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Comment on Noah Carl for *Political Quarterly*

Listening to the experts on European monetary integration

Waltraud Schelkle

Noah Carl's article is a fairly representative contribution to the distinctive genre of 'European dystopias'. His Eurozone is a dystopia in the precise sense of the Oxford Dictionary: 'An imagined place or state in which everything is unpleasant or bad, typically a totalitarian or environmentally degraded one.' The fevered imaginations are usually those of US economists; the source of their bleak predictions is the economic theory of optimal currency areas. Carl extends the economic analysis to the realm of identity politics, and enlists a few more authors that inspired his own dystopia, among them that well-known scholar of all things monetary and European, Mrs I-want-my-money-back Thatcher.

My comment takes up three claims that characterise the genre. The first is Carl's central argument that the monetary union got into such a bad state because Eurozone policymakers did not listen to economic experts when embarking on the euro experiment. The second is that the Eurozone has only a political and no economic rationale. The third is that the US-Dollarzone is the blessed land which functions so well because it conforms to the theory of optimal currency areas.

The economic experts told you so

Carl's argument on expertise goes like this: we can find a number of people who express scepticism about the euro and, because most of them are economists, their scepticism represents an expert consensus which must be true. But, with the exception of Paul Krugman, none of the economists Carl cites has ever contributed to research on currency unions or optimal currency areas. They just refer to received wisdom – not the latest research -- on the subject. Even if their claims to expertise were better founded, scholarly debates are not decided by referendums of experts. For good reason: there are different interpretations of the same theory, qualifications to every finding, legitimate questions about applicability in each specific case. Carl does not give the reader any of this. His majoritarian approach to truth and knowledge is closer to Michael Gove's than he realises; the difference is that Gove would enlist a larger constituency in his search for the majority opinion.

A quote by Paul Collier sets the scene of 'we told you so'. He is the key witness for Carl that all euro-sceptic experts are inspired by the same theory. But economists do not speak with one voice when they express scepticism about the euro experiment. Joe Stiglitz thought the euro was a good idea, but he criticised the member states for not going far enough and forming a full-fledged fiscal union that would protect member states against the vagaries of imperfect financial markets. For Stiglitz, more political will is all that's needed and electorates would follow, contrary to Carl's own bottom-up view of politics.[1]

[1] My review of Stiglitz (2016), *The Euro and its threat to the future of Europe,* published by Penguin, can be found at URL: https://www.eustudies.org/eusa-review-of-books/11.

Martin Feldstein saw the euro project as a French-led plot against US leadership; in other words, as a triumph of political will over economic calculation, the exact opposite of Stiglitz. Milton Friedman was most explicit in invoking the theory of optimal currency areas, but he used the theory loosely to support his case against any management of exchange rates. His view was that exchange rates, just like any other price, should be as flexible as possible. The three authors are at different ends of the spectrum as regards the underlying economics and politics.

The theory of optimal currency areas enjoys much less secure support among economists than Carl realises. For a start, there are at least two versions of the theory. The original static version says that countries should not join a currency union unless they have sufficient wage flexibility or labour mobility to adjust to economic shocks without incurring a high cost in unemployment. Only then should they give up the possibility of using the exchange rate to adjust real wages fast. A dynamic version, much more in keeping with modern economics, proposes that wage and price setters will adjust to the exchange rate regime. In other words, forming a currency union could produce adjustments that lead towards optimality. This was an attractive possibility for policy-makers in European countries that had experienced cycles of inflation and currency depreciation.

The founding father of optimal currency area theory, Robert Mundell, subsequently distanced himself from it. The theory was developed in the early 1960s, when governments might reasonably think of the exchange rate as a policy instrument that they could adjust to steer the economy in the desired direction – capital mobility was low and financial markets repressed. Subsequently, as the Bretton Woods system collapsed and capital mobility increased, the exchange rate became not a servant but a tyrant, subject to overshooting and speculation, requiring interest rate policy to be dedicated to its stabilisation. Experts change their minds when circumstances and evidence change, and, by 1973, Mundell thought the priority must be to get rid of the instability of exchange rates that constantly upset growth and employment in major economies.[2]

European policy-makers shared this view: as I explain below, they sought to maintain stable parities for many years before the introduction of the euro. Curiously, Paul Krugman, nowadays one of the leading US critics of the euro, made a major contribution to the theory of speculative currency attacks that could support the euro experiment.[3] He developed simple models to explain why foreign exchange markets were so whimsical, despite traders acting rationally. Others went even further and argued that there could be rational self-fulfilling attacks, when currencies were forced to devalue not for any

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[2] Mundell, R. (1973). A plan for a European currency. In H. G. Johnson & A. Swoboda, K. (Eds.), *The economics of common currencies*. London: Allen & Unwin.

[3] Krugman, P. (1979). A model of balance-of-payments crises. *Journal of Money, Credit and Banking, 11*(3), 311-325.

fundamental economic reason but because speculators had taken against them. The last big currency crisis in Europe, in 1992-3, seemed to follow exactly this pattern.[4]

Another expert that Carl invokes was Peter Kenen, who pointed out the importance of fiscal transfers in managing economic shocks. In a balanced appraisal towards the end of his life, Kenen conceded, however, that optimal currency area theory simply did not speak to the Eurozone project.[5] It was only about currency unions, where countries fix the exchange rate but retain their own monetary (interest rate) policies, exactly to make these fixed parities hold. This was not relevant for a monetary union that would create a common currency issued by one central bank, operating a common monetary policy.

In sum, it is a myth to think that there was some simple message of optimal currency area theory that the Eurozone architects and decision-makers could have taken on board: there was neither a single view nor a lasting message to take to Brussels and Frankfurt.

Why they did not listen

The architects of the Eurozone were not ignorant of the theory of optimal currency areas. The *One market, one money* report, which is the founding document on the Economic and Monetary Union, is quite explicit about the limitations of the theory.[6] The report was written by competent economists, with advisors from outside the Commission, among them Peter Kenen.

Getting rid of the sources of exchange rate instability was the key common objective for all member states in the early 1990s. For two decades, they had tried all kinds of arrangements to stabilise exchange rates, with and without the cooperation from the United States. Whenever the D-Mark revalued against the US dollar, Germany's European neighbours were between a rock and a hard place. If they kept their currencies pegged to the D-Mark, they lost market share in the US and other markets tied to the cheaper dollar. If they dissociated themselves from the strong German currency, they saw a rise in inflation and capital flight which forced their central banks, sooner or later, to tighten monetary conditions. For all prospective member states but Germany, exchange rates were not effective instruments of adjustment that could be reliably influenced but volatile prices that they had to stabilise with other instruments.

Even for Germany, exchange rate fluctuations were a nuisance. Changes can be abrupt and are motivated by financial conditions, not by bringing trade into balance. Rather than responding to whether a country produces as much as it consumes, currency traders ask whether it is worthwhile to invest in assets denominated in one currency or another. A reliably strong currency may make such investment more worthwhile, strengthening it

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[4] This was the influential interpretation of Eichengreen, B., & Wyplosz, C. (1993). The Unstable EMS. *Brookings Papers on Economic Activity, 1993*(1), 51-143.

[5] Kenen, P. B. (2000). Currency areas, policy domains, and the institutionalization of fixed exchange rates. *CEP Discussion Paper, 467*, London: LSE, Centre for Economic Performance, pp.16-17.

[6] CEC (1990). One Market, One Money. An evaluation of the potential benefits and costs of forming an economic and monetary union. *European Economy, 44* (October), Brussels: Commission of the European Communities, pp. 34-6; 45-6.

further. And vice versa. In economies with less trusted currencies, firms and governments have to pay permanently higher interest rates and these risk premia stifle investment and the provision of public goods. Moreover, the Bundesbank policy that was right for Germany did not suit its neighbours and their different cyclical conditions. The tensions thus created also frustrated the steady growth of German export markets. Finally, the power that foreign exchange traders bestowed on the Bundesbank was a political reason to press for currency unification, above all in France. So every prospective member state had its own reasons for seeing merit in a common currency; these reasons were neither irrational nor economically illiterate.

Nor was the theory of optimal currency areas the only relevant economic theory. Indeed, the euro experiment could draw on the most advanced economics at the time. Paul Krugman received his Nobel Prize in economics for work that – unintentionally -- provided several rationales for the Eurozone. As already mentioned, the theory of speculative currency attacks underpinned the creation of the euro. He had also revived economic geography and trade theory by adding theoretical insights about market imperfections to these somewhat stale areas of economic research.[7] For instance, a common currency – by removing a trade barrier and by creating a zone of stability -- increased the economies of scale for national champions as well as producers of specialised brands, allowing them to lower their prices and raise the growth potential of entire economies.

Against this background, it is not at all puzzling why EU member states did not listen to the theory of optimal currency areas. They did not try to create one. Rather, they were tired of their dependence on the US for monetary stability and were not keen to simply substitute the D-Mark for the US-dollar; not even German policymakers sought this responsibility. It is rather more puzzling why a brilliant economist like Paul Krugman has forgotten that his path-breaking work could be read as justifying the euro experiment and now prefers to sound like one of the grumpy old men he once challenged so successfully.

The sub-optimal Dollarzone

The dystopians rarely feel the need to provide evidence that the euro area is exceptionally unpleasant or bad. If they do, the promised land for the Europeans is the US. The US is, allegedly, an optimal currency area, with its flexible labour market, high labour mobility and a federal budget. The contribution of labour mobility to the stabilisation of shocks on a state's output and income has always been trivial, as research since the early 1990s showed.[8] Moreover, recent evidence casts doubt on the oft-repeated claim that mobility is higher in the US than in the euro area.[9] Labour mobility in the US has been in secular

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[7] For instance, Krugman, P, (1991). *Geography and Trade*, Boston, MA: The MIT Press.

[8] Barro, R., & Sala-i-Martin, X. (1991). Convergence across States and Regions. *Brookings Papers on Economic Activity*, 107-158.

[9] Dao, M., Furceri, D., & Loungani, P. (2014). Regional Labor Market Adjustments in the United States and Europe. *IMF Working Paper, No. 14/26*, Washington, DC: IMF; Jauer, J., Liebig, T., Martin, J. P., & Puhani, P. (2014). Migration as an Adjustment Mechanism in the Crisis? A Comparison of Europe and the United States *OECD Social, Employment and Migration Working Papers, No. 155*. Paris: OECD Publishing.

decline since around the 1980s, with a new low reached in the recent crisis.[10] However, and this is the last blow to the obsession with labour mobility, it is questionable whether this matters: not only does labour migration contribute little to stabilisation, it can have perverse long-run effects. When young pro-active members of the workforce leave a country, high mobility can turn temporary economic troubles into permanent decline.

The thrust of Carl's article is, however, that the Eurozone needs a US-style fiscal federation or it is doomed. This is why national identity is so important: the attachment of Europeans to their national histories, languages and traditions makes a fiscal union impossible. In this light, it is interesting to note that the US dollar (the 'greenback') was introduced during the Civil War when the country had politically broken up. It was an imposition of the victorious North on the defeated South, consuming political life in the following three decades with bitter disputes about the monetary regime. Indeed, the sequencing of the single currency experiment in the US had pitfalls even greater than those of the euro area. Two attempts at introducing a central bank were short-lived, and the country experienced an endless series of financial crises. Not until after the trauma of the Great Depression were the institutions of monetary stability put in place, with the emergence of an effective policymaking central bank and the creation of a bank deposit guarantee scheme with resolution authority.

Furthermore, fiscal union in the US is not all it might appear. There are indeed federal transfers to the states but these induce responses in the states' own budgetary practices which limit their stabilising effects. Balanced budget rules make US states tighten their belts in recessions and spendthrift in booms, obstructing the counter-cyclical stabilisers of the federal budget. Welfare states are great automatic stabilisers, through progressive income taxes and unemployment benefits. But the US system creates incentives for welfare minimalism because the states do not want to attract vulnerable migrants and retain high earners with low taxes. The Eurozone architects did not deny that monetary unions need fiscal activism, but they thought that, in a union of welfare states, each government should take measures at the national level to promote stability.

Evidently they underestimated the need to share fiscal safety nets, particularly in the aftermath of the financial crisis when some governments lost access to sovereign debt markets. But how much fiscal union is needed to counter that problem? It is by no means self-evident that a large expansion of a conventional central government budget is needed. The creation of the European Stability Mechanism, which issues bonds that fund loans to member states without market access, has helped to calm the crisis. It constitutes a very large mutual insurance fund: at its height, guaranteeing sums about three times as great as the maximum that the IMF ever lent. The EU[11] managed this politically because, contrary to Carl's presentation, the European Stability Mechanism is not 'indirectly funded by taxpayers in rich Northern European countries'. Loans are guaranteed by every

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[10] Molloy, R., Smith, C. L., & Wozniak, A. (2014). Declining migration within the U.S.: the role of the labor market *NBER Working Paper 20065*. Cambridge, MA: NBER.

[11] Non- euro members can draw on this emergency fund, too, if they have signed the Fiscal Compact. The UK under David Cameron's government refused to sign this multilateral treaty outside the EU framework.

member state (except those who have a bailout programme) according to its share in the paid-up capital of the ECB, emulating exactly the funding of IMF programmes. More resource pooling is probably needed for cases of a systemic crisis (ie vast *common* shocks), such as a joint fiscal back-up of the newly created resolution mechanism to be paid for by the financial industry. But such fiscal re-insurance may be sufficient to make the monetary union viable. The maximalist demand for a full-fledged fiscal union is dancing to the euro-phobes' tune.

Experts who want to be respected must earn it. Their job is to update received wisdom, call their own preconceptions into question when new phenomena arise, and explain to policymakers why there are no simple answers. The creation of the euro, a supranational currency that democratic nation states can choose to adopt, is one of the greatest experiments in history. Rising to that challenge requires more than recycling outdated economic theories and advancing loose claims about the need for a common European identity.

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