Article for Le Monde, May 2008

The orphan currency

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Stable growth in Austria but on the way down in Spain. Inflation accelerating in Belgium but still weak in the Netherlands. Thriving German and flaccid French exports. Ten years on, or near enough, and the euro is witnessing divergences in its midst.

How do one conduct a single monetary policy for countries at different stages of the cycle? How does one cope with the same exchange rate when companies in one country are world-beaters and in another country business is regularly routed? The problem was spotted at the beginning of the 1960s when the Canadian Robert Mundell defined the criteria for optimal monetary areas. It re-emerged during the initial years of the euro and it is staring us in the face today, for two reasons.

The first reason relates to the combination over the last year of shocks whose effects are or can be asymmetric. Spain and Ireland are being pulled into recession by an abrupt property crisis, a mirror image of the frenzy of the preceding years, and which will doubtless take several years to work itself out. German banks have made losses of more than €20 billion on subprime mortgage lending and French banks more than €15 billion, but subprime losses have been minimal in Italy and Spain. The rise in the euro is affecting all countries but Ireland, which exports one fifth of its GDP outside the EU, has been hit harder than Greece, which is lagging behind everyone else. The euro area in its entirety is suffering as a result of energy and commodity price rises, but not all peoples are equally prepared to incur the resulting drop in spending power. The overall system is out of kilter.

The second reason goes back further in time. The fixing in euro of the conversion rates of the old currencies closed the door to devaluations but did not fix relative competitiveness. This is slowly evolving in step with structural change and inflation gaps. Today there are marked disparities. On the back of cost-cutting, offshoring and fiscal measures Germany, which had entered the euro with an overvalued currency, has resumed its place as export champion, while Italy and Spain, which were in the opposite situation, have gradually lost ground. And Spain, which neglected a current account deficit of more than 10% of GDP, is left worrying about its ability to export. The time for adjustment has arrived for those countries whose competitiveness has deteriorated. They will have no choice but to make a patient and, in general, painful effort, just as Germany did after 1999.

While the first decade of the euro has been characterised by budget rows and the debate about the European Central Bank's (ECB) monetary policy, the second may well be dominated by the issue of the disparities between member countries and what to do about it. The European Commission has grasped this risk. It has just published a report which marks a departure from past obsession with budgets and analyses how to prevent and remedy divergences. But its clout on this issue is mainly rhetorical. The ECB has grasped the risk, too. But it has no option but to adopt a policy to

suit the average. The key role must be played by national governments, and even more by workers and business.

Citizens, for their part, will have to accept that common monetary policy may not be optimal for their individual country and to make a sustained adjustment effort. But for what reason? Their leaders will no doubt explain to them, quite rightly, that it is for their own economic good, but it is to be expected that the euro will be associated with undue belt-tightening here and there.

It is at this point that the debate ceases to be economic and the initial questions about the political counterpart to monetary union resurface. During discussions about the creation of the euro German tradition saw in the birth of a quasi-federal political community the *sine qua non* for the success of monetary unification. France, on the other hand, wanted a form of collective government as a counterpart to the central bank. These concepts, equally fuzzy, both pointed to one thing missing: a 'mother' in the one case, and a 'father' in the other. But France, suspicious of federalism, wanted nothing to do with the 'mother' favoured by Helmut Kohl, and Germany, which feared capture of the central bank, rejected the 'father' called for by François Mitterand. So Europe's currency was born, and remains, an orphan.

After the failure of the constitution and the abandonment of French whims about economic government, it must be admitted that the currency has not driven political unification. This has prevented the euro from succeeding, from establishing itself as the world's second currency, and from gaining new members. Why not simply continue in the same vein? For this to happen, a little like in the nineteen century under the gold standard, countries must recognise the hard economic realities, and political leaders must refrain from shifting the responsibility for solving their problems onto Frankfurt. Neither of these imperatives is straightforward.

It is only in the long run that we will know if the euro can live without a political counterpart, and if the euro can survive as an orphan. Ten years is not long for matters of this kind.