Britain must avoid Germany's mistake
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Published: April 21 2003 19:11 | Last Updated: April 21 2003 19:11

As Gordon Brown, the chancellor of the exchequer, considers whether adopting the euro would be in Britain's interest, he should look carefully at the experience of Germany. Membership in the monetary union has weakened the German economy and is preventing it from escaping its current slump. Although Germany also suffers from a variety of structural problems, it is the euro that raised its unemployment rate over the past year to 10.6 per cent.

The German example shows that Britain's decision about adopting the euro is not a question of whether the time to do so is now right. Adopting the euro is a permanent commitment with permanent consequences. My judgment is that it would not be in Britain's long-term economic interest to accept the constraints of the single currency.

Here are the facts. Germany's gross domestic product rose only 0.5 per cent last year, the lowest of all the leading European countries, and ended the year in decline. Germany also has the lowest inflation rate, just 1.2 per cent. Because the single currency means that all eurozone countries have the same nominal interest rate, Germany's real interest rate is the highest in the eurozone. This is a very dangerous situation in which the high real interest rate weakens the economy and causes inflation to fall further. As the inflation rate falls, the real interest rate rises, creating the potential for a dangerous downward economic spiral.

If the German economy were not constrained by the single currency, natural market forces would cause interest rates to decline, thereby boosting all kinds of interest-sensitive spending. Weak demand in Germany would also cause the D-mark to decline relative to its trading partners, boosting exports and helping producers to compete with imports from the rest of the world. Instead, German manufacturing has been weakened by the sharp rise of the euro over the past year.

In addition to these automatic market responses, an independent Bundesbank would probably have responded to the weak economy and declining inflation by temporarily lowering short-term interest rates. This is now impossible. The European Central Bank must make monetary policy for Europe as a whole, an area in which inflation is now above the 2 per cent target ceiling.

The Stability and Growth Pact also prevents Germany from using a temporary fiscal stimulus to increase growth and bring down unemployment. Although persistent deficits are harmful in the long term, a temporary rise in the fiscal deficit could in principle provide the stimulus needed to rekindle growth. But the eurozone countries have had to constrain themselves from running deficits because of the potential danger to the common currency.

As an American who has long been sceptical about the economic effects of the euro, I am often asked why a single currency should be good for a large continental economy such as the US and yet not for Europe. The answer is that the US economy has three basic features that make it possible to have a single currency without the harmful effects that now arise in Europe. First, American employees move within the country when demand is relatively weak in a particular region, facilitated by a common language and a culture that regards moving across the country as perfectly normal. Germans are not leaving Germany in large numbers for areas of Europe with faster growth or lower unemployment. Second, wages are much more flexible in the US than in Europe, reducing the decline in regional employment that occurs when demand falls. And third, the US has a federal fiscal system that directly offsets about 40 per cent of the relative decline in any state's gross domestic product by a lower outflow of taxes to Washington and a higher inflow of transfer payments. European fiscal systems are still largely national.

Germany did not decide to embark on the single currency after a careful evaluation of its economic costs and benefits.

Helmut Kohl led Germany into the single currency in order to create a stronger political union in continental Europe, a political union that would have common economic, social, defence and foreign policies. The euro would be a symbol of that solidarity and a mechanism for centralising economic power.

Many Germans expected that Germany, with the largest population and the biggest economy in Europe, would be the natural leader of the unified Europe. The French assumed that monetary union would at least end the frustrating subservience of the Banque de France to the Bundesbank. More generally, many Frenchmen saw the stronger political union as a vehicle that would allow Europe to compete with the US on political and foreign policy issues as well as in economics.

Adopting the euro would be a long-term economic mistake for Britain, increasing cyclical unemployment and potentially endangering price stability by entrusting it to a European Central Bank that will soon have more than 20 voting members. It is hard to believe that there are political advantages of greater solidarity with continental Europe that can outweigh these long-term negative effects on the British economy.

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