough fiscal squeezes usually ease their monetary policy. In this case, most of the countries of the eurozone are suffering from increasing fiscal policies and high interests rates, with the result that economies are so far growing rather than stagnating under controlled inflation rates. This outcome for the Eurosceptics is a set-back, because it proves that the economic integration of the EU, with its ups and downs, is really a fact and no longer a chimera.

World Consensus

The economy of the eurozone has been enjoying a "sweet" moment with a strong euro and sustained economic growth. However, the US dollar still maintains its hegemony as a currency of reference which grants the US economic gains derived from seigniorage.⁴⁶ This hegemony of the US dollar can be explained by understanding that in today's foreign exchange market the US dollar remains the reference currency against which all other currencies fluctuate in a "zero-sum game" market; that is, one currency increases its value to the expense of the other's currency value. However, the Renminbi or Yuan is the only currency which is controlled by the (Chinese) government, and whose value against the US dollar is highly refuted by the academic, economic and financial community. This zero-sum game has always existed in the foreign exchange market, as it did previously with the Deutsche Mark, and as it exists now with the Euro. But due to today's deregulation and globalization, currency fluctuations have become highly independent from political decisions and governments can intervene in the performance of their currencies less than they would prefer. One major reason for this is that it is impossible to calculate how much currency is held by countries as for instance China's and Russia's reserve of US\$ are unknown.

For this reason Commissioner Almunia has criticized French President Sarkozy's latest statement regarding the value of the euro and the performance of the ECB. French president Sarkozy has been making economic headlines with his comments about the urgency of a common policy to drive down the euro's external exchange rate. He has declared that politicians, not central banks, should be in charge of exchange rate policy, as is the case in the US and most other countries including Germany before 1999.⁴⁷ He has stated that the euro's exchange rate should be actively managed to be competitive; that is, deliberately kept from appreciating above a certain level: a level that in the medium and long-run can hurt the eurozone economy. Commissioner Almunia rebutted that France should stop blaming the ECB and the euro for France's current difficult economic situation, but that France should instead "to pay attention to the evolution of

⁴⁴ Direcció General de Comunicació Exterior, "España, el país de la UE donde más subió la presión fiscal en 2005", *La Gaceta de los Negocios*, 27 de Junio de 2007.

⁴⁵ Ralph Atkins, "ECB keeps World guessing on next rates decision," *Financial Times*, Tuesday August 28, 2007. p. 2.

⁴⁶ Patrick Artus, Andre Cartapanis, and Florence Legros, "Towards a Macroeconomics of Exchange Rate Regimes," *Revue économique*, Vol. 54, No. 5, Sep., 2003, pp. 905-912

⁴⁷ Wolfgang Munchau, "Sarkozy jeopardises the future of the eurozone," *Financial Times*, July 2, 2007.

unit labor costs and productivity⁴⁸ as a way to improve its economic performance (see graph above on labor cost).

Final Word

The eurosceptics never expected the eurozone to become such an economic success. Their underlying assumption was that, based on the previous failed attempts, the EMU and the introductions of the euro were just going to be further failures. However, in my opinion they misunderstood one important economic point: all previous economic unions, including the Bretton Woods system, failed because the underlying asset holding the system together was gold, a scarce resource, and countries' economic growth was tied to the production of gold. However, the EMU and the euro are backed by unlimited resources like productivity, growth, investment, etc. that can be "managed" to suit the requirements of the SGP which, while met, guarantee the continuation of the union.

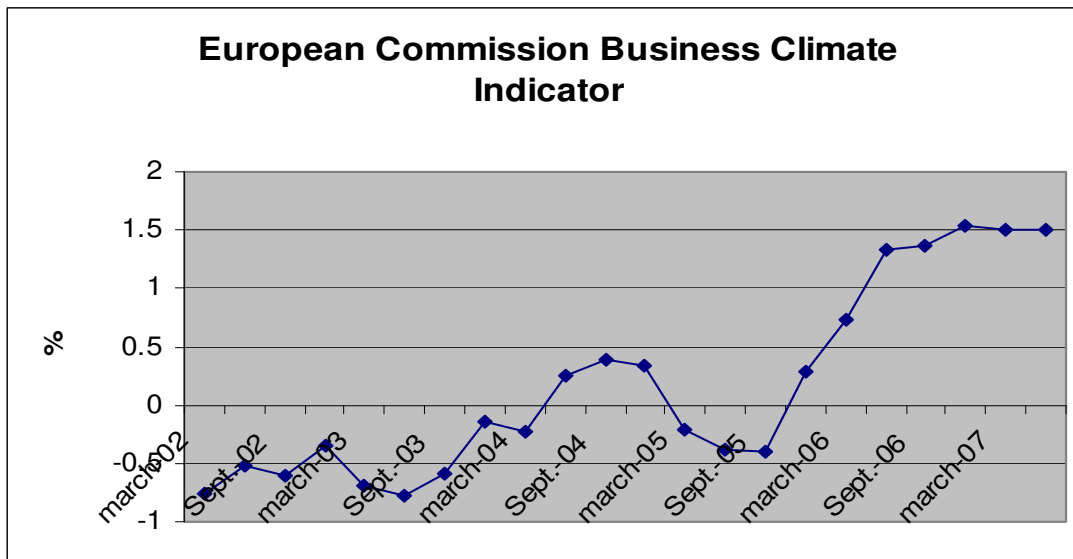
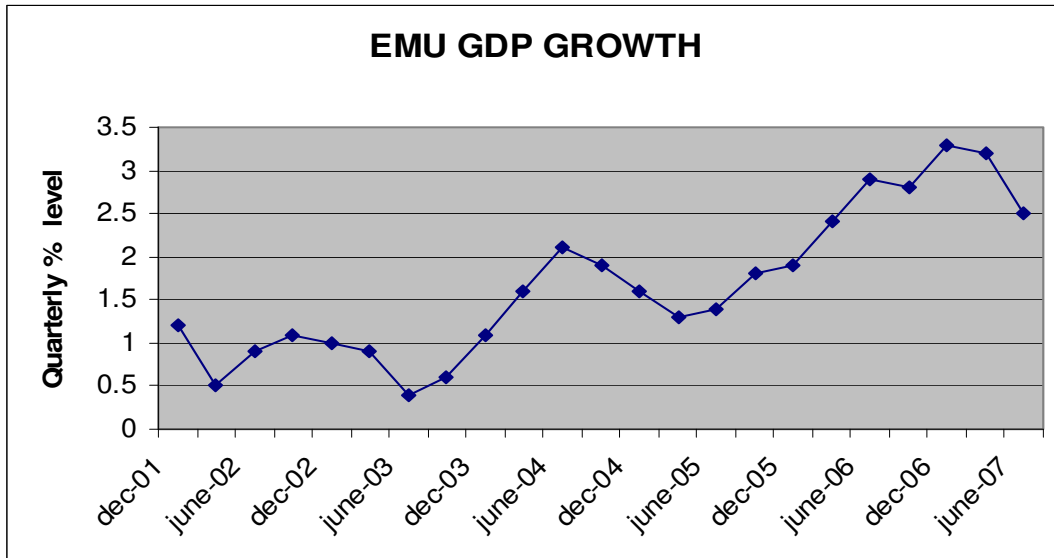
The monetary and fiscal discipline that comes along with the euro has stabilized the member states and turned the eurozone in an economic giant—the second after the EU—and the strong currency is ensuring the role of the eurozone as an important economic key player. Additionally, due to the current strength of the euro, the eurozone has gained status and prestige in the international political arena, and, as the issuer of a main global currency, it has also strengthened its "soft power". This soft power, together with the strength of the euro against the US dollar, makes the eurozone very attractive as a labor destination for those seeking to improve their work conditions: In fact, member states of the eurozone do not export, but import, labor.

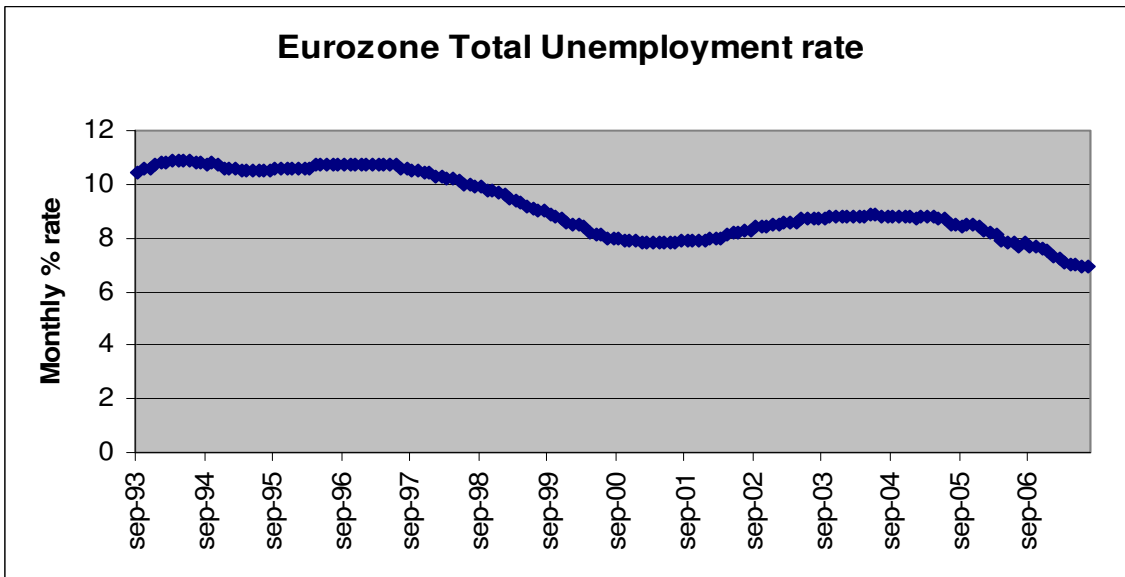
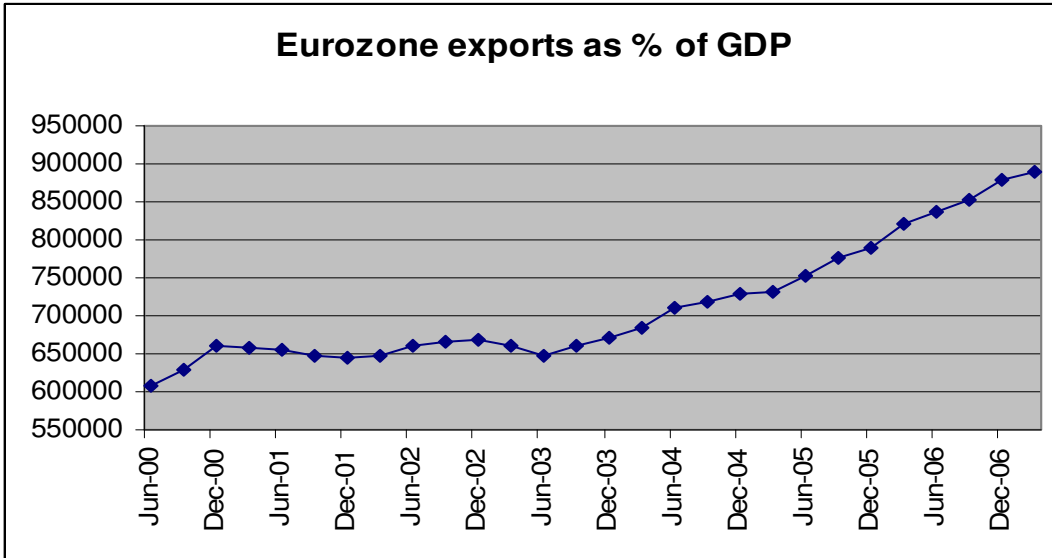
Finally, the EU is beginning to create its own political and economic cycle like the US or the UK. Since its creation until the last enlargement, the EU has been enjoying a "growth phase." The EU has been growing like a political actor reinforced by a general favourable economic cycle, characterized by strong growth, controlled inflation, and reduced unemployment. Now it seems that the EU has entered a political "plateau phase" due to the difficulties encountered by the Reform Treaty. However the political "eurosclerosis" of the eurosceptics must be overcome in order to help maintain economic growth which faces two linked challenges: One economic, caused by external shocks due to the deregulation of markets and institutions in countries like US, China, and India. The second is an internal challenge, because certain parts of the EU and the Eurozone are developing a tendency to protectionism, not to hurt the EU or Eurozone, but as a defense mechanism against their deregulations as well as the effects of globalization.

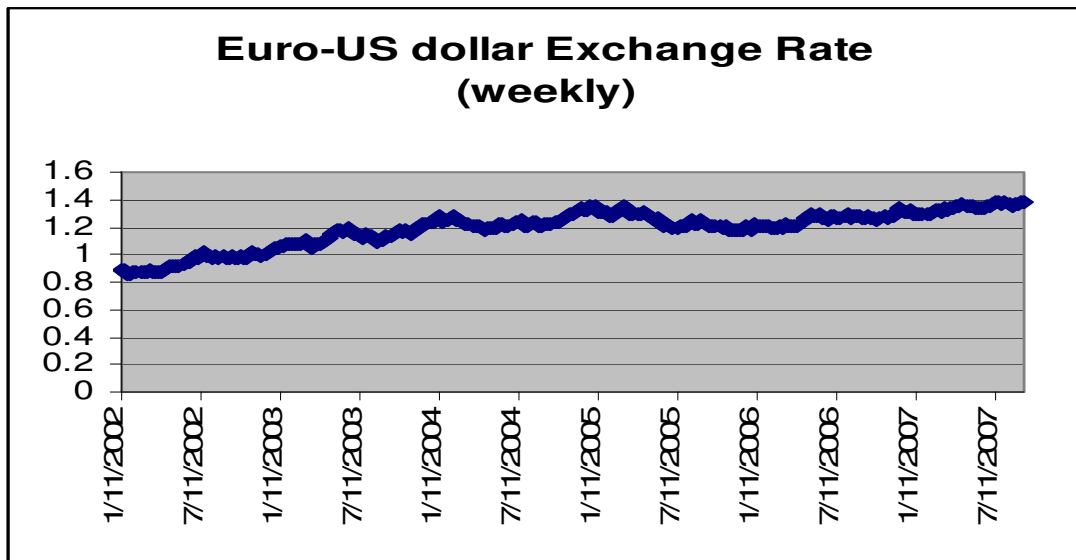
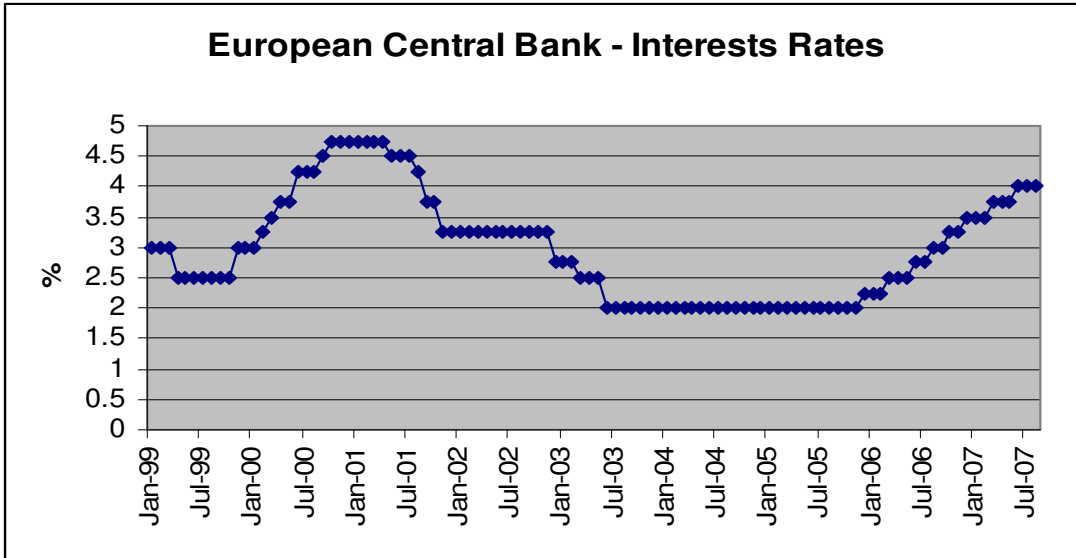
⁴⁸ Renata Goldirova, "Stop Blaming ECB and euro, Almunia Tells France," *EUObserver.com*, Sept, 28, 2007, <http://euobserver.com/9/24866/?rk=1>

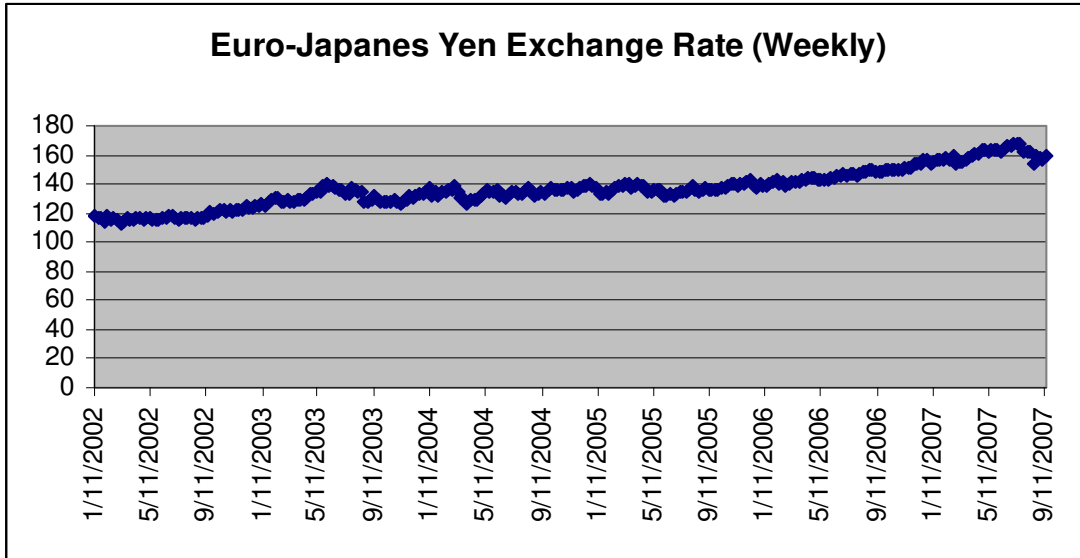
APPENDIX 1

Note: these graphs have been elaborated by the author. The data used for these graphs can be found in Eurostat (http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1090,30070682,1090_33076576&dad=portal&schema=PORTAL). The numerical data has been imputed manually and graphed using Microsoft Excel



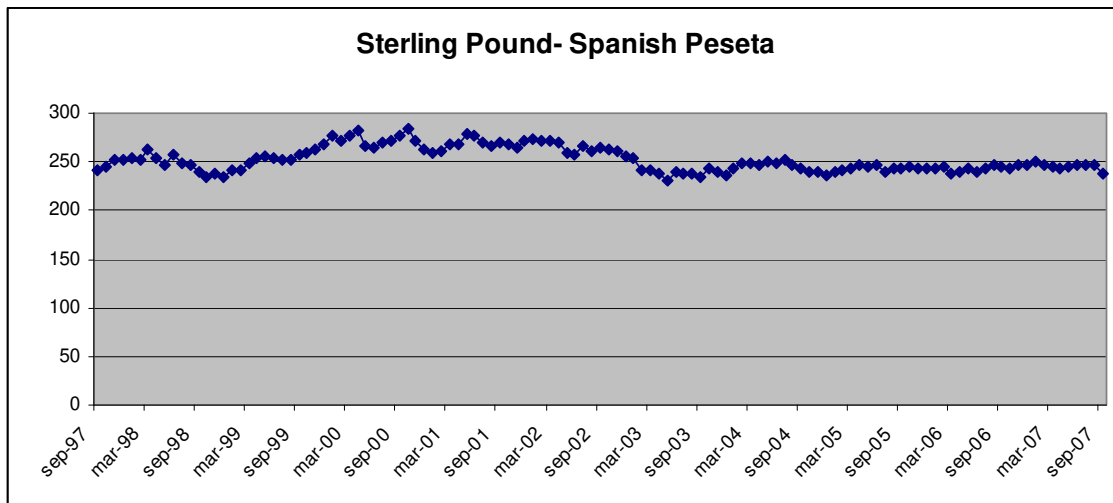
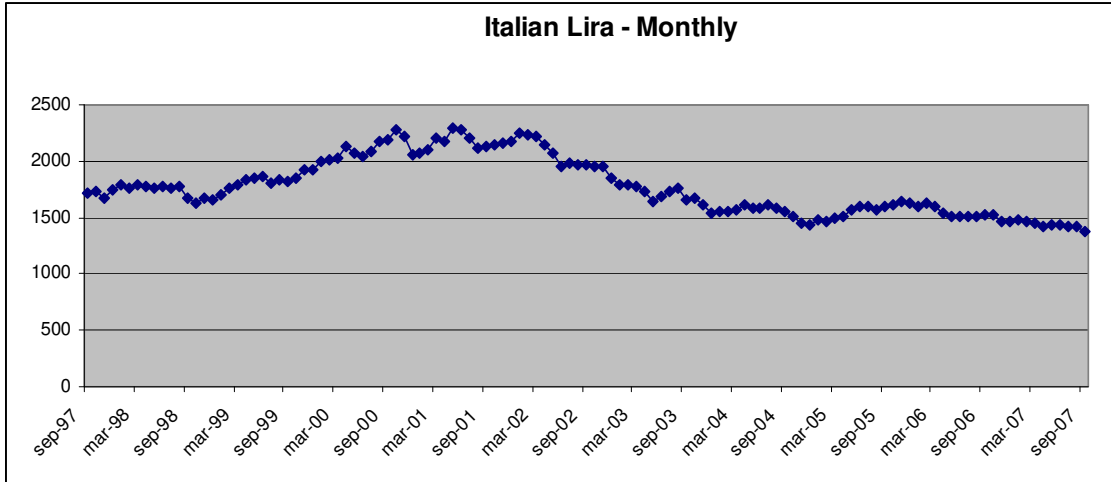






APPENDIX 2

Source: This graph has been elaborated by the author. The data used for this graph was provided by eSignal (www.esignal.com) and graphed using Microsoft Excel



APPENDIX 3

Member States	1992-1996	1997-2001	2002-2006
Belgium	-5.3	-0.5	-0.5
Germany	-3.0	-1.6	-3.4
Greece	-10.7	-4.7	-5.4
Spain	-5.6	-1.8	0.4
France	-4.9	-2.1	-3.3
Ireland	-1.6	2.3	0.7
Italy	-8.3	-2.2	-3.7
Luxemburg	1.6	4.5	-0.2
Netherland	-3.3	0.0	-1.4
Austria	-4.1	-1.5	-1.2
Portugal	-4.7	-3.3	-3.9
Finland	-5.8	2.8	2.9
Slovenia	n.a.	n.a.	-2.1
Euro area	n.a.		-2.6
U.K	-6.1	0.8	-2.9
EU 25	n.a	n.a	-2.5
Bulgaria	n.a.	n.a.	1.7
Rumania	n.a.	-0.6	-1.6

Source: Subdirección General de Asuntos Económicos y Financieros de la Unión Europea, "El Pacto de estabilidad y crecimiento," Boletín Económico de ICE n. 2905,