How *to* Revive *the* Euro Economy

By Allan H. Meltzer

Begin with a one-time devaluation of the weaker economies followed by structural reforms.

After five years of stagnation, the once-bright prospects promised for the euro have vanished. Citizens of major countries—Germany, France—join other once-strong proponents of "United Europe" in demonstrating against the European Union. The massive rallies and growing opposition parties do not distinguish between the failing monetary union and the European Union. They do not like what they are getting and want more than the poor future they expect.

The main objective of the European Union was to join Germany and France in an arrangement that would avoid another European war. As other countries joined the union, that objective remained and other objectives were added. A common monetary policy with a common currency was promoted as a way of maintaining low inflation in member countries, avoiding periodic currency crises and devaluations, and promoting economic growth.

Inflation has remained low, but economic growth and employment outside of Germany and a few other countries has been disappointing. Gross and net investment show a weak expected future. Gross capital formation has fallen to the level reached in 2000, and net capital formation is negative. Expected growth of output is 1 percent or less. Still others want to make Germany buy the government debt of other member countries. This would convert the European Central

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Bank into a successor to the Bank of France instead of the successor to the Bundesbank. It effectively repeals the commitments made in the Maastricht Treaty.

Skeptics warned from the start in 1999 that the agreements in the Maastricht Treaty were incomplete. Critics said that a common currency can succeed if and only if there are compatible arrangements for relative price and real wage changes. Without such arrangements, real production costs do not adjust in a timely way that a common currency requires. Regulation, taxation, and government spending policies in such principal countries as France and Italy hinder any adjustment.

After adopting the euro, France and Italy chose labor market policies that strengthened strong unions but discouraged new hiring.

The Schröder government in Germany recognized that German production costs limited Germany's ability to export. Labor market and pension reforms changed that. The next German government, led by Chancellor Angela Merkel, became an export powerhouse because of its excellent products such as machine tools along with very competitive prices. Some other members of the currency union—notably the Netherlands and Finland—adjusted to a compatible position. But most of the other members did not. France and Italy are principal examples of countries that took advantage of lower interest rates to increase government spending and debt. They have not adjusted relative prices to maintain a competitive position consistent with the common nominal euro exchange rate against third countries.

Many market participants want the ECB to expand money and credit. Some look enviously at the rise in stock market prices in the United States promoted by low interest rates and expansion of bank reserves. Others blame Germany's low inflation and trade surplus for their malaise. President Mario Draghi of the ECB has now committed to a more expansive monetary policy.

That decision can devalue the euro against the dollar, the yen, and the yuan, but it will not substitute for reforms in Italy and France that reduce production costs. A nominal devaluation could change relative production costs only if prices and costs rise in Germany relative to other countries. Germans are unwilling to accept higher inflation, and it violates price stability, the main objective of the treaty creating the ECB.

WHAT THE ECB CAN DO

There are only three ways to restore growth. None is easy or popular. By doing little or nothing, the ECB has imposed deflation on the stagnant countries. This has been painful but partially successful first in Ireland and now in Spain.

Deflation increases production by lowering relative costs of production. As the economy improves, investment increases and growth resumes. Unwillingness to change taxation, spending, and regulation policies in Italy and France prevent these countries from following Ireland, Spain, and Greece. There has been some progress achieved by higher labor costs in Germany and some relative reduction in France and Italy. But this process is slow, much too slow compared to political developments in several member countries.

The second way to restore growth is for the stagnant countries to adopt spending, taxation, and regulatory policies more compatible with German, Dutch, and Finnish policies. They need not be identical, but they must be compatible with more flexible relative prices and real wages. Italy's Prime Minister Matteo Renzi favors steps of this kind, but the Italian parliament has not adopted any.

The third alternative would separate the euro into two currencies. The current euro would remain as the strong euro. Countries could choose to join a common soft euro that would float down against the strong euro. That would rather quickly adjust relative costs and prices and would restore growth. Countries in the soft euro could rejoin the hard euro only if they adopted reforms. Without reforms that permit relative costs to adjust, the euro would sooner or later repeat its current problems.

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My conversations with many Europeans show that relative devaluation is unpopular. That was what the ECB treaty ruled out. Some assert that any devaluation would cause a crisis. This seems just the opposite of past history.

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Before there was a common currency, France, Italy, and others devalued against Germany many times. A brief crisis ended with a devaluation that permitted growth to return to the indebted country.

POLITICAL PRESSURES

Pressure for change is rising in many ECB countries. Voters are joining parties that oppose the European Union, not just the ECB. In two of the principal countries, the National Front in France and the Alterative for Germany have grown in importance. Opposition to "Brussels" and the European Union goes too far when it threatens the union because the union is the way chosen to avoid a European war by giving France and German some common interests.

The splinter parties may never take power. The bigger threat comes from the political movements. If the voters move to anti-EU parties, politicians in the major parties will not be far behind. The movement away from "Europe" will grow. As an example, see the immigration policies proposed by the British Conservatives to bring voters back from voting for a splinter party, UKIP.

The euro's substantial problems illustrate why many economists do not favor fixed exchange rate systems. Systems like the gold standard or other common currencies are more suitable for a time when most workers were in agriculture and governments were smaller and less likely to regulate, tax, and spend in ways that favored some groups and harmed others. These restrictions made it difficult to adjust relative prices and production costs to shocks from the external world.

Gross and net investment show a weak expected future.

Many in Europe clamor for increased monetary expansion. This misreads the reasons for sluggish growth and high employment. Although money growth has been restrained, the problem is not primarily monetary: it stems from real differences in production costs that work to the disadvantage of countries with higher costs. Some of those countries have chosen policies that make cost adjustment extremely difficult. Before there was a euro, devaluations particularly of the French franc and the Italian lira ended crises.

To restore growth and employment in the euro area, countries must adopt policies that enhance their relative competitive position. I propose some policies that would end current stagnation. A one-time devaluation by the stagnant economies to restore growth followed by adoption—not a promise, but an adoption—of structural reforms would improve current and longer-term prospects for the euro area. ◆