The Euro: The Engine That Couldn't

Josef Joffe

1.

"European Monetary Union—The Movie" would have to begin with the following scene. The place is the library of the Elysée Palace, the time is about March 1990. Only three people are present: François Mitterrand, the French president; Helmut Kohl, the chancellor of soon-to-be reunited Germany; finally, since neither speaks the language of the other, a faceless interpreter sworn to silence.

Mitterrand is in a melancholy mood. During the last few months, ever since the collapse of the Berlin Wall in November 1989, he has tried every conceivable diplomatic strategem to stop, or at least brake, the quickening pace of German reunification. But to no avail. Glumly, he stares into the fireplace, as his friend Helmut talks. "Look, François, this time it won't be like Versailles in 1871, when Paris was encircled by German armies, when the new Reich was proclaimed on the ruins of French pride. We have Franco-German friendship, we have the European Union, our forces are completely integrated in NATO; indeed, we don't even have our own general staff any more."

The mention of NATO, America's foot in Europe's door, hardly cheers Mitterrand. So Kohl goes on. "My dear friend, this is 1990—not 1914 and not 1939. These days, my countrymen are polishing their BMWs, not their jackboots. Come on, François, what do you say?"

Mitterrand continues to stare into the fire for a minute that seems to stretch on forever. Finally, he bursts out, "*Bon, Helmut, c'est ce qu'on va faire.* You get all of Deutschland, if I get half of the Deutschemark."

2.

The point of this imaginary scene is that the euro, Europe's soon-to-be common money, is a political currency. It was born out of the abrupt transformation of world politics: Moscow's capitulation in the cold war, which suddenly revealed the true power relationships on the Continent. In a few months, Germany would be "whole and free" again, as George Bush had put it. Once united, the country would also shed the ancient dependencies that had tied two thirds of it, the Federal Republic, to France.

But Helmut Kohl is not Wilhelm II. Like Bismarck, he understood the precarious position of Germany about to become the most powerful country in Europe again—at least if power is measured by the size of Germany's population and GDP, and by its central strategic position. Like Konrad Adenauer and Willy Brandt, Kohl knew that Germany was too weak to act alone, but too strong for the rest of Europe to leave it alone. The lesson of the past hundred years for him was clear. When Germany, its power untrammeled, struck out on its own, the result was ever greater disaster. When it was safely locked into European institutions—when its power was tamed by cooperative arrangements with other countries—Germany flourished beyond anyone's expectations.

Now the division of the country imposed by the cold war was about to end, and Kohl wanted to reassure France and all of Europe. The Deutschemark, the strongest currency on the Continent, was the very symbol of German primacy. What better way to soften its edge than by *more* integration? By way of the euro, one might say, Gulliver proposed to tie *himself* down. The sentiment and the logic of self-containment were as commendable as Kohl's intentions were historically honorable.

But Gulliver would not actually immobilize himself—that was the elegant part of the deal. In essence, the euro would be the Deutschemark writ large. It would be administered by a European central bank patterned after the German Bundesbank which, in turn, was largely modeled after the American Federal Reserve. This super-Bundesbank would be totally independent of political control; with its mighty autonomy, it would impose strict financial discipline on countries like France or Italy, whose central banks usually acted as handmaidens to their profligate political masters in Paris and Rome. So Germany would not so much sacrifice its precious currency as it would extend its sway beyond the informal Deutschemark zone that already encompasses Austria, Denmark, and the Benelux countries.

To the French, invaded three times by Germany in the space of a lifetime, the euro nonetheless offered fair compensation. The losers of the Franco-Prussian War of 1871, the French had emerged from World War I and II only as nominal victors. In each case, they saw their strategies for postwar containment of Germany come to nothing. By 1922, at the time of the Rapallo Treaty, with Soviet Russia in economic difficulty and the Anglo-Saxon powers turning in on themselves, Weimar Germany had actually improved on the strategic position of the Wilhelmine Reich. By 1955, West Germany, freshly installed in NATO, was free of occupation forces and had become a junior partner of the United States. And now, in 1990, the last constraints would melt away. On October 3, reunification day, the Federal Republic would expand by one half while regaining complete sovereignty. Kohl's offer to give up the Deutschemark was a godsend for Mitterrand. And so, on they went to Maastricht—with good instincts, but bad economics and politics.

3.

In Maastricht, a small town in the Netherlands, the twelve members of the European Union (now fifteen) gathered in early 1992 to pledge something history had never recorded before. They would sign away several of the largest sovereign powers at the command of the modern nation-state. These are the power to mint money and the power to regulate its quantity as well as its price both at home (the interest rate) and abroad (the exchange rate).

Adenis/SIPA

The euro at the Brandenburg Gate, Berlin, May 1997

The Maastricht Treaty contains two critical dates. At the beginning of 1999, those countries whose economies meet the standards set at Maastricht—the fabled "criteria"—will yield their monetary sovereignty to a European Central Bank, which is to manage both the money supply and interest rates of all the European countries taking part, with national currencies irrevocably chained to one another. For the next three years, the euro and the various national currencies will exist side by side. But on January 1, 2002, marks, guilders, francs, etc., will vanish. There will only be euros and cents.

Such a brief summary of the Maastricht Treaty hardly suggests the enormity of the task ahead. Before national currencies can become *e pluribus unum* they must be brought into line. To conceive of what that will involve, we can visualize several locomotives, each running under its own power, strung together to make up a single train. Each engine must steam ahead at the same speed in the same direction at the same time. All currencies must behave as one, with no fluctuations among them and hence with virtually identical interest and inflation rates—as if there were only one lead locomotive that pulls all the others with their engines switched off. If there is no strict coordination, the locomotives will run into one another and go off the rails, or the couplings linking them will break. In the real world, the required degree of coordination is called "political union" or "federation"—something like the United States.

Had Messrs. Kohl and Mitterrand made this logic explicit, the euro would have died right after it was conceived. Frenchmen and Germans don't want to be like the citizens of Michigan and New York; nor do Italians, Spaniards, or Britons. They like Europe, but they like even better their national homelands, which have been around for one or two millennia. They don't speak each other's languages; they do not share each other's memories.

So the would-be members of the euro club are not like railroad cars just coasting along or waiting passively in the Brussels switching yard. Each has its own "engineer"—its government whose politicians face reelection. Each has its own "engine"—its macroeconomic policy that determines spending and taxing, debt and interest. Each follows its own "timetable"—i.e., it is situated at different points in the business cycle.[1] And none can ignore its own history and the basic national assumptions and habits that define the unwritten social contract by which the state gives to, and takes from, its citizens. By comparison with France's, only a small part of the British economy is state-based or state-controlled; Germany's falls somewhere in between.

Compare this to the United States. Michigan and New York don't conduct

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[1] A recent report by the British treasury made this point in warning of the dangers posed by the euro to the British economy. As the *London Observer* reported on October 19:

> The Treasury review underlines that the British economy is seriously out of line with continental economies, with Britain's recovery years more advanced. Treasury officials have warned that cutting British interest rates to continental rates—appropriate for countries where economic conditions are more depressed—could detonate a runaway boom, with inflationary pressures that could not be responded to by devaluation.

In view of such advice, we can understand the government's position that any decision on the euro must be delayed until after the next election.

macroeconomic policy; their money, like that of every other state, is managed nationally by the Federal Reserve. Lansing and Albany have limited powers to tax and spend, but the country's fiscal policy is decided in Washington, by the US Congress and by the executive branch. France, Germany, and other members of the European Union are not and will not be like any of the fifty American states. They are sovereign entities, with national parliaments and executives, and the large countries like Britain, Spain, and Italy have proportionally far more effect on the European economy than the economy of California does on the economy of the US.

How can they be kept on the same track? This is where the famous "criteria" of the Maastricht regime come in—the gates to the inner sanctum of monetary union. In essence, the criteria demand of each would-be member that it stop behaving like a sovereign state. In order to qualify for euro membership, their annual budget deficits must not exceed 3 percent of GDP. Accumulated public debt must stay within 60 percent of GDP. Long-term interest rates must be lower than 10 percent, and the inflation rate must be lower than 3 percent. In short, though each state, like a locomotive, still obeys its own driver, engine, and timetable, it has to act as if it were Michigan or New York. It has to forget virtually everything that turned fiefdoms, duchies, and city-states into modern nation-states between the fourteenth and the nineteenth century: first the king's, and later the parliament's, supremacy over public finance.

At this point, only Luxembourg qualifies on *all* counts, if the criteria are applied rigorously. By next May, the European Union must decide who else makes the cut on the basis of the 1997 figures. "Eurostat," the statistical research branch of the European Commission in Brussels, has just announced that, except for Greece, all the members of the European Union are likely to squeeze by.[2] How will they do so? By creative bookkeeping, if not outright cheating.

4.

Take Germany, once the fiscal disciplinarian of Europe. Without some imaginative maneuvers, its annual budget deficit would be closer to 4 than 3 percent of GDP at the end of the year; and its total debt, rising of course, has passed the 60 percent limit. How, then, will Germany fulfill the criteria? Deutsche Telekom, the state-owned telephone service, is being sold off on the stock market. So is Lufthansa. The receipts will look good on the nation's books by the end of the year. Also Theo Waigel, the finance minister, has conveniently discovered that the gold held by the Bundesbank—the German version of the Federal Reserve—has been badly undervalued for many years. Revalue it to reflect the market price for gold, shunt the paper profits into the federal till, and the deficit shrinks some more.

The Italians, whose country, next to Greece, has the largest deficits, are desperate to be founding members of the euro club, and so they are prettying up the books *all'italiana*, while trying to impose austerity measures on the economy. This led to a bit of political commedia dell'arte in October. Assaulted by the Communists on grounds of excessive social cruelty, the Prodi government fell—only to be resurrected forty-eight hours later. This does not bode well for a sustained budget-cutting policy past the magic date in May, when the EU must decide on admission to the euro club.

First prize for creative accounting must go to the French, though. There is no way that the defiant Socialist government of Lionel Jospin, which took power from the Chirac coalition earlier this year with promises of 350,000 public jobs, can bring about a budget deficit as low as 3 percent of GDP. But the French have told the Germans they have found a brilliant solution. They will simply withhold tax refunds for a while, thus "proving" that France, when the 1997 figures are tallied, is marching straight toward the 3 percent deficit target.

Why the obsession with meeting criteria which are more or less arbitrary anyway? Theoretically, the European governments and central bankers could have set the deficit-to-GDP standard at 5 rather than 3 percent, and the public debt-to-GDP ration at 80 or 100 rather than 60 percent. But the exact limits are not the critical issue. The real point, to recall the railroad metaphor, is simultaneity, with everybody moving at the same speed in the same direction.

Unless they do, the couplings break. This is exactly what happened in 1992 when George Soros, betting on the Deutschemark, sold billions of pounds sterling on the international market, forcing Britain to devalue the pound and leave the European Exchange Rate Mechanism (ERM). This was the system set up in 1979 to preserve rough parity among European currencies—a forerunner of the euro. Italy followed and devalued, too. So did Spain, Portugal, and Sweden. This episode may now seem past history, but its lesson is still valid. Nations may pledge the kind of fiscal and monetary probity that keeps exchange rates in lockstep. But then governments look at their unemployment rates and think of their coming elections. They then choose economic policies—a bit of easy money there, a few more public works there—that strain, and then break, international monetary agreements.

The history of the ERM nicely illustrates the skeptic's worries about the euro. It worked as long as the dictatorship of virtue was regularly relieved by an occasional brush with sin. Until 1987, there were many realignments of the different currencies, on the average once every eighteen months. Everybody

(Continued on page 30)

[2]Eurostat is not a totally independent body. Attached to the European Commission, it assembles and evaluates economic and budgetary data given to it by each national government. For a sober analysis of Eurostat's operations and the bookkeeping tricks of EU governments, see Andreas Oldag, "Schlüssel zur Währungsunion liegt bei Eurostat" (The Key to Monetary Union Rests with Eurostat) and "EU-Mitgliedstaaten entwickeln immer neue Ideen, um ihre Haushaltsdaten zu schönen" (EU Member States Come Up with Ever New Ideas on How to Prettify Their Budget Data), *Süddeutsche Zeitung*, October 25–26, 1997, p. 2.

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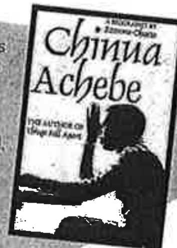

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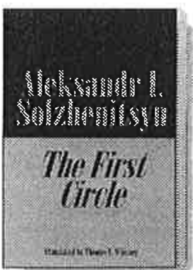

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could stay on the wagon precisely because he could take an occasional swig from the bottle. But after 1987, currencies became fixed, to be defended at all costs and against all comers. Hence, the pressures derived from incompatible economic policies began to build up, exploding five years later with Britain's withdrawal in 1992. Thereafter, realism was given its due: exchange rates, previously within a range of 4.5 percent, were allowed a leeway of 30 percent, which is another word for "floating currency."

Today, life on the wagon has become a bit easier, above all because inflation and interest rates have been dropping throughout Europe, even among famously improvident states like Italy. Advocates of the euro have been citing this cheerful news as proof that Maastricht is working. Alas, this may be like that famous correlation that links the decline of the stork population to the receding birth rate, both of which happen to be the case in postwar Europe. The fact is that inflation has been falling throughout the entire Western world since the early 1990s. If Maastricht had acted as such an effective taskmaster, why did inflation also ebb in the US and in Britain, countries that were not clamoring to get into the euro club?

5.

By next May, most of the European countries, prodded by France and Germany, will most likely certify themselves ready for the euro. They will look at the dressed-up numbers, wink and nod; in the case of countries where even the most creative accountant could not hide the gaps between rule and reality, the others may agree to be charitable and say that since they are trying so hard they can join anyway.

What then? Traditionally, states have used the exchange rate as a major cushion against external shocks, and they have manipulated the money supply, the interest rate, taxes, and spending for the sake of stability and growth at home. But in 1999, the exchange rate, as an instrument of national policy, will have gone the way of the halberd. Monetary policy will be set by the European Central Bank. And fiscal policy, including taxes and spending, though legally still in the hands of states, will be severely constrained by the demands of the "stability pact" that the Germans have insisted other members of the European Union must sign. Essentially, the pact says that the Maastricht criteria must rule forever. Or as some French politicians suspect, it will be the Bundesbank-writ-large that will rule, plus a softer version of the US balanced-budget amendment. (This is why the French above all have been pushing for an Economic Council that would set macroeconomic policy for the euro zone and thus counteract or dilute the stringent monetary policies of the European Central Bank.)

The resulting loss of autonomy is an economist's nightmare. Individual governments in the euro zone will no longer be able to do what they have done since the invention of the printing press. They will no longer be able to increase the money supply to drive down interest rates and stimulate investment. They will no longer be able to devalue their currency so their exports will grow. If they are obedient to the stability pact, they will have a very limited ability to increase aggregate demand through deficit spending. With national monetary policy determined supranationally, and fiscal policy heavily limited, a national economy is left with three, and only three, ways out of trouble. And each of them spells more trouble.

To take a simplified example, let us assume that there is stubborn and growing unemployment in the northeast of France, a traditional industrial region. There are only three solutions to the problem. One: wages fall, attracting new investment and generating new employment. But wages do not fall in Europe, and least of all in France. National or industrywide collective bargaining agreements inhibit payment of different wage rates in different regions. In the United States, the Carolinas or Alabama, with wages lower than California's or Connecticut's, may lure capital investment from inside and outside the country. European capital in

search of profits migrates to the Czech Republic, if not China.

The second solution is geographical mobility. If capital does not come to the workers, they go to where the jobs are. In the early 1970s, Sunday papers from Houston and Dallas sold well in depressed Detroit, where the Big Three auto makers were being done in by foreign competition. Unemployed auto workers would scan the want ads and then pack up their families to move to Texas towns that were then booming. Some of the workers by now have moved back to Michigan, which is again in strong economic shape.

By comparison, Europeans do not move. Theoretically, Lille's unemployed could migrate to high-growth regions like southern England or Munich. But unlike relatively poor Turks or Serbs, they don't. First of all, a lavish welfare state, plus large benefits for shrinking industries (steel or agriculture), allow people to stay in places from which the jobs have departed. Second, if they *did* want to move, they would face intimidating cultural barriers, above all a new language, unlike Detroit workers in Texas. Third, although Germans have used Turks for menial labor, much as the French have used North Africans, Europeans are less and less willing to accept "cheap foreign labor" that can do more skilled work. Construction workers' unions in high-wage Germany have been fighting hard against Polish migrants. They would not welcome migrants from Lille either.

Which leaves the third, and most troublesome solution: transfer payments on a Europe-wide scale. In the absence of wage and labor flexibility, this has been for decades the favorite European economic strategy for dealing with unproductive regions. The rich Italian North subsidizes the *mezzogiorno*, the agrarian South. Prosperous Bavaria pays large subsidies to Bremen, a Social Democrat–ruled city-state on the North Sea, which has been keeping shipyards alive against all economic reason. Indeed, Western Germany has annually been plowing the equivalent of the entire Marshall Plan—which gave aid to fifteen countries for three years—into Eastern Germany, a region of 15 million people, since reunification.

Bavaria pays grudgingly for Bremen, but it pays. Lombardy supports the Italian South, but resentfully so; indeed, the secessionist Lega Nord has been demanding partition for years. Now imagine that Germany and Italy have to shell out billions to help their less fortunate brethren in Euro-Land. What is, and will be, lacking is the kind of common identity that justifies expenditures, often rather grudging ones, on behalf of poor regions or groups. "Europe" is a construct, not a country. Though it has a flag (fifteen golden stars on deep blue), it does not evoke the kind of loyalty the Stars and Stripes evokes among Americans. The European Union is not—and will not be for a long time—a community of identity and obligation. And money, as a German saying cautions, is where friendship stops.

6.

The larger point is that Europe, by plunging into monetary union, is putting last things first. It is erecting a vast structure without having prepared the indispensable foundation, a common state. One might think that so sweeping a sacrifice of sovereignty would require a "general will," expressed in an institution that transcends the feeble European Parliament in Strasbourg and the rudimentary apparatus of governance in Brussels. Power in the EU is still lodged in the Council of Ministers representing the fifteen member states, not Europe. History confirms such a somber assessment. Bismarck had to force twenty-five little Germanies to accept the Reich before the new state could move on to a national market and currency. It took the United States from 1788 to 1913, from the approval of the Constitution to the founding of the Federal Reserve Board, before it established a central bank and true monetary union (with a murderous civil war in between).

Political union must precede monetary union—that is what historical experience keeps stressing. Nor is monetary union a kind of furtive shortcut to political union, as Europe's federalists might presume. Money, in fact, does not bind what pulls apart. The first thing secessionist states do is to print their own tender—as the American Confederacy did in 1861, as Slovakia did in 1993. Money, as every unhappy family knows, is a prime cause of discord and divorce.

Still, the euro will spawn powerful benefits. Big business, even in Britain, loves it because it will do away with

costly hedging operations to insure against currency fluctuations. It will make the mechanics of international payments easier and sweep away the exchange-rate risks of long-term investments. Europe's exporters also surmise that the euro will be "softer" than, say, the mark, franc, or pound, and thus give them a competitive edge over exports that must be paid for in dollars and yen. Europe's large banks and insurance companies can hardly wait for the euro. They see a vast market awaiting them in which every bond, stock, and insurance policy will be denominated in a single currency. That will bulldoze barriers of habit and tradition and deliver a continent-sized playing field for the best and biggest financial institutions in Europe. Corporate capitalism salivates over the euro, and for good reason.

But the citizens of France and Germany do not do so, if we are to believe the opinion polls—at least the polls not conducted by the European Commission, which likes to produce good news for its masters. In those countries whose economies have the most valid chance of meeting the criteria next May, opposition to the euro or desire for a delay unites up to two thirds of the populace. And fondness for the euro tends to grow with the distance from the Maastricht criteria, most dramatically in Italy.

Kohl, Chirac, and their colleagues are thus plunging head-on into a current of popular distaste against the euro. They have been able to brave the resistance to the plan because only very few politicians, whether on the center left or center right, have dared to seek votes by turning against it. To oppose the euro is to oppose Europe —the equivalent of motherhood. On the Continent, at least, nobody of stature and ambition wants to be seen in the company of the main opposition to Maastricht—whether the neo-right, like Germany's Republikaners, or the paleo-left, like the French Communists. That has deadened the debate, leaving behind a mood of sullen passivity fed by hopes for postponement.

7.

A lengthy trial run of, say, three or five years of strict observance of the rules of economic convergence would be a wiser course than adopting the euro now. For it might or might not prove what the euro enthusiasts merely assume: that nations, though they remain nations, will act as if they were not. To repeat the cruel textbook truth, they must remain in tandem not just in the period before the deadline, but forever more. *They must stop acting like sovereign states* in matters monetary and economic.

By next May, when the cut is to be made, the euro-aspirants will have proven only one thing: that they are capable of making a desperate dash for the 3 percent deficit line. But in order to cut the deficit, they have sold off public assets instead of reducing government expenditures. These are one-time solutions that do not change the underlying dynamics of fiscal policy. And since the states act as their own referees, they have been able to fudge the numbers quite nicely.

True, inflation has dropped throughout Europe, and medium-term interest rates are converging. But there is less progress than meets the eye. Inflation rates, as was noted before, are down in the entire West, reflecting a mildly deflationary world economy rather than the fiscal virtue of the euro candidates. Italians today dwell proudly on the fact that the yield spread between Italian and German government bonds, about six percentage points just two years ago, has come down to less than two. But Italy's plummeting rates do not prove that the Italians have really changed their ways, and that goes, *mutatis mutandis*, for the others, too. Money traders have simply concluded that, for political reasons, France and Germany will have to take in Italy, a founding member of the old European Economic Community, no matter what. They are happily buying lire bonds (which drives down Italian rates) because they no longer need to fear yesterday's devaluation risks. And why not? In 1999, these bonds can simply be converted into euros or Deutschemarks at predictably fixed rates.

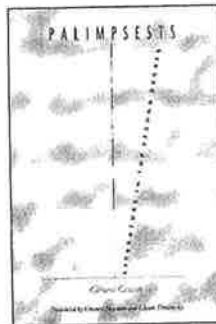
In short, the EU countries have not proven that they can sustain convergence over the long run. Long-term discipline was precisely the test set up more than five years ago. But Europe cannot be said to have met it. Hence the wisdom of postponing the plunge for three or five years. During such a period, the candidates could confound the skeptics by actually doing what they should have been doing since 1992. They would live up to the logic of monetary union by scrupulously sticking to parallel macroeconomic and monetary policies as opposed to merely selling off the family silver and cooking the books.

By definition, inflation and interest rates would then remain in lockstep, and so would exchange rates. This would be de facto monetary union, though with national currencies still in circulation. At the end of the "trial marriage," real monetary union would be a mere formality, or, to return to the train metaphor, visible proof that everybody had maintained the same speed and direction not just in the run-up but over the long haul.

In so submitting to a general will, each of the European nation-states would prove that it is indeed ready for self-transcendence. But the European nation-state is still vigorously alive—that is the problem. Nor do Kohl and Chirac even contemplate yielding their power to a European president lodged in Brussels. And their citizens, who do not really understand the enormous loss of sovereignty the euro entails, still want to be ruled from Paris and Berlin, and not from Brussels. But who is going to read through the 250 pages of the Maastricht Treaty, which flummox even trained lawyers?

Never in the history of democracy have so few debated so little about so momentous a transformation in the lives of men and nations. And so the train will probably leave the station on time, on January 1, 1999, but with screeching wheels and shaky couplings. If it goes off the rails, as economics and politics suggest it will, the consequences may contaminate much of what Europe has achieved during the past forty years. □

—November 6, 1997



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