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"THE SINGLE CURRENCY AND EUROPE'S ROLE IN THE WORLD ECONOMY"
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REMARKS TO THE WORLD AFFAIRS COUNCIL

As Europe embarks upon the era of the euro, it is interesting to step back and ask "what does this really change?" Is the single currency important in its own right or is it merely shorthand for describing more important issues of economic policy and performance in Europe? For the rest of the world. is the "euro area" more important than the sum of its parts?

It is important to note, before I offer you my perspective on these questions, that the U.S. Government has not had a grand "official policy" or "viewpoint" on European monetary union precisely because we have had no direct role in the project. This has always been a European endeavor in which we are very interested observers. At the same time, we have an important stake in the economic and financial success of monetary union because a prosperous Europe is good for American prosperity and for the world economy.

From my personal perspective, the real importance of the single currency lies with how it affects the cohesion of the policy process and the quality of economic performance in the euro area, Certainly, the effort to qualify for EMU membership catalyzed the macroeconomic policymaking process in many countries in a beneficial manner. Spurred on by the incentive of EMU membership, a number of countries made long-overdue adjustments that contributed to reduced government deficits, inflation rates, and interest rates. Regardless of the motives, from the American perspective these were positive developments that would have been in each country's interest even without the prospect of monetary union. In that sense, the single currency has already been a beneficial force for change. However, some in the markets have quite reasonably asked whether the fiscal adjustment went far enough to free up automatic stabilizers and potentially to allow a more flexible mix of monetary and fiscal policy in Europe.

The single currency is now a fact, and Europe's policy choices increasingly will affect not only Europe, but the rest of the world. Euroland's aggregate economy is of roughly similar size as the U.S. economy, and its external trade as a share of GDP is roughly equivalent. In the United States. we are used to the consequences of our size and the economic and financial responsibilities as well, at least in the sense that we are used to being criticized for not being sufficiently sensitive to the effects of our policy decisions on the rest of the world. Although Euroland as a whole is not more important in the world merely as a result of EMU, its policy

decisions henceforth will have greater repercussions because they will apply to all member countries simultaneously, and the constituent economies will increasingly expand and contract together.

An example of an appropriate area for adjustment in policy orientation is the degree of Europe's reliance on export-led growth. As part of a move toward external balance, or during periods of worldwide inflationary pressures, export-led growth can have beneficial effects for a country as well as for its trading partners. For a small economy, reliance on export-led growth may have a minimal impact on other countries regardless of global economic conditions. However, for a large economy, when the balance of risks has shifted to concern about global deflationary forces, reliance on export-led growth in Euroland imposes economic burdens on others, The U.S. current account deficit has increased by almost $100 billion from 1996 to 1998 largely as part of the adjustment in the crisis-affected countries in Asia. Europe and Japan have added an additional $60 billion to their already large external surpluses over the same period -- $5 billion for Euroland and $55 billion for Japan. Europe and Japan appear to be reluctant or unable to move back toward balance. In this context, recent expressions of concern in Europe about a prospective slowdown in export growth are disturbing; it is more appropriate for Europe and Japan to promote growth led by domestic demand. In this connection, the new German government's stated endorsement of policies to promote domestic demand led growth is welcome

It is important to recognize that Europe does have superior policy alternatives available to promote growth: structural reforms of labor, goods, and financial markets and tax policies that are more conducive to investment and employment. The United States and those members of the European Union -- such as Denmark, the Netherlands, the United Kingdom, and Portugal -- which have taken important structural measures, have been able to achieve solid growth in recent years without undue reliance on exports.

It is disconcerting that many of Europe's most persistent and troubling problems are, to borrow a term from medicine, -- iatrogenic-- physician induced. No matter how well intentioned, Europe has relied too much and too long on policies that to some extent have aggravated the very problems they were meant to address. As many Europeans have acknowledged, Europe-wide unemployment is high in part because of policies intended to alleviate the pain of unemployment. Reductions in legal working hours, early retirement programs, and restrictions on layoffs have exacerbated structural problems. To make the same point in another way, I was reminded of the words of the late CBS news commentator Eric Sevareid: "The chief cause of problems is solutions."

Many believe that these issues are too politically sensitive to be addressed directly. However, I would note in this connection the recent observation by Bank of Finland Governor Matti Vanhala, "If the structural measures needed to absorb unemployment are politically difficult it is the same thing as saying that it doesn't have the political priority." Certainly it is true that the benefits from these reforms may appear only after a lag, while the adjustment costs are felt more immediately. On the other hand. the longer the inevitable reforms are delayed, the longer the benefits also will be delayed.

It is useful, when considering these issues, to reflect on Europe's economic performance

during this decade. It took until 1998 for the absolute level of real investment in the Euro-l 1 to reach its previous cyclical high in 1991. By contrast, in the United States, the 1998 level of private investment was 54 percent greater than the previous cyclical peak in 1989. Similarly, in Europe, total employment levels are only now clawing their way back to previous cyclical peaks, while the unemployment rate remains high. When firms wish to produce additional goods or services, it seems that they are reluctant to hire Europeans to make them. These aggregate numbers mask large differences in experiences across EU countries. Investment and employment outcomes are worse in the large core countries, Germany, France, and Italy, which have lagged behind on reforms. They are best in the countries that I mentioned earlier that have done the most to improve product and labor markets.

Europe's investment climate will be critical to its playing a constructive role in the world economy with a reliance on investment-led, rather than export-led, growth. Persistent low levels of domestic European investment have resulted in capital outflows and weak aggregate demand. Last year, it seemed that the Euroland economy was finally embarking upon a period of robust growth. However, it now appears that disturbances in the world economy may be slowing Europe's recovery. As exports decline and investment opportunities outside Europe are reassessed, investment demand in Europe is not now positioned to absorb fully the increased supply of savings.

This weak investment climate has deprived Euroland and the world of many of the benefits of its other policy reforms. The fiscal consolidation carried out in Europe to comply with EMU membership requirements has not led to all the benefits that had been anticipated. In theory, government deficits soak up available savings and constrain productive investment. Reducing deficits should free up resources for investment and boost long-term growth and employment. However, in Europe's less attractive investment climate, the response to deficit reduction and lower interest rates has not been higher investment, but larger trade and current account surpluses.

A stronger European investment climate would slow or reverse capital outflows. At the same time it would contribute to global economic growth and help move Europe's current account back toward balance. This would be the ideal outcome for both Europe and the world economy.

Europe as a whole has made impressive progress on its overall macroeconomic framework over the past several years in the run-up to the birth of the euro. What the world needs from Europe, and what monetary union by itself does not automatically provide, are policies that will stimulate employment and domestic investment. Europeans should embrace such outcomes; indeed, many of their leaders recently have called attention to their desirability. Our hope is that active, pro-growth policies in Euroland as a more unified whole will contribute to more rapid European growth and a stronger world economy.