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The Euro and Its Benefits: Trade in Hard and in Soft Currencies

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Abstract: The introduction of the euro is a momentous event that has important implications for the world, for Europe, and also for the world. Protectionism in Europe in its various forms is being given a final blow with the introduction of the common currency that, for the first time, will lead to genuine convergence in prices. The abolition of the internal foreign exchange borders has profound effects for competitiveness and trade. It entails more freedom for Euroland's producers to swim competitively – and especially to sink. What looks like a more self-sufficient (or 'closed') Euroland is in effect an open domestic market that has converted into domestic-currency transactions what previously constituted international trade involving foreign exchange. This conversion is uniquely beneficial for the partners that previously had the relatively softer currencies. Finally, the benefits to the EMU partners multiply and spill over to the global level as the euro becomes a strong, and potentially a parallel reserve currency.

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Introduction

The euro has been introduced with understated dignity. In an attempt to diminish expectations the European Monetary Union (EMU) has been billed as a further exercise in exploiting the economies of scale of a large market, plus an attempt to

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enjoy the economies of scope of moderating the uncertainty inherent in currency fluctuations. This paper argues that the introduction of the euro is a momentous event that has important implications for Europe and the rest of the world.

The seemingly innocuous innovation of the euro is to replace ten national exchange rates by one. By the same stroke, ten bilateral exchange rates for the 'Ins' have disappeared. Exchange rates are a necessary, yet awkward set of prices that are in place to provide protection *vis a vis* trading partners and are used to manipulate other sets of prices, notably the prices of commodities that enter international trade, the tradables (or 'tradeds'). This becomes a difficult balancing act if the objective is to unify markets and not to separate them. The paper introduces an early attempt in the European Community to achieve uniform prices in agricultural markets through protectionism. But the elusive target of uniform prices did not become an explicit objective until the European Community was transformed into the European Union with the purpose of creating a seamless market web among the partners. The introduction of the euro is the final act in this drive for unification of the market and for establishing uniform prices in Euroland. What are the implications of this innovation?

The euro, as a global replacement of ten national exchange rates, had the immediate effect of restructuring the international trade matrices by redefining tradability in Euroland. This is hardly an innocuous accounting transformation. The analysis in this paper shows that Euroland as a result has become more self-sufficient all around. There is an irony in these findings: by fully opening up and creating a more perfect market for the 'Ins', Euroland registers as being more closed to trade and less open to the rest of the world. This contradiction is further pursued in which returns to the oxymoron of Euroland becoming more 'closed' in having perfectly opened its internal trade by adopting the euro. Perfect opening to trade is only possible when what was previously 'Out' becomes 'In'. Pre-euro trade between Portugal and Germany was free, but it was still international trade: the two countries were 'Out' in the sense that they were separated by an exchange rate which, as long as it was fluctuating, it was a price that mattered. By trading in the same currency, the euro, the partners in Euroland have become 'In', in other words they exchange in domestic trade in the same way that the fifty states in the USA. are 'In' and practice domestic trade. Does this then mean that all a country has to do in order to be 'In' and thus share the benefits of monetary stability, as in America or Europe, is to join a currency block? This is painfully incorrect. Exchange rates still matter and they are needed for countries that are not 'In'. Abolishing them through a monetary board or 'dollarisation' may offer a false sense of security but it is a perilous and costly endeavour.

Suppressing the Role of Exchange Rates: Agricultural Protectionism

Since the inception of the European Community the stability of intra-European prices was an unspoken political desideratum. It was to be achieved in time through the efficiency gains resulting from the increased size of the market. The exception was agriculture where bringing forward in time stable agricultural prices seemed politically attractive for combating agricultural poverty. The objective of furthering agricultural price convergence was pursued with protectionism. Thus uniform support prices were established in the early 1960s for a number of (important) 'intervention commodities' It was a well-intended idea that went totally wrong and begat the monster of the 'agri-monetary system'.

Cross-border prices are vulnerable to exchange rate instability that was transmitted to unstable agricultural prices. This became painfully clear to the European Community by 1969 when the fixed exchange rates of the Bretton Woods system had started eroding and there was a realignment of the French franc and the Deutsche mark (in opposite directions) towards the US dollar. The devaluation of the FF increased the price of wheat in France relative to the fixed support price, while the appreciation of the DM decreased the price of wheat in Germany. Since devaluation improves competitiveness, exports of French wheat to Germany increased. In fact exports turned into a flood as French farmers could sell their wheat to the German intervention system and receive their fixed support price in appreciated DM that exchanged at home for even more FF than the post-devaluation high wheat prices would have brought in the home market.

The lesson gathered from that experience was that exchange rates had to be suppressed: farm prices would be sheltered from exchange rate fluctuations and thus the 'purity' of competitiveness would be protected. The idea was pursued with vengeance in what soon became the monster of the agri-monetary system. Throughout its various transfigurations the system has centred on adjusting upwards the fixed farm prices in order to solve the problem of the farmers, mainly German, who were hurt by the secular appreciation of the DM or their respective national currencies. And lest there develops a flood of exports/ imports from weak to strong currency EU countries the protection offered had to be matched by levies on (cheap) imports and subsidies to (expensive) exports in countries with appreciating currencies — which developed into the 'positive MCAs' (monetary compensatory accounts). The converse applied to weak-currency countries, with the 'negative MCAs'. The challenge to this system came in 1992 when the abolition of the national borders made the collection of MCAs impractical. At that time the European Commission, making a virtue out of necessity, 'abolished' the MCAs, and put in their place lump-sum 'compensatory payments'.

At the end, the agri-monetary system was a good idea run amok. Instead of creating unitary pricing in EU it produced a patchwork quilt of national prices, buttressed by an inscrutable system of taxes and subsidies that intended to discourage profitable arbitrage among EU partners. This is the bad news. The good news is that European agriculture prospered (and so did farm surpluses) and farm incomes increased as a result of ever-increasing green prices. Moreover, it was all done in a good cause: pursuing a single market with converging national prices within the EU, while at the same time offsetting the pernicious effects that exchange rate instability had in agriculture!

From (Foreign) Trade to 'Domestic Exchange': Suppressing the Role of Exchange Rates in Euroland

The objective of the agri-monetary system to free agriculture from the vagaries of exchange rates is fully achieved, and generalised to the entire economy, by the advent of the euro. The 'Ins' have been freed of the tyranny of exchange rates in the sense that cross-border trade which was previously settled in foreign exchange is now being settled in domestic currency, the euro. This has important implications for the real economy and for competitiveness in Europe, especially for the weaker partners of Euroland.

The prevailing idea that the euro is just a linguistic linear transformation of, say, 1.96 DM to one euro or of 1936 Italian lire per euro, is only half-true. The transition matters little to the countries with hard currency who could settle their current account positions in their own, say, Deutsche Mark, French Franc, or British Pound. But the transition to the euro is a significant economic event for the countries with softer currencies, who had their imports denominated in foreign exchange - say the DM, the FF, the GBP or for that matter the US$ - and had to settle their current account overruns also in foreign exchange. Since Portugal could not pay for imports of French wheat in escudos, it could import only as long as it could shift resources from nontradables (or rather 'nontradeds') to tradables ('tradeds') — which in turn could be exported to procure the FF to pay for the wheat. In a world where the shift from nontradeds to tradeds is not costless, a gap in the balance of payments can become binding.[1] This is no more the case in Euroland. Effectively, Portugal can pay for French wheat by the proceeds of producing more haircuts for the domestic market, since both Portuguese haircuts and French wheat trade in euros. The EMU makes in fact the current account balances among the 'Ins' irrelevant. The situation is equivalent with the state of the world that Arkansas and California face in the US. The former is a poor state, the latter is rich. But Arkansas enjoys a tremendous advantage in not having to produce 'exports' to pay for importing pentium chips from

California's Intel Corporation. Similarly, by joining the EMU the 11 'Ins' have made all their outputs, from haircuts to computer chips, exchangeable in 'home' trade and in domestic currency. Another way of putting this is that tradability has been redefined in the EMU, by shifting things that were imported and exported previously from the tradable column to the nontradable column of the ledger. Only trade conducted with non-Euroland partners is international trade post-EMU, which means that self-sufficiency has increased and the share of trade in GDP has shrunk.

How important is this trade effect? Does it have any real implications?

For answering this question we utilise trade data for the year 1993 (OECD database). All trade in the database is aggregated to 200 commodities that are evaluated in domestic currency, 1993 nominal prices, and are weighted by the share of each commodity in domestic consumption. Summation over the 200 commodities expresses trade as share of GDP (total consumption side). In updating these trade flows to the date of the birth of the euro, it is assumed that prices and quantities remained at their 1993 levels, and the only thing that changed is the geographic definition of tradability. In other words, the share of international trade that was previously carried out among the 11 EMU members was redefined on January 1, 1999 as domestic trade. The data that follow are based on this construct.

Figure 1. Trade share in total consuption (%)

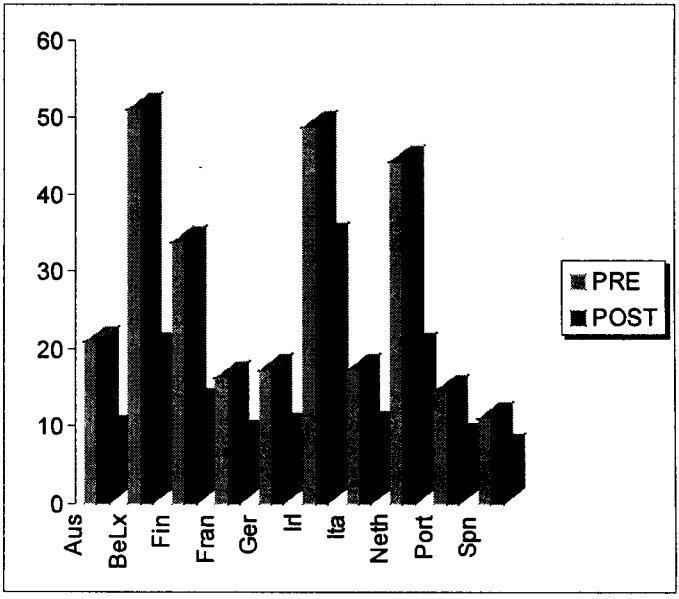

Figure 1 shows trade share in GDP (total consumption) for each of the EMU partners in comparison for the pre- and post-EMU situation. By definition, the

comparison between pre- and post-EMU in the figure shows an inevitable decrease of the share of trade in GDP. With the exception of Belgium/ Luxembourg, Ireland, the Netherlands, and partly Finland, the share of trade in GDP was modest for the 11 EMU countries in 1993—typically about 20 percent. The redefinition of the borders of Euroland decreased trade share to canonical values close to 10 percent of GDP—except again for Ireland (closer to 40 percent) and Benelux and the Netherlands (about 20 percent). The effect of the size of the 'country' alone - now accounting for one-quarter of the world's output, close to that share for the US - has had a dramatic effect in increasing self-sufficiency.

Figure 2. Share of agricultural trade in total consumption (%)

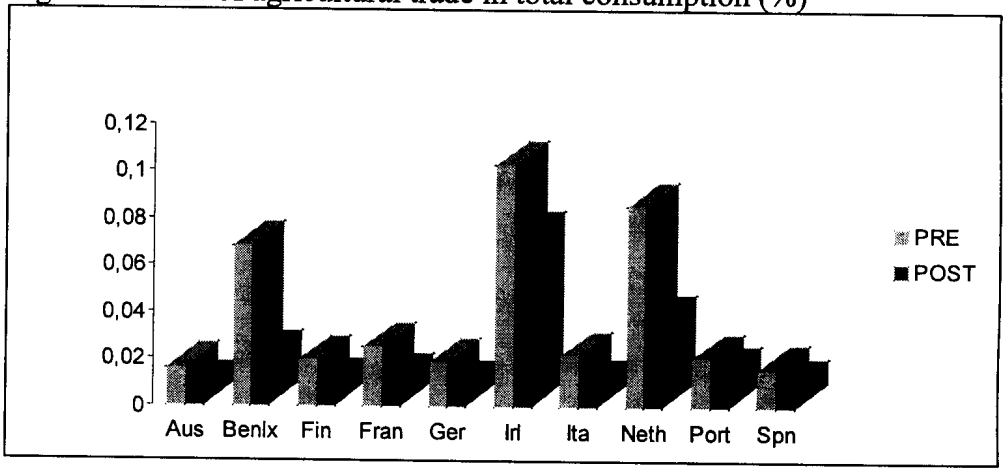

Figure 2 shows the same situation for trade in agricultural commodities as percent of GDP. European countries have always been close to self-sufficiency in agriculture, as shown by the canonical values in the figure of between 2 and 4 percent of GDP — with the exception again of Belgium/ Luxembourg, Ireland and the Netherlands which have values of agricultural trade to GDP closer to 10 percent, still a tolerably low figure. The redefinition of the borders of Euroland decreased agricultural trade also by about one-half — a little less than that for Spain and Portugal and a little more for the Netherlands and Belgium/ Luxembourg. The impact of the redefinition of the borders on agricultural trade was more pronounced than it was on total trade. This has probably to do with the place of honour that trade in 'intervention' agricultural commodities had within Europe. As part of this is no longer 'trade' within Euroland the need for designating intervention commodities for considerations of exchange fluctuations has abated.

The conclusion drawn from the data is that the abolition of the internal foreign exchange borders in Euroland had a profound effect in decreasing trade with the

outside world – which is tantamount to increasing self-sufficiency of the 'Ins'. Self-sufficiency has a negative ring to it since it evokes images of trade diversion. In this case, instead, self-sufficiency is an unmitigated blessing. It is not based on closing-in but on opening-out: it means that the same goods and services that were paid for previously in foreign exchange are now obtained from the very same sources in domestic currency. The benefits of the euro, that derive from dispensing with current account balances for the 'Ins', accrued mostly to the countries with the weakest currencies that had previously faced a binding foreign exchange constraint. The choice of paying in domestic currency or in foreign currency becomes irrelevant for the strong currency country – and *a fortiori* for the reserve currency country.

Dynamics: The Euro as a Reserve Currency?

There are also global implications of the introduction of the euro. These transcend the pre-existing intra-European exchange rates and the effects of the redefinition of tradability.

The most immediate gain from the euro that is shared with the rest of the world is the creation of a large, stable economy that is better able to defend itself in case of a speculative siege. Should contagion from faltering markets become a problem, the Central European Bank, as a supranational lender of the last resort within Euroland, can provide the liquidity necessary for institutional agents to make orderly financial adjustments. The existence of a credible lender of last resort guarantees that temporary liquidity shortfalls of otherwise solvent financial institutions — where the assets exceed the liabilities — do not turn into indiscriminate financial crises of the type experienced in East Asia.

A globalised economy with free capital flows and free exchange rates magnifies the risk of compounding otherwise benign liquidity episodes into gratuitous financial crises. A country with a current account deficit or one with a short-term foreign currency debt that exceeds its foreign exchange reserves could simply become temporarily illiquid because it lacks the funds to meet its immediate obligations. But it may otherwise be a solvent country that could service its debts from future export earnings. This basic solvency, however, was of small consolation, e.g., for (S) Korea that fell the victim of a financial crisis at the cost of an economic contraction of 14 percent of GDP in one year.[2] If a similar situation arises in Euroland, the European Central Bank can provide the liquidity needed to extricate a country from the claws of such punishment.

In the context of a globalised market with free capital flows and free exchange rates, in survival in an uncertain environment places a premium on flexibility and liquidity (Feldstein, 1999). In this respect the operation of the euro in Euroland is

totally different from the short-term palliatives advocated as cures for financial crises. Setting up a monetary board is one of the ideas that have recently surfaced for preventing future financial crises. Abandoning the domestic currency altogether by creating a 'dollar-zone' ('dollarisation') or a 'yen-zone' is the other.[3] Both solutions are expensive and contractionary (Yotopoulos, 1996, 1999).[4] What is even more important, neither solution works when the chips are down. Mexico currently faces a balance sheet crisis: the bad loans in the portfolio of commercial banks amount to 20 percent of GDP. All the same, the banking sector in Mexico has not imploded yet because depositors know the central bank of Mexico can generate enough pesos to replace their deposits with any bank that fails. The same but more credible solution applies for the case of Portugal or Italy within Euroland. Should there be a bank crisis, their central banks can provide as many euros as bank depositors wanted to avoid a widespread run on banks that would lead to financial chaos. But should Mexico abandon the peso and adopt the dollar as its domestic currency, the issuer of the currency is the Federal Reserve. The Fed is in the business of last-resort lending for the US, not for the world. At the first intimation, then, of a banking crisis in Mexico which is a member of the dollar zone, the reaction of the public would be to take its dollar deposits and flee. A run on banks and a financial collapse come fast behind.

The implicit model that underlies these two novel components of the 'new architecture' of the international financial system is a model of 'asymmetric reputation' between reserve/ hard and soft currencies (Yotopoulos, 1996). Where a currency is located in this continuum of reputation becomes especially important when currency markets are free and currencies are used not only for transaction purposes but also as assets in agents' portfolio. Reserve/hard currencies enjoy a reputation of stability: it is an implicit commitment that their relative prices will not change drastically. This reputation is both the cause and the effect of central banks' holding these currencies in their reserves. Soft currencies, on the other hand, may devalue since they lack the reputation of the reserve currency. A free currency market puts soft currencies and reserve currencies in head-to-head competition with the cost of exchanging the one for the other being minimal. In such an environment, the option between holding the reserve or the soft currency is a one-way-option for the investor of liquid assets. The soft currency may or may not devalue. By substituting the reserve currency for, say, the (S) Korean won, the investor enjoys a capital gain if devaluation takes place, while losing only small transaction costs if the (S) Korean currency does not devalue. The exercise of this one-way option creates a one-way traffic of currency-substitution in a free currency market: fleeing the soft currency by substituting the reserve for asset-holding purpose. The asymmetric demand for liquid-asset holding in reserve currency originates in the asymmetry of reputation favouring that currency. And the same asymmetry in demand for the two currencies

makes devaluation of the soft currency a self-fulfilling prophecy. It is asymmetric reputation that exposes soft currencies to the risk of financial crises when currency markets are free.

The problem with using creative financial engineering, like a monetary board or dollarisation, for the purpose of creating reputation is that such half-way-houses do not work. One solution to the problem of currency-substitution-induced devaluations — and their attendant financial crises — is to treat asymmetric reputation as a market failure parallel to 'asymmetric information' that becomes the cause of market incompleteness. The remedy in such case is to impose controls on foreign exchange by rationing out of the market the demand for reserve currency to be used for asset-holding purposes. The other solution is to engage in the long, arduous and frustrating process of growth and development which also makes soft currencies harden. In a globalised economy there is no royal way to monetary stability. The stability of hard currency is not created by 'borrowing' somebody else's hard currency. As Ceasar's wife knew well, reputation is only earned; it cannot be borrowed.

It is instructive to examine the euro from the point of view of the flexibility enjoyed by a reserve currency for two reasons: First, it is all but likely that the euro will become a parallel reserve currency with the dollar. Second, if this happens, the benefits of Portugal (in the previous section) who post-EMU can procure German imports by paying from the proceeds of producing more haircuts are extended to all EMU members with respect to the world. With the euro as a reserve currency it would be as if the entire output produced in Euroland could be traded for any output produced anywhere in the world! In a sense, current account balances between Euroland and any country in the world would become irrelevant, as long as the European Central Bank could pay for any trade deficits by printing and exporting more euros.[5]

One way of understanding the coupling of the distinction between hard and soft currency with that of tradables and nontradables is to extend the previous example of Portugal and to compare two economies along the continuum of possibilities for transforming nontradable output, or the resources that produce it, into tradables. To enhance the intuition suppose both countries are overindebted, e.g., the United States and Mexico. With the peso being a soft currency and the Mexican debt being denominated in dollars (because the peso is soft currency), Mexico cannot service its foreign debt from the proceeds of producing nontradables. These are traded in pesos. It has instead to shift resources away from the nontradable sector to produce tradable output in order to procure the dollars for servicing the debt. In the US, on the other hand, the debt is serviced in dollars. Then all output produced, whether it consists of more aircraft or more haircuts, serves directly to service the dollar-denominated debt.

The additional flexibility enjoyed by the country with the reserve currency is matched by an additional disadvantage that creates contraction in the soft-currency country. A parable can help enhance understanding of how the process of shifting resources from the production of nontradables to that of tradables, when fuelled by currency substitution and systemic devaluations, can create a negative feedback loop that leads to resource misallocation in soft-currency countries. Consider an equilibrium allocation where a bundle of resources produces tradables (T) and nontradables (N), measured so that one unit of each is worth US$1. Entrepreneurs should be normally indifferent between producing one unit of the former or one of the latter. Should this equilibrium allocation of resources be changed one would expect to register losses. But this is precisely what happens in soft-currency countries. In the case of Mexico T trade in dollars while N trade in pesos. Since the soft currency may be devalued it becomes risky for Mexican entrepreneurs to produce (or hold) one unit of N that could not be converted for later spending into US$1. Expressed in another way, entrepreneurs see the future price of tradables increasing relative to the price of nontradables and they are attracted to producing T because that is the cheapest way they can acquire US$1 from their bundle of resources in the future. This dilemma does not exist with the countries that have hard currency. For their entrepreneurs US$1 of T will always be worth US$1 of N in hard currency, contrary to the soft currency case where the expectation of devaluation becomes a self-fulfilling prophesy.

In this scenario production in soft-currency countries becomes biased excessively toward T, despite the fact that the relative productivities of the bundle of resources have remained unchanged *ex hypothesi*. This excessive shift of resources represents misallocation[6]; it becomes the cause of inefficiency and output losses. The intuition behind the parable is simple. Distortions inherent in free currency markets lead to systematic devaluation of soft currencies — to 'high' nominal exchange rates. Devaluation of the exchange rate means increasing prices of tradables and leads to increased exports. But not all exports are a bargain to produce compared to the alternative of producing nontradables. Currency-substitution-induced devaluations can lead to competitive devaluation trade as opposed to comparative advantage trade. Competitive-devaluation trade is misallocating resources against nontradables at great cost to growth and to the detriment of development.

In an international environment of free capital flows and free exchange rates monetary instability in soft-currency countries is an endemic allergic reaction. It can develop into a full-scale financial crisis at the drop of a pin. All halfway remedies of the ailment have huge side effects on the growth and development of the country. And the tragedy for emerging economies is that without vigorous growth and development soft currencies cannot be hardened to provide monetary stability.

Conclusion

From its origins, the enterprise of the European Union was viewed, at worst, with suspicion as a project of building 'fortress Europe' that would lead to isolationism, and at best as a partnership pursuing the economies of scale that can materialise in the process of production and distribution (De Grauwe, 1997; Eichengreen, 1997). Similarly, the enterprise of the euro has at worst been viewed as a folly that could lead to civil war in Europe (Feldstein, 1997) while at best it represents an innocent linguistic scalar transformation of the individual national currencies that would make the life of tourists easier and the profits of banks fatter. Both judgements on the two issues could not have been farther from the truth.

The introduction of the euro has been a momentous event. It immediately had an important impact. As already evidenced in the agricultural sector the euro has made the objective of unitary prices accessible for the first time without bureaucratic curlicues and political double-talk. The obverse side of this coin is that the euro has made Euroland more self-sufficient all around — and more closed. Are we back to the 'fortress Europe' business again?

The idea of fortress Europe conveys the general impression that the welfare of the EU membership is being fostered at the expense of their economies' openness to the rest of the world. The tariffs towards the outsiders — that are now receding towards the WTO mandated levels — have helped cultivate that image, and the internal trade that has grown disproportionately to trade with the rest of the world has helped strengthen the misconception. The dramatic decline of openness to international trade post the EMU that was documented in an earlier section may be interpreted as the culmination of European economic isolationism.

There is an irony in all this: the irony of the stockade fence turned inward. Fortresses and fences are used for barricading one against enemies or neighbours. This might well have been the case at the origin of the EU. But in time, the spiked, unfinished, ugly side of the stockade fence was turned inward — instead of looking out. The bad side of the fence that now looks inward represents the sacrifices made for achieving convergence in the economies of the 'Ins' that was the precondition for establishing perfectly free-flowing internal trade. The painful adjustment to the Maastricht criteria was matched by abandoning the pseudo-isolation that national foreign exchange rates provided. The results trickled down to the level of the firm and the farm that earned the freedom to sink or swim in competition with all players in the broad arena of Euroland. This is the bad side of the stockade fence turned inward.

There is a bad and a good side to everything — especially in fences. And just like we do in families, the idea of the inward-looking stockade fence is to put the better side out in public. The euro as a currency that is stronger than its parts, let alone as a reserve currency, will safeguard monetary stability in Euroland and will provide

another reliable anchor for the world's monetary system. In the meanwhile, as long as there exist different countries in the world that have not all come out of the same cookie-cutter, stockade fences are necessary with their good side and bad. National exchange rates as links to trade and instruments of protection can be eliminated only through total economic integration. They cannot be done away by a sleigh-of-hand.

NOTES

* We are grateful to Tim Josling who provided valuable insights into the European agriculture and the CAP.

[1] This is an old idea that related to the 'three gaps' for developing countries: the savings gap, the investment gap, and the foreign exchange gap. The foreign exchange gap has gone out of fashion since the bold assumption that capital markets are perfect and current account deficits can be financed become part of the mainstream wisdom in the 1980s.

[2] The growth of 7.1 percent of 1997 turned into - 7.0 percent for 1998. By comparison, the contraction in the US recession of 1992 was only one percent of GDP.

[3] The latter is advocated, among others, by Barro (1999).

[4] The foreign exchange reserves needed to form monetary base, or merely to back it up, have to be earned or borrowed. Earning them is not so simple and borrowing them drives interest rates up and contributes to the contraction in the economy. Furthermore, there is an opportunity cost to the foreign exchange that a soft-currency country has accumulated in terms of, say, paying for capital imported to produce development. This cost far exceeds the interest earned for the reserve-dollars that are lent back to the US Treasury. Finally, the system imports the world's (US) rate of inflation, which may be appropriate for an economy that has only a tradable sector, but it is certainly non-optimal for most countries that (unlike Hong Kong and Singapore) have a sizeable and vibrant nontradable sector.

[5] In the same sense the US has long been immune to ballooning trade deficits because the dollar is a reserve currency.

[6] Wouldn't the process make N relatively scarce and help restore equilibrium? This is the classical textbook case. But the answer is 'no' in incomplete markets where there is 'bad competition' that sets off a race for the exit of currency substitution.

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