The Euro: Engine for Prosperity

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I am delighted to be here at this conference, and especially delighted to be able to participate in this session. Before proceeding, though, I want to emphasize that the views I express are mine and do not necessarily reflect official positions of the Federal Reserve System. I retain full responsibility for any errors in what I am about to say.

The first thing to emphasize about the euro is that creation of this new currency and new central bank is a remarkable political, operational, and monetary policy achievement. When I came to the St. Louis Fed three years ago, I joined a well-established organization with a long history. Given my personal experience and all I had to learn, I find it mind-boggling to think about the challenge of establishing a new central bank from ground zero. There was a certain amount of anguish last year as the euro depreciated against the dollar, but that happens from time to time to the very best currencies in the world. The dollar, of course, has seen its ups and downs over the years. That the euro was beset by nothing more serious than a perfectly normal period of weakness is evidence of just how remarkable the achievement has been.

It is obvious, but nevertheless worth repeating, that building the institutions and practices of the European Central Bank will take time. The way in which the ECB handles the problems and even crises that will inevitably arise will shape future events. I am sure that the leadership of the ECB understands the precedent value of everything that is done. But observers may not always understand this point, and it is worth emphasizing in the strongest possible terms that every action by the ECB needs to be viewed as part of a developing long-term policy strategy and not just in terms of the pressures of the day. I have not followed the ECB in fine detail, but to me the Bank has done an excellent job in establishing policies that will only be fully understood and appreciated in the future.

Creation of the euro has already had a major impact in unifying the capital markets of the member countries. Interest rate spreads have narrowed dramatically now that exchange-rate risk has been eliminated. I've looked at a number of charts showing spreads for government bonds issued by various euro countries and it is striking how spreads against German government bonds have narrowed with the introduction of the euro.

Spreads within the euro area now reflect differences in default risk and in market liquidity. As a consequence, capital flows within the euro area reflect fundamental investment considerations rather than speculation on exchange rates and policies that might interfere with the free flow of capital. Capital flowing in response to economic fundamentals will surely create a more efficient use of available capital, which is always a scarce resource.

I believe that creation of the euro will also lead to a more efficient pattern of trade in goods within Europe. Investment and production decisions will depend now on comparative advantage to a greater degree than before. Without the uncertainty over exchange rates, firms can proceed with greater confidence that their decisions will not be upended by protectionist actions motivated by efforts to influence exchange rates or to offset the competitive effects of exchange rate changes.

I have long been an advocate of floating exchange rates, a position that initially reflected the fact that I did my graduate work at the University of Chicago under Milton Friedman. What I have come to understand over the years—and this view was always an important part of Friedman's thinking on currency issues—is that the currency arrangement that works best is the one that permits and encourages free and open trade in goods and capital. As its economic integration increased, Europe found that freely floating exchange rates too often created sharp changes in competitive conditions, which made it difficult to maintain the momentum toward increased trade and capital openness within Europe. Fixing rates to a degree through snakes and tunnels did not work well either, as evidenced by exchange market crises on several occasions. Indeed, a fixed or semi-fixed system works much less well than freely floating rates. Full currency unification is surely more efficient and more stable than separate currencies with fixed rates. If fixed rates are truly fixed, there is no reason to have separate currencies; if fixed rates change from time to time, the instability damages efficient trade and capital flows.

I've spoken briefly about the floating rate option because I do not want to leave the impression that a single unified currency is the best arrangement for all countries in all conditions. That is a subject that goes well beyond this panel discussion, however.

From an economic policy perspective, the main argument against the creation of the euro has been that a country might believe that it could create more stable employment and a more stable internal price level by employing an independent monetary policy. Concerning price stability, most countries in the euro area—the major possible exception is Germany, of course—believe that the euro promises more rather than less price stability. Whether the euro will achieve a price stability record as impressive as the DM did, only time will tell. Clearly, though, the institutions of the ECB have been designed to achieve that end and it is hard to know what else might be done to improve the odds on maintaining price stability over the long run.

The common currency obviously eliminates certain transactions costs related to exchanging one currency for another and hedging currency risks. This sort of microeconomic efficiency is at the heart of the economic growth process. Reducing currency risks and price level instabilities creates favorable conditions for higher economic growth, but does not by any means guarantee such growth. It is critical to understand that higher growth in Europe does not depend on an expansionary monetary policy, but instead on microeconomic reforms. Europe needs more flexible labor markets, a more entrepreneurial business environment, a reduced burden of government regulations, and a more efficient system of taxes and subsidies to create improved incentives for growth.

The United States, although in better shape on many of the microeconomic dimensions than Europe, needs exactly the same reforms to increase its growth rate. There are so many opportunities in the United States and in Europe for improving efficiency that I do not know where to start such a list.

In closing, I want to emphasize a point that I include in almost every presentation I make. The primary responsibility of a central bank is to maintain low and stable inflation, or price stability if you prefer that formulation of the same idea. That is the way a central bank can contribute to achieving maximum sustainable economic growth. In the Eighth Federal Reserve District—the St. Louis District—I have explained to agricultural audiences that creating more money cannot solve the problems created by inadequate rainfall, or by the fact that agricultural commodity prices have been trending down for 150 years relative to other prices because farm productivity continues to outpace the increase in the demand for food. I have explained to other audiences that printing more money, or less, will do nothing to solve the electricity demand-supply imbalance in California. Nor can monetary policy relieve airport congestion or any of thousands of other problems that directly impact economic growth.

Of these examples, my favorite is that printing money can't increase rainfall, because the example is so obvious. Monetary policy is simply not a substitute for addressing environmental and other disputes that must be resolved through political means if, to continue the example, we are to build more dams to provide irrigation water. All too often, people seem to believe that monetary policy is an easy way out to create growth, when it simply isn't because monetary policy cannot, as I like to say, make the rain fall.

As I travel around my district I emphasize that economic development depends on microeconomic policies that are substantially under the control of local authorities and local business leaders. Although not obvious to most European observers, the United States has major regional differences in unemployment rates and growth rates. Within the Eighth Federal Reserve District, for example, some markets enjoy an unemployment rate in the 2 to 3 percent range while others have an unemployment rate in the 8 to 10 percent range. These unemployment rate differences are persistent, but they can be addressed by suitable government policies that promote economic growth. Good monetary policy contributes enormously to economic growth by creating price stability, but cannot be expected to create the microeconomic efficiencies that are at the heart of the growth process.