



## Euro Symposium

# The Secret of the Euro's Success

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### ABSTRACT

I never doubted that the euro could succeed, allowing “success” here to connote nothing beyond the new currency’s ability to take root and survive. As I wrote in 1994, the successful establishment of a new fiat money depends mainly on its promoters taking advantage of “a launching vehicle consisting of a fixed exchange rate link either to an established money or to some real good or goods” (Selgin 1994, 821). In the euro’s case, the link consisted of a set of fixed exchange rates with the various pre-existing European fiat currencies which, as Jonung and Drea (2010) observe, were themselves “irrevocably locked together” by fixed rates at the start of 1999. The fixed rates made it easy for potential euro users to place an initial value on the new currency and to overcome the “network externality” that might otherwise have discouraged them from adopting a new currency and underlying unit of account.

But the Europeans wisely went beyond merely making it relatively easy for people to switch from established fiat monies to the euro: they made a wholesale switch compulsory by announcing the older monies’ eventual withdrawal. Small wonder, then, that the euro “flew” instead of foundering! Had a plan along the lines of British prime minister John Major’s “hard ecu” proposal been adopted instead, with euros forced to compete indefinitely with Europe’s established monies, things might have been very different: perhaps euro notes would have suffered the same fate as Susan B. Antony and later Sacagawea dollar coins, becoming mere curiosities to most Europeans, and a nuisance to merchants.

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The euro's prospects for success in the narrow sense considered here clearly had very little to do with those considerations that form the basis for the theory of optimum currency areas. Such considerations would, to be sure, have bearing on whether and to what extent the euro's adoption would contribute to cyclical and regional unemployment within the euro zone, and might therefore matter to the euro's *political* popularity and to individual nation's decision to join or not join the euro zone. But they could only play but a minor part in otherwise influencing the European public's real demand for euros, through their influence on European real income and on the actual and expected willingness of the European Central Bank to preserve the euro's purchasing power. In general, individual money holders give no thought to a currency's macroeconomic virtues or shortcomings in choosing whether to hold it, and in what amounts.

Of course the theory of optimum currency areas might suggest that a benevolent social planner would have opposed European monetary unification. But as Eichengreen and Frieden (1994) correctly observe, no such planner took part in the decision to foist the euro on Europe. The tendency of some economists to reason otherwise, as if denying that we live in a theoretically "optimal" world were tantamount to abandoning the assumption of *individual* optimization, may be the greatest single fallacy perpetuated by contemporary economists.

The strategy that succeeded in establishing the euro was also far more capable of assuring its survival than many critics appear to have anticipated. By first linking the euro to established European currencies and then withdrawing the latter, the euro's sponsors were able to take advantage of what the network externalities literature calls "lock-in." In effect, the authorities kicked away the ladder Europe's economy had scaled to establish a common currency, leaving Europeans with no equally convenient way of retreating to the *status quo ante*. It was mainly for this reason that predictions like Dominick Salvatore's (1997), to the effect that "a major asymmetric shock would cause the euro area to dissolve," proved overly pessimistic.

To be fair to skeptics about the euro, though, their concerns that the EMU might not fly were for the most part grounded, not on the belief the euro could not take root and survive if the European powers chose to adopt it, but on the belief that those powers would fail either to gain their citizens' approval of the plan or to meet fiscal and other participation conditions set forth in the Maastricht Treaty. These concerns were certainly legitimate; that they failed to materialize suggests not a failure of economic analysis, but at worst a failure of economists to fully grasp the direction and strength of European political movements.

Although I myself steered clear of public pronouncements concerning the likelihood of European nations adhering to the Maastricht timetable, I did offer some thoughts concerning the euro's likely influence on inflation. In particular, I

sought to counter Hayek’s suggestion that, by reducing opportunities for currency substitution, the substitution of one European currency for many would prove a recipe for higher inflation—higher, certainly, than what could be expected from the best of the original European currencies—the German mark and the Swiss franc. This belief, I argued, overlooked the fact that, once having conquered Europe, the euro had “a fighting chance to become a serious rival to the dollar as an international currency” (Selgin 2000, 107; see also Selgin and VanHoose 2007). The European Central Bank might therefore choose “to take the high road of endeavoring to supply the international currency market” by securing for the euro, by means of a relatively tight monetary policy, a reputation as a low-inflation currency, foregoing thereby the low-road option of merely exploiting its European monopoly. To this extent I was, I suppose, something of a euro-believer, if only relative to my Hayekian counterparts. Alas, under present circumstances it would be tempting fate to claim that my view has been vindicated.

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