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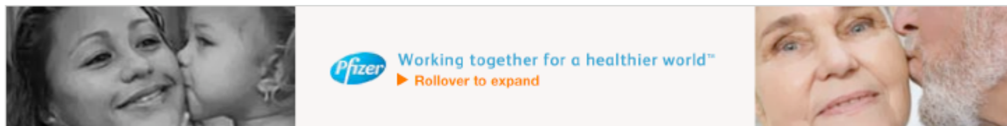

Special report

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A special report on the euro area

Fear of floating

Jun 11th 2009
From *The Economist* print edition

The financial crisis has made the euro look more alluring

Illustration by M. Morgenstern

IN 1999, the year the euro was launched, the Nobel prize for economics was awarded to Robert Mundell, a Canadian economist. That was good timing because his work was influential in shaping the euro zone. In a 1961 paper Mr Mundell had pioneered the theory of an "optimal currency area", a territory suited to adopting a common monetary policy. A main requirement, he concluded, was that workers throughout such an area would be sufficiently inclined to move jobs to even out regional booms and slumps. In later research others added strong trade links, wage flexibility and a central fiscal authority to the list of necessary features.

Equally important to the decision to join a monetary union was another of Mundell's insights, developed with Marcus Fleming at the International Monetary Fund, which entered the economics textbooks. This was the idea of the "impossible trinity": that a country could not simultaneously have a fixed exchange rate, be open to capital flows and operate an independent monetary policy. It could opt for any two of these features but not all three together. With free capital flows, monetary policy could be directed either at stabilising an exchange rate or controlling inflation, but not both. A country that targets domestic inflation and is open to foreign capital must have a flexible exchange rate.

When Mr Mundell expounded his theory, in the early 1960s, most rich countries were tied to the Bretton Woods system of fixed exchange rates. Because capital flows were tightly controlled, countries could set their own interest-rate policies and still keep exchange rates more or less fixed against the American dollar.

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Canada was different. Its long border, heavy trade and strong industry links with America made capital controls impractical. For Canada to have an independent monetary policy, it had to let its currency float. In later writings Mr Mundell expressed regret about Canada's choice, as well as enthusiasm for European monetary union. In principle, a currency adjusts to keep economies in balance, but in practice, argued Mr Mundell, exchange rates veer wildly from their ideal levels. Large and volatile capital flows mean that floating currencies can be a source of instability. They are also a poor substitute for fully flexible wages and prices.

In or out?

The merits of monetary flexibility versus exchange-rate stability have to be

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JSTOR, an archive of academic works, has Mr Mundell's paper on currency areas (subscription required). The EU has economic statistics for its member states. The European Commission has information on the ERM-2.

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weighed up by the 11 EU countries that are not (yet) in the euro. The choice is straightforward for Britain, which has long been reluctant to give up its independent monetary policy and has an opt-out from the euro. Britain's policy brass tend to see a flexible exchange rate as a useful safety valve. Sweden, like Britain, does not seem to have much to gain from hitching itself to the ECB. It has built a credible monetary regime, with an independent central bank, along similar lines. Since a referendum in 2003 that came out against membership, Sweden has shown no interest in getting closer to the euro club.

Denmark's currency is pegged to the euro but the country remains outside the euro zone after twice failing to secure a popular vote in favour of joining. It has the worst of all worlds. The currency peg is open to speculative attack, so its exchange-rate stability is precarious; yet to preserve it, the country has had to sacrifice an independent monetary policy. The government has been mulling a third referendum but the new prime minister, Lars Lokke Rasmussen, said in April that it would not take place this year.

The other eight potential members are former planned economies in central and eastern Europe (CEE) that joined the EU on or after May 2004. All are keen to adopt the euro. Those that had been cool on membership, such as the Czech Republic, have warmed up since last autumn's financial turmoil. Most are small and very open economies whose exports account for a large share of GDP and whose trade ties to the euro area are strong. As emerging economies they are prone to sudden shifts in foreign-investor sentiment, which makes for volatile currencies, so exchange-rate stability holds considerable appeal for them. None of them has a long record of stable money, so loss of monetary independence would not be greatly mourned. For four of the eight the euro is already their monetary anchor. The three Baltic countries, Estonia, Latvia and Lithuania, have long pegged their currencies to the euro, and before that to the D-mark. Bulgaria also has a euro peg.

For small, open economies such as those of the Baltic states (and Iceland, which now plans to join the EU as a stepping stone to adopting the euro), it makes sense to tie currencies to a big and stable neighbour. Even Milton Friedman, a fervent advocate of floating exchange rates, thought so. In the Baltics, Latvia's euro ambitions are on hold. Following a bail-out led by the IMF in December, its economy and public finances are in intensive care. Estonia wants to join quickly and may do so as soon as 2011. A realistic target for Lithuania is 2012.

For a larger country, such as Britain, the benefits of membership are less obvious. A bigger portion of the goods and services it consumes is produced at home, so there is more scope to manage domestic prices through an independent monetary policy.

The outsiders 5

	% of GDP 2009					
	Budget balance	Public debt	GDP at market prices, €bn, 2008	Exports, % of GDP, 2007	Consumer prices*	10-year gov't bond yield, %†
Euro area	-5.3	77.7	9,209	41.6	2.7	3.69
Britain	-11.5	68.4	1,812	26.4	3.7	4.11
Bulgaria	-0.5	16.0	34	63.4	10.1	7.04‡
Czech Republic	-4.3	33.7	149	80.2	4.7	4.65
Denmark	-1.5	32.5	233	52.3	3.2	4.10
Estonia	-3.0	6.8	16	74.4	8.6	na
Hungary	-3.4	80.8	105	80.3	5.0	9.40
Latvia	-11.1	34.1	23	42.2	13.4	7.90
Lithuania	-5.4	22.6	32	54.4	10.5	7.89§
Poland	-6.6	53.6	362	40.8	4.0	6.02
Romania	-5.1	18.2	137	29.5	7.6	8.95
Sweden	-2.6	44.0	328	52.6	3.1	3.49

Sources: European Commission; Thomson Datastream; Bloomberg
*% increase on a year earlier, latest 12-month average †Latest 12-month average ‡Latest 5-month average §8-year gov't bond

Poland could fit that bill too. It is the largest and one of the least open of the CEE8 (see table 5). Though not nearly as rich as Sweden in terms of income per head, it has many more people, so its economy is bigger. Its exports account for two-fifths of GDP. Because its exposure to world trade is smaller than that of many other EU countries, it has suffered far less from the global recession. The European Commission reckons its economy will shrink by 1.4% this year, which is not a lot by the dismal standards of the region.

The case for a quick dash

Despite the size and resilience of Poland's economy, its government wants to get into the euro as soon as possible. It hopes to join the ERM-2 (a pledge to keep the exchange rate within agreed bounds for two years) early next year in order to qualify for euro membership by 2012. As elsewhere in the region, part of the rush to qualify is to forestall a further drop in the zloty, which would make foreign-currency loans harder to pay off. Around 30% of private-sector debt is in foreign currency, far less than in Hungary but more than enough to hurt the economy if the zloty sinks. Hopes of entry in 2012 may be optimistic, and some economists question the wisdom of forcing the pace. As a fast-changing economy Poland

might need the flexibility of a floating exchange rate for a little longer to keep it competitive and to smooth adjustments.

But can it rely on the right kind of help from currency markets? Recent experience suggests that there is no stable link between the economy's vital signs and shifts in its currency. For a while the exchange rate had been a balm. Between 2005 and 2007 the zloty's value increased in line with productivity (as a country becomes richer, its currency tends to rise in real terms). That helped to keep inflation low without harming exports.

The benign period ended in the autumn of 2007. The zloty, and some other eastern European currencies, were driven up (see chart 6) as investors piled into emerging markets in the belief that they would soon "decouple" from troubled rich-world economies. A year later, following the collapse of Lehman Brothers, the markets made a U-turn. Capital flooded out of eastern Europe, starving the region of foreign currency and plunging it into a severe crisis.

When a floating exchange rate proves to be an irritant rather than an emollient, fixing it once and for all has greater appeal. Most of Poland's trade is with the euro area and much of that is intra-firm trade: between, say, a German firm and its Polish subsidiary. Adopting the euro should open Poland up to more of that sort of trade and the stable, long-term capital investment that goes with it. And once currency risk vanishes, government, firms and households will all be able to borrow more cheaply—and, as important, given the recent freeze-outs—more easily.

In purgatory

The financial crisis may have increased the allure of the euro zone, but it has also made it trickier to get in. To join, countries must first meet the "convergence criteria": targets for inflation and public finances, as well as market-based tests for low long-term interest rates and a stable exchange rate (ie, two years in ERM-2). Slovakia made the cut when the criteria were last assessed, in May 2008, and joined in January. Of the eight CEE countries still outside, all bar Poland and the Czech Republic missed the mark on inflation, which was supposed to be no more than 1.5 percentage points above the average of the three EU countries with the lowest rate. Poland, for its part, failed to qualify because of doubts that it could control its budget deficit and worries that it owed its low inflation to the rise in the zloty (which was not in ERM-2).

With economies facing a deep recession, inflation is set to drop sharply (though the benchmark for the test is falling too). The public-finance criteria will be far harder to meet. Euro aspirants must show that they can keep their budget deficits below 3% of GDP and cap their debt ratio at 60%. That is tough in a downturn: most countries inside the euro area are already in breach of these rules. But hopes that the rules might be relaxed have been dashed. Those inside the euro fear that easing up on potential entrants would undermine the single currency. There may be a feeling that "we had to suffer to get in; so should you." Some outside the ark are also against a free-for-all. The stronger aspirants, Poland and the Czech Republic, have distanced themselves from calls by troubled Hungary (like Latvia, an IMF supplicant) to shorten the qualifying period in ERM-2 from two years.

Would fast-track entry really harm the euro? The worry that euro-zone countries such as Spain may suffer prolonged slumps because they lost control of unit wage costs lends the inflation test some weight, though not much. Willem Buiter at the London School of Economics is not convinced. He thinks that inflation convergence is something to be expected after adopting the euro, not before. Getting rid of anything that may give rise to inflation is in the self-interest of new joiners. So is fiscal discipline. But insisting on them prior to entry amounts to "misplaced paternalism", according to Mr Buiter. "If you have time to get inflation down, fine. But floating exchange rates are dangerous. The main thing is to get in."

On one count, the would-be entrants are more flexible than the incumbents. Migrants from Poland and other eastern European countries have shown themselves willing to move in search of work. Lessons can also be learnt from the mistakes of others. Andrzej Slawinski, a member of the Polish central bank's monetary-policy council, believes there is less of a risk that the new member states will follow in the footsteps of Greece, Ireland, Portugal and Spain. They are still poor by EU standards, so can look forward to a period of fast productivity growth. Were unit wage costs to rise too far, they could recover competitiveness more quickly.

Poland may be able to guard against the risk of credit and housing booms because the climate now favours tighter bank regulation. "Banking supervisors must have the authority to react to the business cycle in a dynamic way," says Mr Slawinski. Governments must also be careful not to fuel housing booms with tax

breaks. Instead property taxes could be used to cool overheated housing markets.

Once Poland and the smaller CEE countries adopt the euro, might Britain's attitude change? If Denmark were to join too, the euro area would cover almost all of the EU's member states, so Britain might once again look like the odd one out. Even so, it is likely to draw the same lesson from this crisis as it did from the ERM expulsion in 1992: that devaluation is a good thing. There is chagrin in some European capitals (especially in Dublin) that sterling has dropped so far and fast against the euro. A weaker pound, even with world trade in retreat, still cushions the profit margins of struggling exporters. It will only harden the belief in Britain that currency flexibility should not be lightly given up.

In any case, no British government could now consider signing up to the euro without first winning a referendum, and opinion polls have shown a fairly consistent two-to-one majority against joining the single currency. Even if Britons could be sold on the narrower issue of economic benefit, they are more likely than most Europeans to see national control over monetary policy as indivisible from other kinds of sovereignty. The euro's success so far has suggested that a currency can be stable without the backing of a unitary state. But the financial crisis has raised a fresh question mark over that idea.

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