Sunday Wrap

Greetings from Caffe Nero in Clerkenwell in London,

Today, I'll celebrate the 25th anniversary of the euro. As you know, the euro was introduced on January 1, 1999, although only as "book money", i.e., for accounting purposes. Three years later it arrived as physical notes and coins. While incomplete in its construction, it's been a huge success, as I'll argue below.

But first, I'll need to briefly highlight the unmistakable messages from the ECB this past week that market expectations of any early rate cuts are plainly wrong. Most importantly, Christine Lagarde made clear that there'll be no cut until the summer, the earliest. It was a statement which, in the FT's interpretation, triggered the global selloff in mid-week. Yet, Lagarde's statement should not have come as a surprise. As I have discussed in recent notes, including last Sunday, the hawkish message has been clear for some time to most economists watching the ECB, if less so to those who actually allocate capital.

The hawkish stance is supported by the IMF. This past week, first deputy MD, Gita Gopinath, repeated in an interview with the FT her long-held recommendation that central banks delay any urge to start the cutting cycle. She sees as a continued risk of a reversal in the disinflation process, including here near the end of getting to the 2%.

I continue to find the "last mile argument" unpersuasive. Why should the last mile to the 2% inflation target be harder than any of the previous miles travelled from the peak in late 2022, particularly in Europe, where the base effect of the big cost-push inflation has now driven inflation down almost to the target?

I have always thought that this conclusion might be a little trickier for the US because of the role excess demand played in their inflation story. And yet, this past week, the Atlanta Fed published a paper by their research economist and policy advisor, David Rapach, in which he made a persuasive case why the "last mile" worry – even in the US – is unfounded. He concludes that: "After examining a number of potential mechanisms, it is difficult to conclude that the last mile of disinflation is more arduous than the rest. In terms of policy, this implies that the Fed need not view the final phase of the disinflation process as fundamentally different from the other phases. Specifically, the Fed need not exert some sort of extraordinary effort to consistently bring inflation down the last few percentage points to reach its 2 percent target". It's here, and highly recommended: Is the Last Mile More Arduous?

If nothing else, this goes to illustrate the different economics advice presented to the policymakers, who'll need to make up their mind how to run policies. Ironically, in my view, the ECB seems likely to follow the advice of Gopinath, while the Fed will probably follow the advice of Rapach, and hence begin the rate cut cycle earlier than the ECB.

I'll leave it like this for today – confident that there'll be plenty of opportunities to return to this important topic – and return to the celebration of the euro. In the grander scheme of things, 25 years are, of course, only a blink of an eye for a currency, but it still calls for a celebration, not least because of the many sceptics who pronounced its early demise.

So, three brief sections in today's note:

- **The birth of the euro.**
- **I'll argue that the euro has supported European growth during these past 25 years.**
- **But it's still an incomplete project. I'll summarize the key missing structure in the euro set-up, and one important one that's not missing!**

1. The birth of the euro

The euro was created as part of a political project, rather than being the natural next step in an economics first-best manual of integration. In the environment of the fall of the Berlin Wall and German reunification, it aimed to accelerate the long-running European integration process, which has served Europeans - and the world - so spectacularly well during these past 65 years.

Normally, one would have wanted to see a common fiscal agent (with the appropriate democratic accountability) being introduced in parallel with the common currency and preceded by the integration of financial markets and the creation of a proper single market not only for goods, but also for services. Most economists warned against the experiment of moving ahead without those pillars in place, including at the Bundesbank which, of course, stood to lose relative power over monetary policy. But reluctance was also visible among some of the other central banks, which actually stood to gain power, as they would gain a seat at the monetary policy table, as opposed to following the Bundesbank after the famous "15 minutes before the decision" phone call.

But bold political leadership in, particularly Germany and France, overrode such economic concerns. I recall a conversation I had - quite precisely 26 years ago - with one of the leading political drivers of the project. His reaction to my question about the sequencing of the integration process was clear: The euro will - in itself - help crystallize the needs for those additional areas of integration and thereby trigger a faster integration process than if we build it all from the bottom up.

And if in doubt about the political dimension, Angela Merkel made it abundantly clear in September 2011 in the German Bundestag: “The euro is much, much more than a currency. The euro is the guarantee of a united Europe. If the euro fails, then Europe fails.” And in May of last year, Christine Lagarde said at the ECB’s celebration of its own 25th birthday: “The euro is more than a currency, it is the strongest form of European integration and stands for a united Europe that works together, protecting and benefiting all its citizens”.

Importantly, however, the euro is held together by more than a political commitment (which, after all, could change). It is also – and more critically - underpinned by powerful economic forces. Once a country is a member of the euro area, any attempt to leave and re-introduce a national currency would come with huge economic costs. Leaving the euro “on the weak side” would impose on the population the transfer of its assets and large-size transactions into a new and weaker national currency. Who would vote for – or accept - that? Leaving “on the strong side” would hardly be easier: The appreciating pressure on a new national currency would either have to be accepted by the authorities, which would cause huge financial losses for economic agents with foreign assets (and there would be many because a large external creditor position is the very definition of being a “strong” member) as well as competitive disadvantages for exporters – or the appreciating pressure would have to be met by massive FX interventions (i.e., printing money) or capital controls, neither of which is the recipe for growth and stability.

But the euro has not only proven its sceptics wrong by its survival, it has contributed to growth and stability in Europe, while policymakers have gradually – if more slowly than desirable - added parts of the missing pillars in its overall construction. Not surprisingly, therefore, the eurozone has not lost any of its members during its 25 years of existence. Rather, membership has almost doubled from its 11 founding members to now 20 member states.

2. The euro has supported European economic growth.

It’s my conviction that the euro has contributed measurably to eurozone GDP growth during its 25 years of existence, although – admittedly - that view is based more on circumstantial evidence than on conclusive academic research.

Indeed, academic research remains somewhat inconclusive with respect to the growth contribution from the single currency, although, on balance, most research suggests that it has been supportive, if less so than, e.g., the single market. The key issue in such research is how to establish the right counterfactual to the past 25 years of the euro. Would individual European central banks have been running free-floating FX regimes, managed floats or fixed-rate regimes? And how would they have implemented their associated rates and liquidity policies?

Would the economic shocks, particularly the great financial crisis’ spillover to Europe, the following European sovereign crisis and the economic lockdown during Covid have played out in similar ways in the counterfactual scenario of multiple European currencies? Nobody knows, but the following three observations lend support to my claim of a net positive contribution to eurozone growth and stability.

First, during the past 25 years, eurozone per capita GDP growth has – on average - been broadly equivalent to that of the US, even though the US economy is more flexible on all available measures. And, given the significantly greater widening of US income distribution during this period than in Europe, a backside-of-the-envelope calculation suggests that 80%-90% of the eurozone population has enjoyed greater per capital income growth than the 80%-90% "bottom" part of the US population.

Only three distinct periods stand out when the eurozone clearly underperformed the US, none of which had little – if anything - to do with the euro: Following the Great Financial Crisis, Europe took much longer than the US to clean up its banking system. I count that as a policy mistake. Then following the eurozone sovereign crisis, Europe introduced an unusual degree of fiscal austerity. The policy's defenders call it "short term pain for long term gain", but as the gain remained elusive for years, legitimate questions as to what "long term" means have been raised. In my book, the size, and particularly the composition, of austerity was another policy mistake. Finally, during the past 18 months, the eurozone has underperformed the US because of the huge terms-of-trade shock from commodity price increases, while the US benefitted from small terms-of-trade gains. (As I noted above, in my assessment, the ECB has excessively tightened its monetary policy in reaction to that shock. If so, this will then prolong the present underperformance into 2024 and maybe 2025 and turn into a policy mistake – but that's for the future to assess more definitively.)

Second, on World Bank data for per capita income in common currency (in this case, the US dollar), Sweden was 9% wealthier than the Netherlands when the euro was introduced 25 years ago. These two rather similar Northern European countries then chose different approaches to the euro: Sweden stayed out and maintained a flexible FX policy while the Netherlands joined the euro area (where, incidentally, in my assessment its central bank governors have been able to punch above their weight throughout these past 25 years). In 2022 (latest available data), Sweden's per capita GDP had dropped to 1% below that of the Netherlands. In contrast, Denmark, which also stayed out of the euro, but fixed its FX to the euro (thereby becoming a de facto member, but without a say in Frankfurt) was 18% wealthier than the Netherlands 25 years ago – and was still 18% wealthier in 2022.

Third, Czechia and Slovakia – two parts of the same country until the end of 1992 and both EU members since 2004 – provide another intriguing comparison. In 2009, Slovakia joined the euro area, while Czechia kept its (supposedly) independent monetary policy. Since then, Slovakia's annual GDP growth, on average, has remained both stronger and more stable than that of Czechia, particularly in PPP-terms. To the euro-sceptics: Was a flexible exchange rate regime not supposed to cushion against shocks and hence provide more stable growth? (Spoiler: There is no such thing as independent monetary and exchange rate policies for small open economies!)

I am not arguing that the euro alone accounts for these relative developments, but the odds seem increasingly stacked in favor of some positive effects of the single currency.

3. The missing parts - and the not-missing part.

A critical explanation for the euro's success has been the combination of institutions and policies introduced to compensate for the missing parts.

In particular, the ESM was created (via the ESFS) and has played a very important role, particularly via its "bazooka" of financial firepower. In addition, the banking union was introduced, including with the common bank supervisor for the largest banks, although (still) without common deposit insurance. The ECB's supervision, including stress tests, of major banks no doubt deserves substantial credit for the robust standing of the major European banks, most recently illustrated during the shocks of the massive increase in yields and the collapse of a number of US regional banks and Credit Suisse.

Meanwhile, the ECB has created additional tools to make it into a more "normal" central bank which – after all – is part of a country's governing institutions, provider of legal tender, and hence ultimate underwriter of governance (not to be confused by the underwriter of any specific government.) As Larry Summers observed in Sintra a few years ago, he had seen a few countries in history without a central bank, but until the ECB was created, he had never before seen a central bank without a country.

Most importantly, in 2012, following Mario Draghi's promise that "within our mandate, the ECB is ready to do whatever it takes to preserve the euro", the Outright Monetary Transactions (OMT) policy tool was created. The OMT opened for potentially unlimited intervention in the sovereign debt market of any member state with an economic program with the ESM. Equally important, partly to accommodate countries' apparent reluctance to ever sign onto such a program with the ESM for the OMT to become operational, the ECB later added the Transmission Protection Instrument (TPI) to its toolbox; a more flexible, opaque – and therefore immensely powerful - tool.

But something is still missing – and something is not:

Most glaringly, the euro is missing a matching euro-denominated common risk-free asset. Without it, a common financial market to allocate capital efficiently across the euro area remains an illusion. (In its absence, markets use mostly German Bunds, which only serves to distort the allocation of capital.) In this context, the much talked-about, but still elusive financial markets union is also missing. In addition, the lack of a common risk-free asset and financial markets union prevent the euro from gaining a role in global markets, including as a reserve currency, comparable to the size and importance of the eurozone economy.

To create a common euro-denominated safe asset, the eurozone needs a common fiscal capacity to issue, and underwrite, the debt. The Next Generation EU funds are important in many aspects, but the NGEU is not equivalent to a fiscal agent with permanent taxing and spending powers. Some have noted in the past that without a common need for fiscal spending and investments, a common fiscal agent would only add unnecessary layers of bureaucracy and taxation to the system. If so, that surely can no longer be the case. Today, it seems clear that a common fiscal capability would be the right agency to finance several common objectives, including defense, climate change investment and research as well as the home-sourcing of critical industries which is pursued at the national level, potentially undermining the Single Market.

Finally, while the missing parts to complete the euro are rather easy to see, one component – already loaded and no doubt to be launched – is not missing, namely the "digital euro". I may write more about this in coming months, but the drive to introduce a CBDC by the ECB – the digital euro – has become one of Europe's great white elephants.

In the excitement of private digital currencies as well as test-runs for. CBDC in China, a number of central banks in the OECD area started to research the possibilities of launching their own CBDCs. Yet, with the exception of the ECB, they have all de facto shelved them – and for good reason.

After all, any individual or business wanting a digital currency has it already via their bank. I therefore predict with great certainty that the take-up of the offer (in a couple of years, when – if -it gets launched) of an additional euro account with the ECB (but via the banks) and with a maximum deposit of just a couple of thousand euros, will be minuscule – beyond European central bank staff who'll like to show support. It is, as they say, a solution in search of a problem.

As this has become increasingly clear, the supporters of the project thought they found "the problem" which "the solution" was in search of, namely the need for a European retail payment system. This is clearly needed – yet, the payment system remains completely absent from the digital euro project, and it could, much better, be created without a digital euro.

In other words, the digital euro project may be diverting important attention, and critical resources, away from the need to put in place an environment that would encourage the private sector to create the much-needed payment system. We shall see.

And with that, I wish you a continued good Sunday. Next Sunday, you'll find me on the slopes in Val Gardena, rather than sitting here at my Stammtisch in my favorite local café – and the following Sunday, I'll be travelling home again, re-energised after a week of skiing (and the occasional Apres-Ski). I'll be back on 11 February. Meanwhile, I hope you continue to follow the outstanding research published by my research colleagues in Marco Valli's team.

Best

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