Comments on “The euro: It can’t happen, It’s a bad idea, It won’t last. U.S. economists on the EMU, 1989-2002,” by Lars Jonung & Eoin Drea

Jeffrey Frankel, Harvard Kennedy School

Euro at 10: Reflections on American Views

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New Year's week is a good time to look back

- On the year, or on the euro's 1st decade.
- Jonung & Drea give us an impressively comprehensive review of what economists thought about the € experiment at the time.   (190 pubs.)
- Specifically *American* economists.
- It's hard to bring order to the subject, since so many of the publications try to assess overall pros & cons, rather than making a single point.
- But the survey is well-organized and readable.
- Overall theme: American economists were generally more skeptical than justified by the €'s subsequent record.   Why?
- It is a useful bit of sociology / intellectual history

Survey divides 1989-2002 literature into 2 periods

- Pre- & post-Dec.1995 (Madrid summit set 1999 date)
- I might have chosen mid-1997 as breakpoint:
  - Opinion was pessimistic from 1992-96
    - Due to ERM crises of 1992 & 1993 (authors discuss)
    - Failure to go ahead with 1997 start date (authors omit)
  - Market-based measures (swaps & options) suggest June 1997 (when SGP was agreed) as the date when perceptions shifted.
- Have the authors found that the literature switched from "It can't happen" to "It's a bad idea" around 1995?

It’s true: American economists, on average, were more pessimistic than Europeans

- and the approach was usually “European nations don’t satisfy the OCA criteria as well as US states.”
- Occasionally this took invidious forms, familiar from other debates,
  - “The periphery countries lack commitment to price stability” (which proved a red herring)
  - Or “Europe has insufficient structural flexibility, especially in labor markets” (which is true).
- But the skepticism not generally American-triumphalist.   Indeed, some economists forecast , as an argument *in favor* of the € that EMU would force European labor markets to become more flexible (incorrectly).

I would have said that the € has been more successful than predicted in *some* ways, …but not in others

- The historic transition to a monetary union among 11 countries in 1999 went smoothly;
- the € instantly became the world's #2 international currency;
- European Central Bank (ECB) officials have from the beginning worked as citizens of Europe rather than as representatives of home constituencies.
  (Apparently Walsh, 1992, had been skeptical that an ECB could be independent; Meade & Sheets, 2002, feared national biases.)

Further ways in which the € has been more successful than predicted:

- Most of us have always thought the "two pillar strategy" (i.e., continuing emphasis on M) was nuts. I now have a bit more sympathy for it.
- After a rocky start (Dornbusch, 2001c; Feldstein, 2000a; Faust et al, 2001), the ECB has achieved a strong reputation: the tradition of the Bundesbank has not been diluted as feared;
- And the € has achieved a strong value.
- New members to the East have steadily achieved membership in the club.

Some prominent predictions that EMU would raise politic tensions rather than lower them have not been born out (at least not yet !)

- Dornbusch (1996b)
- Feldstein (1992-2001)
  has been consistently pessimistic.
  - European conference-goers love to quote MF as having predicted in *Foreign Affairs* (1997b) that EMU could lead to a civil war.
    - To which MF responds that he was merely pointing out that a common currency did not prevent the US from fighting the Civil War. A valid point.
    - On the other hand, he did genuinely predict an increase in intra-European tensions.

In other ways, skeptics' warnings have come to pass:

- Shocks *have* hit members asymmetrically
- Cushions against shocks *have not* developed
  - US-type labor mobility
  - US-type federal fiscal transfers
- The fiscal criteria of Maastricht and the Stability & Growth Pact *have* proven unenforceable
  (Pollard, 1995; Hagen, 1996)
  and were irrelevant to OCA (Frankel, 1993, & others).
- Furthermore, the popularity of the project with the elites does not extend to the public,
  many of whom are convinced that when the euro came to their country, higher prices came with it.

More OCA-warning references

- Lower correlation of shocks in Europe: Sala-i-Martin & Sachs, 1991; Bayoumi & Masson, 1991; Inman & Rubinfeld, 1992; Obstfeld, 1997
- Lack of fiscal cushions in Europe: Sala-i-Martin & Sachs, 1991; Glick, 1991; Inman & Rubinfeld, 1992
- Lack of US-type labor mobility: Blanchard & Katz, 1992 ; Eudey,1998.
- All of the above: Eichengreen, 1990a,b, 1991, 1994a; Tobin, 1998…

Barry Eichengreen

- comes across here as having gotten some things wrong (e.g., p.9 bottom: “1999 unlikely”).
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- But he was the first, after the 1992 ERM crisis, to get one big thing right:

  The metaphor had been “you cross a stream by jumping from stone to stone;” he replaced it with “the only way to cross a chasm is in a single jump” --
  - which became the Corners Hypothesis.
  - Narrow target bands failed; but in the end, the members did in fact jump from formal bands of +/- 10% to full monetary union.

Many thought the € would promote financial integration within Europe

- E.g., Bergsten (1997b)

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- To a substantial extent it has.

- But Frankfurt has not risen
to challenge London as
the financial center of Europe,
or even of the €, as most
foresaw if the UK stayed out.
Rather, London remains dominant.

A majority thought the dollar was safe in its role as #1 international currency

- E.g., Pollard (2001), Masson & Turtleboom (1997)
- But Bergsten (1997b) foresaw a shift out of $ toward €.
  - Also Signalla & Gould (1997), Krugman (1998a, 1999a), Frankel (2000) and Portes & Portes-Rey (not counted as Americans),
- I now think that is right, as a longer term trend (Chinn and Frankel, 2007, 08)

A major conclusion:

- "…the OCA paradigm was the main source of the US pessimism in the 1990s towards the single currency." (p.32) -- *Fair enough*
- "The OCA approach was biased towards the conclusion that Europe was far from an optimum currency area." – *I'm not so sure. For one thing, Bob Mundell coined the phrase OCA to begin with, and he has always claimed that it justifies a common currency for Europe.*

The OCA criteria are not irrelevant.

- After all, it is a fact, even if over-emphasized by Americans, that
  - Shocks are less correlated across Europe than across US states
  - Labor mobility is lower across Europe
  - Intra-state fiscal cushions are lower.

- On the one hand, just because these are lower in Europe, does not mean they are too low.
- On the other hand, can it be a coincidence that currency-area borders, historically, had almost always coincided with political borders?
  - National borders create natural breaks in cyclical propagation, labor mobility and fiscal systems
  - In this sense, it is much less surprising than Jonung & Drea think that "US economists who live in a large monetary union and enjoy the benefits from monetary integration, were (and still remain) critical toward the euro." (p.32)

- The OCA framework is very broad.
- The authors credit a series of papers by Andy Rose & me, beginning with "The Endogeneity of the OCA Criteria," 1997, as representing a more dynamic alternative that better fits what has happened. (p.23)
- I might have said that our work followed directly from the OCA literature.
- But I am not too dumb to accept the compliment,
  - particularly for having predicted that cyclical correlation among members would increase as trade did,
  - contrary to predictions of B.Eichengreen & P.Krugman.
- US took 150 years to become an OCA (Rockoff, 2000)
- Estimates show a steady 10-20% effect on intra-€ trade, << the tripling of Rose (2000).
  - Too early to see if it will rise further with time.

Other possible explanations for Americans' skepticism

- "It was not in US economic or geo-political interest for EMU to succeed."
  - I heard this from Parisian taxi-drivers.
  - But I have been, and still am, more struck by the indifference of Americans, even real-politik power types, to the €'s challenge to the $.
  - ERP (1999) & Clinton welcomed €.
- "Economists are trained to find faults with proposals…" (p.30) *Yes !*


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