

EXPLAINING THE EURO'S INITIAL DECLINE

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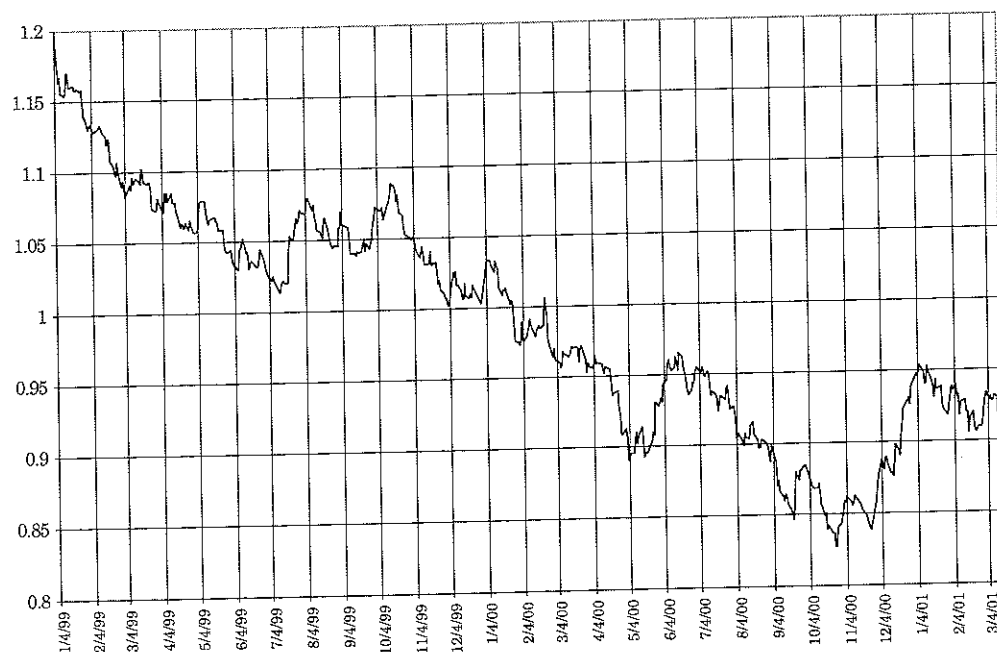
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The euro was formally launched in January 1999. As can be seen in Figure 1, the value of the euro since then has generally declined, with a low reached in May 2000, and again in September 2000. A further, all-time low was reached in October 2000. In a recent paper [Arestis et al., 2001] we reviewed a number of explanations for the euro's behavior¹ and concluded that the emphasis put on the perceived strength of the U.S. economy could only be a partial explanation of this behavior. (This conclusion is strengthened by the recent behavior of the euro, which stubbornly refuses to appreciate despite the U.S. slow down and falling stock market.) In this paper we advance our own explanation of the falling value of the euro, which emphasizes the problems with the institutional set-up of the Eurosystem, that is the European Central Bank (ECB) and the National Central Banks (NCBs). We argue that the early indications are that the *divergent state* of the euro area countries (the geographical area defined by the country members of the Eurosystem) has not been reversed, indeed it may have worsened since the inception of the euro. In the absence of monetary and fiscal coordination and of large-scale regional transfers, such divergence is a fundamental weakness in a single currency area.² Yet, the institutions accompanying the euro preclude the effective coordination of macroeconomic policy (which is limited by constraints on the size of fiscal deficits), and the magnitude of regional transfers within the euro area is negligible. We therefore conclude that a combination of euro area weakness, endogenous to the inception of the euro, and of the strength of the U.S. economy, most plausibly explains the euro's decline in value. While the future value of the euro remains uncertain, the future prospects for the euro area are bleak as long as the current institutions underpinning the euro remain in place, with the associated tendencies toward deflation.

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FIGURE 1

Daily Exchange Rates: U.S. Dollars per Euro



Pacific Exchange Rate Service © 2000 Prof. Werner Antweiler. Time period: 4 Jan 1999-14 March 2001.

EURO AND EURO AREA WEAKNESS: PRELIMINARY EXPLANATIONS

A number of writers such as Cohen and Loisel [2000] have provided explanations for the weak euro related to the policy mix introduced at the time of euro's birth. This mix is perceived to have been tight fiscal policy imposed by the drive to fulfil the convergence criteria of the Maastricht Treaty and relatively loose monetary policy. This resulted in an excess supply of euros that was channelled abroad, leading to a depreciation of the currency. By contrast the United States has gone through a period of excess demand which reinforced its attraction for foreign capital, and produced currency appreciation. This is an interesting interpretation, but it ignores totally inflationary pressures and their consequences on the exchange rate [Arestis et al., 2001].

Others such as Feldstein [2000a; 2000b] argue that the euro has declined in value against the dollar because of the perceived presence and effect of structural labor market rigidities. Indeed, one does not have to go far to find the argument that the structural weakness of the euro area has caused the decline in value of the euro. George [2000], Dornbusch [2000], PricewaterhouseCoopers [2000] and (invoking high German labor costs) Gros et al. [2000], all point to such rigidities. Of course, the vague notion of labor market inflexibility underlying eurosclerosis has been around for over twenty years. Consequently, it raises the question of why "the German mark surged against the dollar during the 1970s and later during 1985-89 when it doubled

in value" at a time when "rigidities in Germany were probably stronger than today" [De Grauwe, 2000, 11]. Consequently, even if the notion were to be accepted, it would require a great deal of further analysis to provide a satisfactory explanation of the decline in value of the euro.

In any case, we do not accept the notion, widespread through the entire literature, that labor market inflexibility is the cause of poor euro area economic performance either on theoretical or empirical grounds [Arestis, Brown, and Sawyer, 2001]. However, it is by no means necessary to accept the labor market rigidity thesis, to recognize that the economic and institutional arrangements accompanying the euro itself (and in particular the essentially monetarist basis of those arrangements), along with the divergent state of the euro area, weaken the euro area economy. This weakening could plausibly cause outflows of both long-term capital and post-euphoric speculative capital and might, therefore, go some way toward explaining the decline in the value of the euro in conjunction with considerations regarding U.S. strength, which we have explored elsewhere [Arestis et al., 2001].

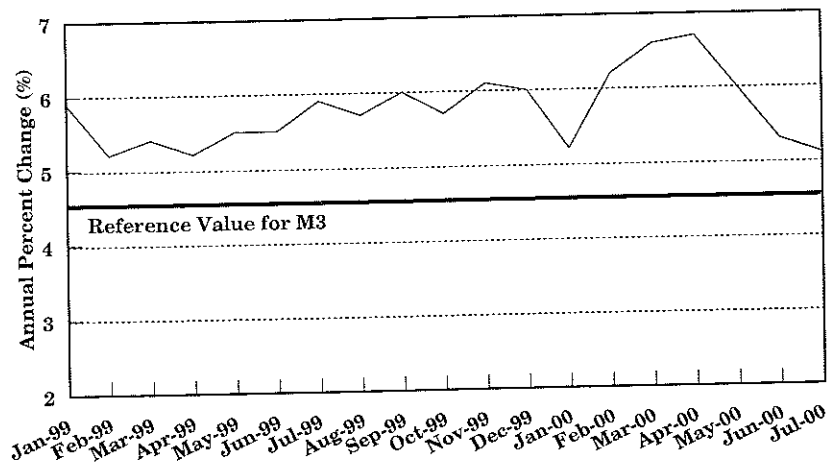
The euro has, of course, ushered in a single monetary policy. At the same time it has constrained national fiscal policy (through the Stability and Growth Pact) and made exchange rate revaluation impossible for the individual euro area countries. This raises two critical issues: (1) the relationship between monetary policy, which is operated independently by the ECB, and fiscal policy, which is clearly a matter for individual member states with little policy coordination between countries (the Stability and Growth Pact notwithstanding); (2) the extent to which the single currency regime can be effective in coping with what is still a number of separate economies with widely differing institutional arrangements and differing economic policy needs. It is widely recognized that this single currency arrangement requires a high degree of convergence of the patently very diverse economies of the euro area [Felstein, 2000a, 2000b]. Without such convergence, Economic and Monetary Union (EMU) will enforce inappropriate economic policies on its member states, constrain automatic and discretionary fiscal stabilization, and negate room for maneuver in the face of economic asymmetries. In addition, a heavy burden of coordination is placed upon the Eurosystem. Clearly, the need to pursue a coherent monetary policy, and to be perceived as so doing, is urgent. These issues are discussed at length in the rest of the paper.

EURO AND EURO AREA WEAKNESS: MAIN EXPLANATIONS

The Performance of the Eurosystem

The credibility of the Eurosystem was set back, at the outset, by the fudging of the Maastricht criteria. As shown in detail elsewhere [Arestis, Brown, and Sawyer, 2001], various member states of the euro area resorted to accounting tricks and the like to meet the criteria for entry into the single currency. This must have raised concerns in the foreign exchange markets and also begs the question, to be explored below, of the extent to which divergence has taken place since the inception of the euro. Furthermore, the performance of the ECB, in terms of its presentation and the transparency of its decision making, has been widely condemned. *The Economist* puts

FIGURE 2
Annual Percentage Change in Eurozone M3



ECB, 2000.

it as follows: "the ECB has not yet learned how to communicate the way it exercises monetary policy to financial markets and the media". So much so that "outside commentators have not yet learned to 'read' the ECB as clearly as they can America's Federal Reserve" [6 January 2001, 67].

Additional problems include: important ECB policy decisions have been leaked prior to official announcement; the speeches of different ECB bankers have given different signals regarding ECB policy; the ECB does not publish minutes, nor divulge information on its econometric models and forecasts;³ the 4.5 percent target for M3, which is one of the two-pillar monetary strategy, has not been met at all (Figure 2), and yet it has been largely bypassed as a serious issue [Arestis, Brown, and Sawyer, 2001, Chapter 3]. Indeed, the ECB recognizes that this monetary strategy led to "occasional misunderstanding of the ECB's policy framework" [ECB, 2000, 37].⁴ In terms of the relationship between the ECB and the NCBs, there is the serious problem of division of responsibilities. The ECB conducts the eurosystem monetary policy while the NCBs have retained many other tasks, including prudential national bank supervision. In a monetary union this poses the serious danger of a systemic risk to the eurosystem banking system. This could conceivably come about when an NCB, by concentrating on its local market, fails to appreciate the dangers to the eurosystem of a large domestic bank failure. Indeed, if the NCB worried about the bank domestic liabilities rather than exposure across the euro area, NCB supervision might increase the risk of a bank failure. It may also be noted that NCBs may be faced with difficulties even in their attempt to rescue domestic banks in view of the bulk of liquidity in the hands of the ECB, over which they have no control at all.

A further example of weak institutional foundations is the criticism of Irish budgetary policy adopted by the European Union's finance ministers (ECOFIN) on 12 February, 2001 (based on recommendations from the European Commission). Far from tightening fiscal policy, the Irish government relaxed it in an attempt to contain

inflationary wage increases. This episode illustrates three points. First, the Stability and Growth Pact is seen to involve the notion that government budgets should be, on average, in balance or surplus to comply with the reference value of 3 per cent of GDP for the budget deficit. The Maastricht Treaty required budget deficits to be pushed below 3 per cent at the time of decision on euro membership, but this is now moved to a much more stringent aim of overall balance or surplus [Arestis, McCauley and Sawyer, 2001]. The European Council is very specific: "The member states commit themselves to respect the medium-term budgetary objective of positions close to balance or in surplus set out in their stability or convergence programmes and to take the corrective budgetary action they deem necessary to meet the objectives of their stability or convergence programmes, whenever they have information indicating actual or expected significant divergence from those objectives" [*Resolution of the European Council on the Stability and Growth Pact*, Article I, http://europa.eu.int/eur-lex/en/lif/dat/1997/en_397Y0802_01.html]. It is also stated that: "Adherence to the objective of sound budgetary positions close to balance or in surplus will allow all Member States to deal with normal cyclical fluctuations while keeping the government deficit within the reference value of 3 percent of GDP" [*Resolution of the European Council on the Stability and Growth Pact*, Article IV, http://europa.eu.int/eurex/en/lif/dat/1997/en_397Y0802_01.html].

Second, the Stability and Growth Pact is interpreted to say that budgets must be tightened rather than loosened when there is evidence of overheating, without regard to the budget position and without regard to the prospects for inflation. The European Commission argues that the Irish budget plans for 2001 will fuel demand but are likely to generate smaller supply effects in the short term, the overheating problem will worsen. However, and as noted above, the proposed tax reductions and expenditure increases were part of an overall package of wage restraint agreed with trade unions.

Third, there are some fundamental differences between governments on economic policy and the workings of the economy. In this instance the European Commission and a number of member governments seem to be saying that inflation is necessarily demand-push and must be met by fiscal demand deflation (even though monetary policy is supposed to be the policy instrument for the control of inflation), whereas the Irish government appears to be arguing that wage agreements can moderate inflation. There is also the point that the Irish experience demonstrates what may happen when a member country acts and reacts contrary to the whims and wishes of the rest of the membership. In this instance the policy coordination has not worked because Ireland has chosen to ignore the relevant recommendation.

The ECB itself and sympathetic commentators, such as the OECD [2000] or Favero et al. [2000], argue, in defense of this performance, that the ECB and the euro area are very new and lack the historical time series and the relative stability that only time can bring. More significantly, for the question of the exchange rate decline, much of the academic literature plays down the significance of the problematic nature of the Eurosystem, and the ECB in particular, and other relevant institutional arrangements for the exchange rate fall, focusing, instead, upon U.S. strength. In the light of the foregoing arguments, we would agree that ECB weakness is by no means the whole, or even the main, story. However, and as we argue elsewhere [Arestis et al., 2001],

TABLE 1
Current Economic Data for Euro Area

Country	Growth Rate (SA) % p.a. 2000Q3	Inflation Rate % p.a. Jan-01	Unemployment Rate (SA) Jan-01	Budget Deficit 1999	Gross Nominal Consolidated Debt as % of GDP 1999	Output Gap 1999
Eurozone	3.4	2.4	8.8	-1.2	72.1	-1.1
Belgium	3.1	2.8	6.8	-0.9	114.4	-0.9
Germany	3.4	2.2	7.8	-1.2	61	-1.5
Spain	3.9	3.8	13.7	-1.1	63.5	-0.2
France	3.0	1.4	8.7	-1.8	58.6	-0.6
Ireland	11.0[99q3]	3.9	3.8	2	52.4	2.6
Italy	2.5	2.7	10.1[Oct]	-1.9	114.9	-2.5
Luxembourg	N/A	2.9	2.1[Dec]	2.4	6.2	N/A
Netherlands	3.6	4.5	2.8[Dec]	0.5	63.6	0.9
Austria	4.1[q2]	2.2	3.7	-2	64.5	0
Portugal	2.6	4.4	4.4	-2	56.7	-0.3
Finland	5.7	2.9	9.4	2.3	47.1	-0.1

Greece joined the EMU on 1 January 2001, and is thus excluded from this Table and paper. Source: Eurostat; OECD *Economic Outlook*; ECB, 2000.

U.S. strength is not sufficient to explain the exchange rate decline. The weakness of the ECB reflects the problems associated with trying to implement a single currency on such a diverse economic and political constituency. It is one aspect of euro area weakness that is specific to the euro itself, and therefore accords with the timing of the euro's decline in value. It could have contributed to the post-euphoric speculative outflows and to long-term fears regarding the ability of the ECB to cope with euro area divergence. Thus, we would argue that it is more important than the academic literature is willing to recognize. The issue of divergence is examined next.

THE EURO AND THE DIVERGENT EURO AREA

Table 1 provides the current respective growth, inflation, unemployment, budget deficit, government debt and output gap figures for the euro area (Luxembourg is included in the table but ignored in the descriptive analysis in view of its small level of relative importance).

There is a relatively low-growth camp consisting of Italy (2.5 percent) and Portugal (2.6 percent). There is also a high-growth camp of Austria (4.1 percent), Finland (5.7 percent), and, spectacularly, Ireland (11 percent!). Inflation rates show the Netherlands to be at 4.5 percent and Spain at 4.4 percent, and at the other end of the scale, France at 1.4 percent and Germany and Austria at 2.2 percent. Unemployment rates vary greatly from 13.7 percent in Spain to 2.8 percent in the Netherlands. The budget deficit and output gap figures confirm the differing fiscal and cyclical positions of the euro area members, with Ireland's budget position being a surplus of +2 percent of

GDP, and output gap at +2.6 percent, whereas the figures for Italy are a budget deficit of -1.9 percent and output gap of -2.5 percent. Portugal and Austria also have relatively large deficits of -2 percent. Finally, both Italy and Belgium record debt levels of well over 100 percent of GDP. Thus economic performance varies greatly—even though the euro is young, there is no sign that it has contributed to any diminishing of these differences. Still, the proponents of the euro could argue that the evidence thus far provides only a snapshot of the euro area economy. To answer questions about convergence or divergence, it is necessary, then, to look at the euro area economic performance through time. Firstly, the recent performance will be considered in its broad, historical context. Secondly, the most recent and detailed evidence on the impact of the euro will be examined.

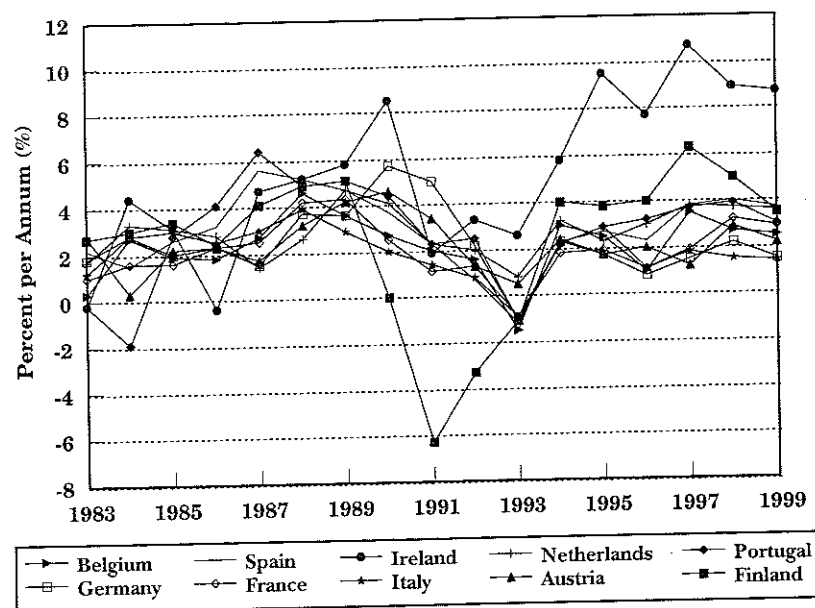
The Recent Euro Area Performance in Historical Context

The importance of the historical trends for divergence/convergence is recognized by the ECB as reflected in two recent ECB studies, ECB [1999] and Angeloni and Dedola [1999]. We consider these papers and examine the annual series for GDP, the output gap, unemployment and inflation. As a preliminary, it can be noted that the degree of convergence is difficult to measure because what relative weighting should be accorded to individual countries is not clear. For example, both the spread (from highest value to lowest) and the standard deviation depend on outliers, but, in fact, such outliers are in some respects of equal interest to countries of far greater size. In this circumstance, plotting the evolution of each country, side by side on the same graph, is preferable to merely quoting summary statistics, since the shape of the euro area as a whole can be discerned.

Figure 3 plots the annual growth rates for GDP over the past 17 years. Looking over the period as a whole, we would stress that a *divergent state* of the euro area is the norm. Even excluding the smallest and most volatile countries (Ireland, Finland, Portugal and Luxembourg), the difference between the highest and the lowest GDP growth rate for each given year fluctuates for the most part between 1.5 percent and 2.5 percent. The difference has never fallen below the 1.3 percent and reaches a maximum of 4.2 percent (1987). The most recent figure is 2.3 percent in 1999. The inception of the euro has not, at this early stage, produced any outstanding change in the norm, but has maintained the euro area in a divergent state, with Ireland clearly threatening to overheat. Excluding the outliers of Ireland and Finland, then a process of divergence is visible, from the unusually convergent state of 1995, through to 1997; this higher level of divergence has been maintained, though it has not widened further through 1998 and 1999. (It could be noted that Finland was hard hit by the collapse of the Soviet Union in the early 1990s.)

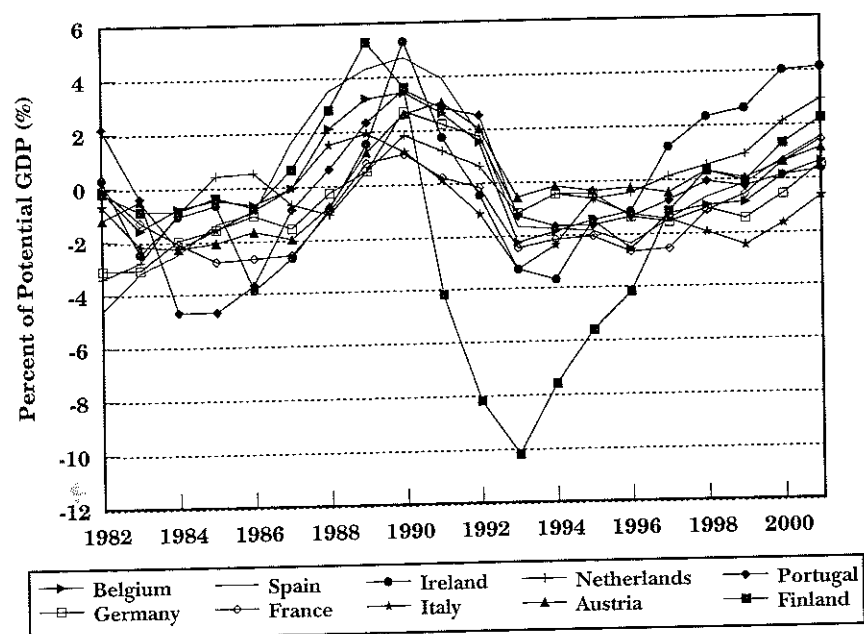
Figure 4 plots each country's output gap, a measure of the difference between the actual and potential output here expressed as a percentage of the country's potential GDP. Thus it provides one indication of a country's cyclical position. The consistently wide spread between highest and lowest, and the many criss-crossing lines, suggest that the euro area is in a continually divergent cyclical *state*, over the period, consonant with the growth rate data. There is an indication of a recent *process* of cyclical

FIGURE 3
Eurozone Annual Growth Rates of GDP



OECD *Economic Outlook*, June 2000.

FIGURE 4
Eurozone Output Gaps



OECD *Economic Outlook*, June 2000.

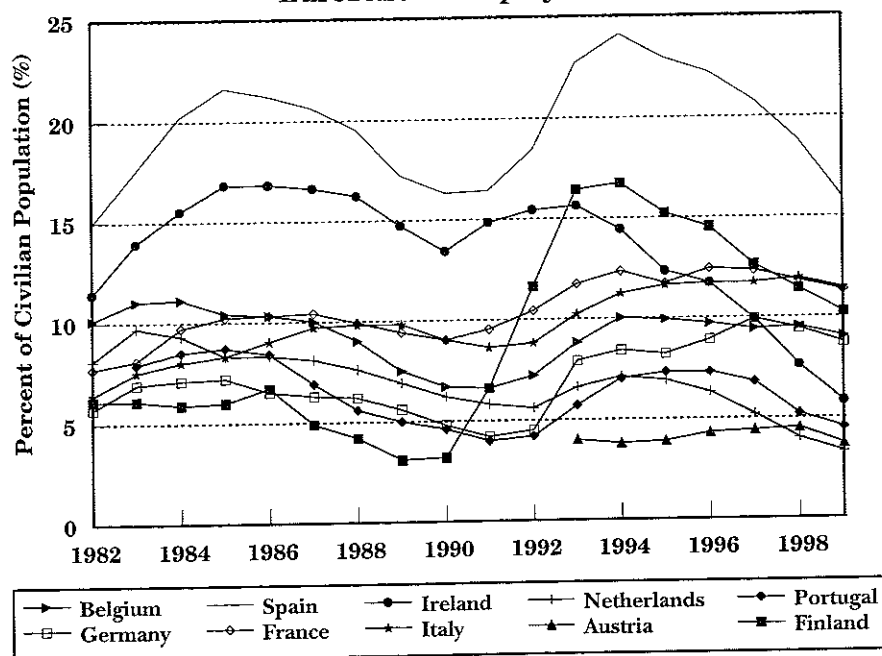
divergence with Germany and Italy falling further from potential output in 1999, and France and most other countries, moving towards potential (further above potential, in the case of Ireland and the Netherlands). This evidence appears to contradict the suggestion of both ECB [1999] and Angeloni and Dedola [1999], that *cyclical convergence* has generally been high over the time period, with a significant recent increase in the level of convergence. Both papers base their view on the decomposition of key indicators (GDP growth, industrial production growth, employment growth and inflation) into trend and cycle components using the Hodrick-Prescott filter [ECB 1999] or fourth quarter difference in logs [Angeloni and Dedola, [1999]. For the period 1994-1998, ECB [1999] find divergence in the growth rate of GDP *trend* but a correlation of around 0.7 to 0.8 (ten-year rolling average) for most country's *cyclical* GDP growth component with that of the euro area average; this compares with lower correlations (down to 0.4) in the early 1990s. Angeloni and Dedola's [1999] analysis confirms the ECB [1999] findings and suggests that German unification caused the divergence in the early 1990s (this is a point that the evidence on output gaps corroborates). For the early and mid-1980s, both papers find levels of cyclical convergence approaching the high levels of the mid-to-late-1990s.

What explains the apparent contradiction of divergent output gaps and high measures of cyclical correlation over the period? This is an important question for an assessment of the prospects for the euro, as currently implemented. We would suggest that the divergent spread of output gaps and growth rates, and the many criss-crossing lines evident on both graphs, reveal that the cyclical correlation coefficient of 0.7 to 0.8 should not be considered high in any absolute sense. Rather, it simply picks up the fact that there is a broad common cycle in the euro area. Within this broad cycle, however, there is clearly much room for a great deal of divergence, of a cyclical as well as trend nature. In any case, such divergence is of obvious policy relevance whatever its nature. We reject the view that trend growth is exogenous and unaffected by economic policy or economic events; on the contrary, the obvious quantitative significance of the "trend" implies its policy significance. Overall, then, the GDP and output gap data reveal that the euro area remains in a divergent *state* with an evident recent *process* of divergence.

Figure 5 plots annual unemployment rates in the euro area from 1982 to the present. The outstanding feature is the continual divergent *state* of the euro area, with the diverse unemployment rates deviating relatively little in their ordering in terms of relative magnitude. (Finland is a clear outlier, in this respect.) In comparison with the previous graphs there are very few criss-crossing lines other than that of Finland. Spain is an outlier, remaining nearly 5 percentage points above the next highest country in 1999, at 15.9 percent, having peaked at 24.1 percent in 1994, when the rate was over 10 percentage points above the next country of substantial size, France.

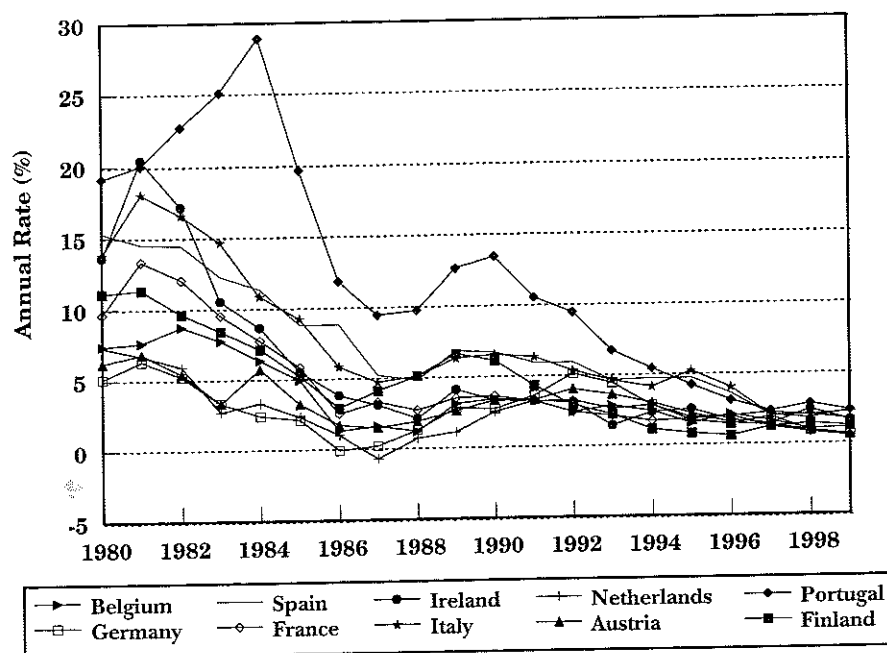
Annual inflation rates, plotted on Figure 6, show strong convergence over the past two decades to the low magnitudes of around 1 percent in 1999. This provides a much better outlook for the institutional mandate of the Eurosystem in general and the ECB in particular (its prime goal being a low and steady euro area inflation rate), than would higher and more divergent rates. However, there are a number of downsides to this evidence. Wyplosz [1999] has pointed out that the Maastricht Treaty was

FIGURE 5
Eurozone Unemployment



OECD, *Economic Outlook*, June 2000

FIGURE 6
Eurozone Annual Inflation



OECD, *Economic Outlook*, June 2000

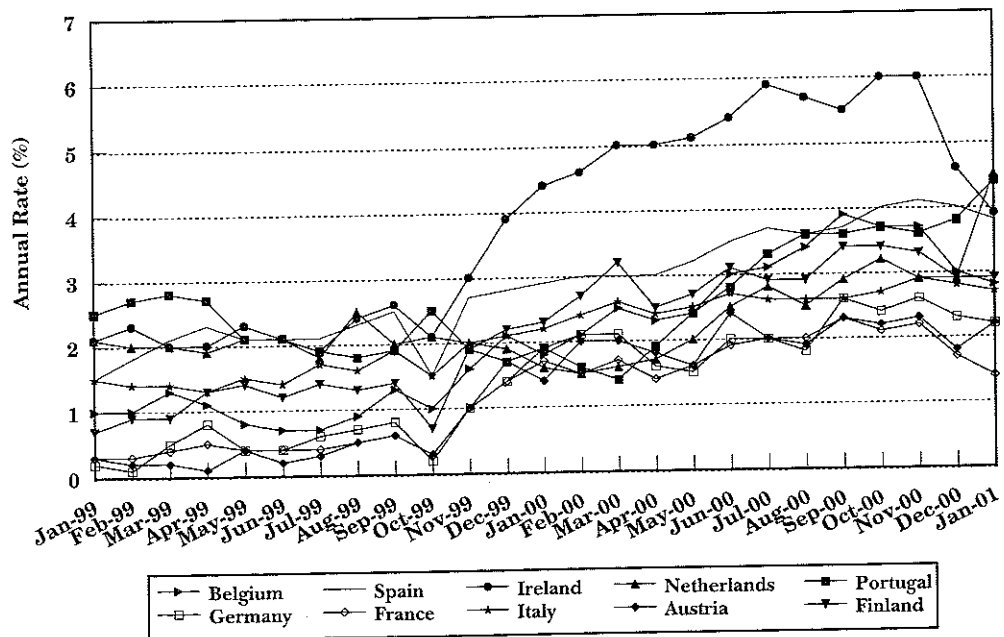
conceived in the late 1980s, when neo-liberal monetarism held considerable sway over policy. Since then, however, the general lowering of inflation, evident on the graph, has downgraded the importance of inflation, certainly in the public perception. The sustained improvement in inflation performance across the euro area has coincided with a period of sustained sluggishness in terms of growth rates, as described above, and has also coincided with a general fall in the rates of inflation worldwide in industrialized economies. This provides some evidence that the prioritizing of inflation is misguided. Finally, it should be noted that the Harmonized Index of Consumer Prices (computed by Eurostat), only available for recent years, tells a slightly different story to the OECD measures for the period from 1998 to 1999. Whereas the non-standardized measure of the OECD shows some convergence for 1998 to 1999, the harmonized index shows divergence, with Ireland moving above the 2.5 percent level and Spain pushing well above 2 percent. This hints at the recent inflationary worries regarding Ireland and Spain, described in more detail below.

Before moving on to look at the impact of the euro on convergence in detail, it can be noted, finally, that optimum currency area (OCA) theory and the debate surrounding it [Angeloni and Dedola, 1999] suggests that the observable variables reviewed above are not the whole story. Rather, it is non-observable shocks, either to aggregate demand (for example, a shift in tastes) or aggregate supply (e.g. a technology shift), that are ultimately of significance. This is because, essentially, OCA theory provides an assessment of the appropriateness of a single currency through a weighing up of the costs and benefits of its introduction. The benefits are reduced transactions costs and transparency of relative prices. The costs are the loss of exchange rate and national monetary policy as buffers and adjustment mechanisms in the face of asymmetric shocks. The important point is that these are *non-observable* shocks to aggregate demand, or to aggregate supply; the observable series reviewed above are only the outcomes of the unobservable demand and supply shocks.

Bayoumi and Eichengreen [1993] first attempted to identify and estimate the underlying shocks and concluded that their correlation for the euro area is, on average, smaller than that prevailing in the United States. Angeloni and Dedola [1999] update this work. They find that the correlation of shocks in the euro area is very low; it suffers from asymmetric shocks. Corsetti and Pesenti [2000] have stressed the importance of this finding (in response to the ECB arguments regarding the observable cyclical convergence, discussed above). Our stance towards this evidence offers an opportunity to clarify our theoretical approach towards the evidence on convergence as a whole.

It is no secret that, as McCombie [1999] and, with gusto, Buiter [1999] point out, the theoretical and econometric assumptions made to try to identify non-observable shocks are severe. On top of the well-known list of strong assumptions, we would add the following general point. The business cycle is not driven purely by economic shocks to an otherwise smooth process towards general equilibrium, though, of course, exogenous shocks are very significant. Rather, the business cycle is an ongoing and endogenous economic process. On the financial side, Minsky [1975; 1978; 1982] has charted the inherent tendencies towards fragility of the unfettered capitalist economy. On the real side of the economy, Myrdal [1957] and Kaldor [1972; 1985] have analyzed the processes of cumulative causation and uneven development generated by the opera-

FIGURE 7
Eurozone Inflation Rates Measured by HICPs



Eurostat.

tion of unfettered markets. It is such endogenous processes that are the fundamental context for the single currency. The potential for increased regional asymmetries of demand and of resources unleashed by the single currency make it imperative that the current monetarist structure behind the euro is transformed fundamentally. The evidence presented thus far, showing on the whole a divergent *state* and recent *process* of further divergence, corroborates this perspective. A more detailed look at the recent impact of the euro is provided below.

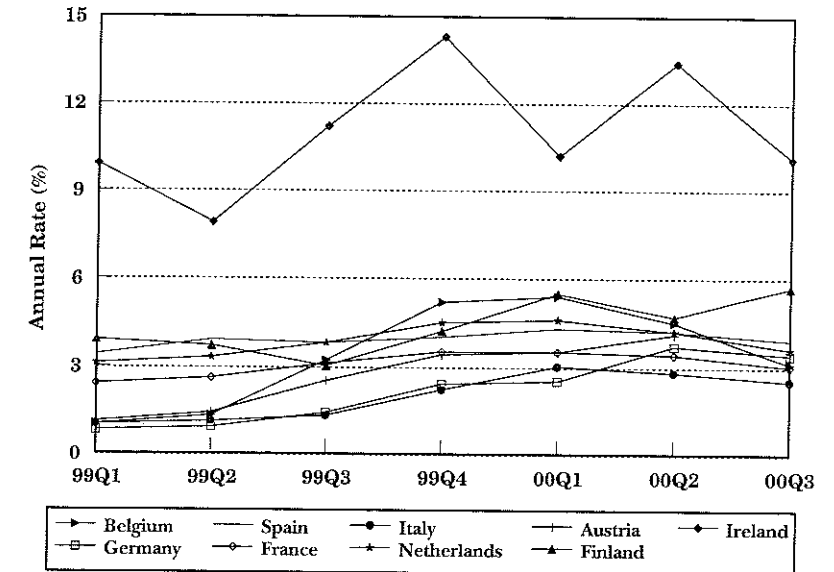
THE IMPACT OF THE EURO: DETAILED EVIDENCE

The impact of the inception of the euro on the evolution of the most recent and frequent series for inflation, growth, unemployment and the budget deficit will be assessed in turn.

Figure 7 plots the evolution of inflation, in annual percentage terms, from January 1999. In terms of the issue of convergence, the outstanding feature of the graph is the exceptionally high inflation rate of Ireland, which moved from 2 percent to 6 percent, when it was 2 percentage points above the next highest rate. Not since 1985 has the Irish inflation rate reached such a level. More recently this rate has fallen to 3.9 percent. Coincident with the recent fall in the Irish inflation rate, there has been a noticeable divergence among the other countries.

Figure 8 plots the quarterly GDP growth performance over 1999 and 2000 of the euro area countries (data for Portugal are unavailable). Here, the outstanding feature is Ireland, which is way above the other countries. Again, if Ireland is taken out,

FIGURE 8
Eurozone GDP Growth



Eurostat and Central Statistics Office, Ireland.

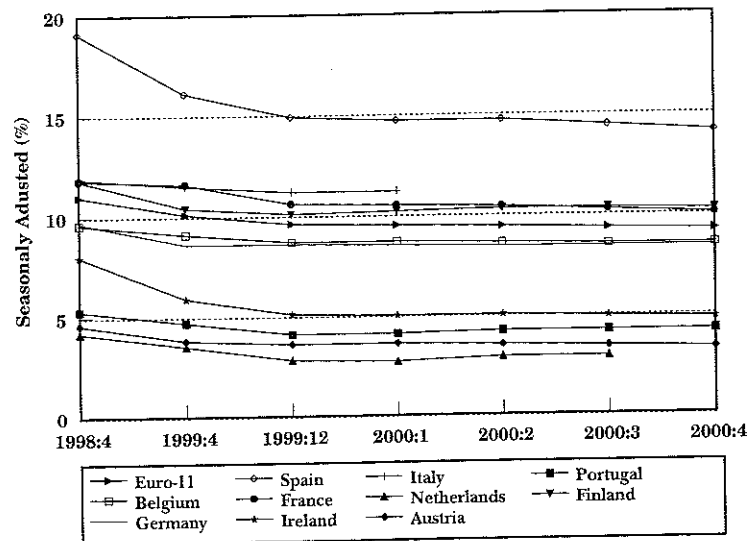
there is slight convergence over 1999, as Germany and Italy slowly begin to recover, and Belgium spurts, but there is divergence in 2000 quarter 3, owing to Finland's growing at a fast rate while all the other countries slow down.

Figure 9 plots the evolution of unemployment. Essentially the spread is wide and static, though Spain's rate has continued to fall from its very high level. The general recovery in the euro area, evidenced in the previous two graphs, has not served to reduce average unemployment any more than a percentage point since early 1999. Figure 10 plots the evolution of the budget deficits of the euro area from 1996. It shows the difficulties Italy has had in achieving the Maastricht criterion (-3 percent of GDP limit), starting from below -7 percent in 1996. The spread from 1998 to 1999 has shrunk slightly, as deficit countries have found that the recovery has eased them above the -3 percent level. The graph, in conjunction with the previous graphs, shows how the slow recovery of 1999, and loose monetary policy of 1999, has generally served the euro area well, with Italy being the one country to experience fiscal difficulties. Italy had difficulties with its stability program but its subsequent performance meant the revision was not required, as it more than met previous targets.

ASSESSMENT

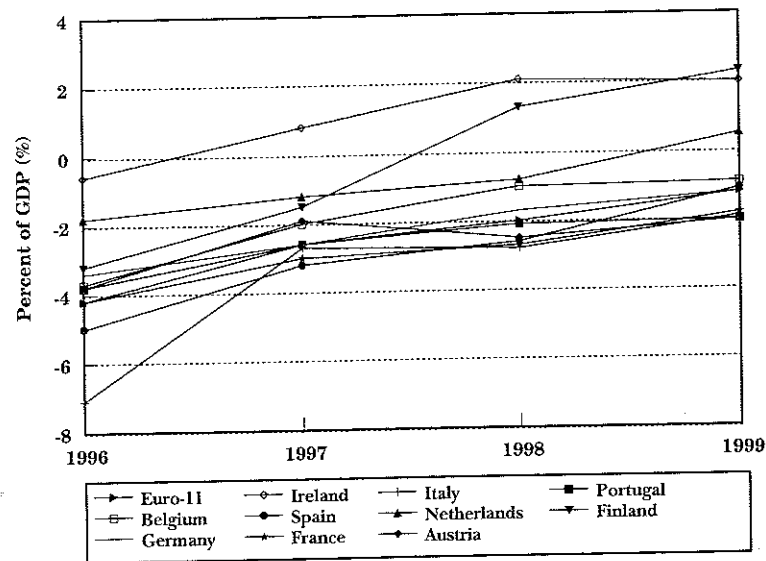
It is obviously early for the euro and two years is not enough time to make clear cut assessments regarding the issue of divergence. Clearly, Ireland is an exceptional case within the euro area, causing some overall divergence on the graphs. Undoubtedly, the Irish inflation rate is a cause for concern, and may demonstrate the dangers of inflationary pressures because policy has been tailored to suit an average from which Ireland is an outlier. The Netherlands and Portugal show some danger of infla-

FIGURE 9
Eurozone Unemployment Rates



Eurostat.

FIGURE 10
Eurozone Budget Surplus/Deficit
(in National Currencies)



Eurostat.

tionary pressures building up. But, the recovery, and the fact that it has been the larger countries, Germany and Italy, that have been at the bottom of their cycle suggest that the jury is still out on fears regarding the deficit levels and general deflationary bias of the single currency. It is hard to believe that when the roles are reversed, with the more peripheral countries, such as Ireland, Finland, and countries such as Spain, at the bottom of their cycles, and Germany and Italy at the top of theirs, that monetary policy will be loose. That will be the real test for the euro area.

What is clear is that there remains a chronic problem of high unemployment, and also large asymmetries within the euro area; there has certainly been no significant trend towards convergence caused by the euro. Business cycles are by no means synchronized, though they do overlap. In terms of OCA theory, countries are likely to receive different shocks as well as being affected differently by shocks. The recent experience has shown that a truly *divergent* state of euro area economic cycles persists: few would argue that Germany actually requires the *same* monetary policy as Ireland! Growth has picked up, but there is no evidence that this is any more than a cyclical recovery around the low trend rate of growth. In terms of OCA theory then, it is very clear that the euro area is not an optimal currency area, and the euro has not endogenously encouraged the necessary convergence for the euro area to become one. Nor has the euro overcome the long-standing difficulties of the euro area. When the economic conjuncture shifts the euro may well prove harmful.

SUMMARY AND CONCLUSIONS

The evidence cited in this paper, and its policy implications, provide a very different picture to the majority of the literature. The prevalent stress on the need for structural reform and the existence of asymmetries can be seen as an attempt to express the idea that asymmetries and structural factors undermine the neoliberal institutional structures associated with the euro, as currently implemented. But this attempted expression is hamstrung by the prejudice towards the efficacy of unfettered markets and so is, ultimately, a failure. The problem with the euro and its associated institutions is not that it diverts attention from, or otherwise hinders, the "needed labor market reforms;" asymmetries are not merely short-run, external shocks to an otherwise smooth tendency towards a general equilibrium. Rather, policy must be allowed to play its vital role in overcoming aggregate demand asymmetries and uneven processes of cumulative causation through coordination of fiscal and monetary policy, within a transformed institutional setting. Thus we take the same phrase (structural reform), backed up by the same evidence (that is, high and divergent unemployment rates and divergent growth rates) to mean utterly different things with radically opposed policy implications. If the markets are right to see problems with asymmetries and the need for structural reform then they are hopelessly wrong in equating structural reform with something called labor market flexibility (and the like). What is needed is an expanded institutional setting, allowing the coordination of fiscal and monetary policy and large-scale regional transfers, guided by an alternative to the stability and growth pact [Arestis, McCauley, and Sawyer, 2001].⁵

We have argued in this paper that the inception of the euro itself, with its restrictive monetarist institutional structures, to an area that is in a divergent *state*, which has recently been widened by a *process* of divergence, is ample reason for long-term investors, and, indeed, post-euphoric, short-term speculators, to regard the euro area as structurally weaker since January 1999. It is difficult to predict the future course of the euro; once portfolio investors have shifted fully back to their pre-euphoria level of holdings of euros, then any number of contingencies may come into play.

NOTES

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1. In particular, we argue that the decline in the value of the euro cannot be explained by the general rise in the value of the ECU (European Currency Unit) prior to the formation of the EMU in January 1999. The initial decline in the value of the euro might be seen as compensation for that prior rise, but the continuing decline and weakness of the euro cannot be so explained.
2. We assume in this paper that divergence is generally undesirable. There is the well-known argument that a common currency will be accompanied by convergence. Further, there is the optimal currency area literature based on market-forces principles [Mundell, 1961; see, also, Feldstein, 1997] which suggests that the prerequisite of a successful common currency area is convergence. Finally, divergence of economic performance can generate social and political tensions, leading to disintegration [Feldstein, 2001a; 2001b].
3. The ECB publishes economic projections (not forecasts) over a two-year horizon as from December 2000. These take the form of ranges of prospective real GDP growth (and its components) and inflation for the euro area. They play "an important but limited role" [Duisenberg, 2000] to the ECB's governing council which "is neither responsible for the content of these projections [produced by staff experts and do not embody the policy judgements of the council itself] nor should its performance be judged against them" [Duisenberg, 2000]. The current projections are: 2.6 percent–3.6 percent (2001 GDP growth), 1.8 percent–2.8 percent (2001 HICP inflation), 2.5 percent–3.5 percent (2002 GDP growth), 1.3 percent–2.5 percent (2002 HICP inflation). These projections are so wide as to virtually eliminate the risk of the ECB being proved wrong.
4. The two-pillars monetary strategy may be briefly summarized: the "first pillar" is a commitment to analyze monetary developments for the information they contain about future price developments. This is the quantitative reference value for monetary growth (4.5 percent of M3) referred to in the text. The "second pillar" is a broadly based assessment of the outlook of price developments and the risks to price stability. This broad range of indicators includes: the euro exchange rate; labor market indicators, such as wages and unit labor costs; fiscal policy indicators; and financial market indicators, such as asset prices etc.
5. One may also suggest that the euro would always be weak in view of the lack of a state to support and create the credibility required for a sound currency. Indeed, this is a condition that if not remedied, could lead to the euro's complete failure (in an article in the *Financial Times*, 23 January 2001, Robert Skidelsky supports this contention). This, however, raises the issue of whether the credibility of the ECB is enhanced or weakened by the absence of a state. Monetarists would argue that it is enhanced, whilst non-monetarists would suggest that it is weakened—the political dimension is paramount. In this context, one should refer to the result of a public opinion poll published in the *Guardian* [Travis, 15 January, 2001]. It had been conducted in seven EMU countries (France, Germany, Greece, Italy, Luxembourg, Netherlands and Spain) by the *Guardian* and ICM. In response to the question "Ever since its official creation, the value of the euro has dropped in relation to the dollar. Do you feel that this situation is worrying?", 71 percent of the respondents felt that "this situation is worrying," to 21 percent who did not think of the situation as worrying.

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