The Birth of the Euro (review)

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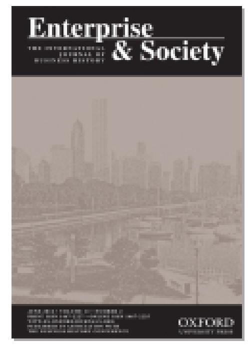

Otmar Issing. *The Birth of the Euro*. Cambridge: Cambridge University Press, 2008. xiv+ 260 pp. ISBN 978-052173, $29.00 (paper).

In this book, Otmar Issing describes the birth of the euro and its performance through 2007. The author is singularly well placed to tell the tale. As a member of the board and council of Deutsche Bundesbank from 1990 through 1998, he was party to the discussions leading up to the creation of the new European currency. Then as the European Central Bank's (ECB) founding chief economist and member of its Executive Board, he was intimately involved in developing its policy framework.

Issing thus provides an authoritative account of the Maastricht process, the statute and structure of the ECB, its conduct of monetary policy, and the relationship between Europe's central bank and the larger integration project. He does this with admirable clarity, betraying his earlier incarnation as an academic. His account is infused by the distinctive German sensibility that places price stability above all other goals of economic policy. Central banks and the societies in whose service they labor may aspire to greater things, but without price stability, there is nothing.

Evaluated on this basis, the ECB's record through 2007 was good. It succeeded in maintaining low and stable inflation. Consistent with the author's worldview, price stability was accompanied by economic stability. But eternal vigilance is required. The ECB must continue to wage its righteous war against those inclined toward more inflationary policies, Issing repeatedly warns.

While it is not entirely fair, it is irresistible to ask whether the author would have offered a different assessment had he known of the events of 2010. Early that year, the markets awoke to problems of over-indebtedness and inadequate international competitiveness in Southern Europe. The Greek government was pushed to the brink of default, a fate that it escaped, at least temporarily, with the help of a $125 billion loan from its European partners and the IMF. To prevent the crisis from spreading, the ECB was forced to engage in extraordinary bond purchases, and the EU assembled a $1 trillion rescue fund. Even this did not dispatch talk that the euro zone might break apart, either because a Southern European country desperate to restore its competitiveness reintroduced its national currency or because Germany, concerned that the euro area was turning into an inflationist "transfer union," opted to leave. The implication, increasingly voiced, was that the euro had been a mistake.

Of course, there is less than full agreement on the precise nature of the mistake. Some say that it was the decision in 1998 to go for a monetary union encompassing not just Germany, France, and their Northern European neighbors but also Italy, Spain, Portugal, and Ireland. Others will say it was the even more dubious decision to admit Greece in 2001.

Still others blame not one country or another but the problematic nature of a one-size-fits-all monetary policy. After 1999, precisely because its interest rates came down to German levels as a result of the euro, Southern Europe went on a borrowing binge. Firms enjoying strong domestic demand felt free to accede to pressure for increased wages. Problems of excessive debt and inadequate competitiveness followed directly. Had they retained their own currencies, these countries could have had a level of interest rates appropriate to their national circumstances, restraining demand. And had they still succumbed to excess, they would have felt the discipline of the market more quickly since their national exchange rates would have dropped. It was the euro, an intrinsically flawed concept, that disabled these corrective mechanisms.

Having completed his book before the crisis, Issing does not speak directly to this controversy. But his account does feature a number of passages relevant to subsequent events. He warns that a single level of interest rates will be tolerable only if governments adjust their other policies to national circumstances. Specifically, countries for which the interest rate is uncomfortably low, encouraging spending, had better tighten fiscal policy to restrain demand. Unfortunately for this argument, the political reality is that it is difficult to restrain spending when revenues are flowing in. The Irish government for one went a considerable distance down this path, but was still unable to prevent the economy and housing market from overheating.

Issing warns further that it is essential for participating member states to obey the monetary union's fiscal rules and specifically the Stability and Growth Pact negotiated by his one-time colleague Theo Waigel. In practice, of course, those rules were honored mainly in the breach. A turning point, as Issing notes, was in 2003–2004 when Germany and France exempted themselves from the pact's sanctions and fines. This made it impossible to impose those provisions on smaller countries.

Finally, Issing cautions against the notion that monetary union is a stalking horse for political union. He frets over the prospect of a "social Europe" where other governments are allowed to foist restrictive social policies on the union's more market-oriented members. He worries about a "fiscal Europe" that becomes an engine for ongoing transfers from strong to weak member states and warns that this could cause a backlash against European integration in Germany and elsewhere.

Others, their views informed by the 2010 crisis, will respond that monetary integration without political integration is untenable. Europe has an excellent set of bank notes and coins. It has an excellent central bank. But it lacks the other elements of a workable monetary union which include an emergency financing mechanism and a system of fiscal coinsurance that provides temporary transfers to members with strong budgets but transitory problems. As things stand, Europe's proto-executive, the European Commission, lacks the power to administer these policies. It lacks the power to apply the Stability Pact without being overridden by narrowly self-interested national governments. These are problems of monetary integration that, like it or not, only steps toward political integration can solve.

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