



EURO: PARADOX AND ERROR IN A WEAK EUROPE

On 28 May 2010, the Fitch rating agency downgraded Spain's public debt from AAA to AA+. On 17 June, Russian president Dmitry Medvedev told the press he had doubts about the future of the euro.

The single currency is Europe's most important federal creation. It is perhaps the only one that can be considered as such, in that it brings together cogent powers that no other European institution possesses to the same degree. Since 2010, it has been afflicted with a malaise reminiscent of the one which in 2000 followed in the wake of a negative outcome in a referendum on the euro in Hamlet's homeland. The euro at the time had as yet no direct influence on the lives of the citizens, featuring only in accounts and exchange rates which had been fixed in 1999. Due to a laboured beginning which prompted sector operators to side with the dollar, the euro was undervalued and had no significant impact internationally, failing even to match the combined weight of member state currencies just a few months earlier. In the Autumn of 2000, 80 US cents were all that was needed to buy one euro.

But the unsustainability was not only due to bureaucratic complexity and the Treaty of Maastricht. The weakness was caused by a lack of trust in the single currency among sector operators and major American and British banks, the so-called market makers which set currency values. On the American side, there was scepticism and fierce criticism blended with an undisguised fear that the euro might overtake the dollar as the international currency and preferred activity for the bulging portfolios of foreign exchange reserves of emerging economies like China.

Despite a halting start, since its inception eight years ago the euro has slowly but inexorably appreciated in value, thus redeeming its shortcomings. Now, in 2010, it has suddenly depreciated, and its international role is once more under discussion. Its weakness resurfaced after a run of almost seven years, in which it appreciated against the yen and the dollar by nearly 100%, reaching a high-point of 1.6 dollars to the euro. The paradox inherent in such a quotation, which flies in the face of the basics of economics, is that the euro

continued to drag its feet institutionally and to reflect Europe's relative weakness with respect to the USA. Quotations for the euro in 2008 and 2009 were the result of blinkered monetary and fiscal policies and the misconceived idea that Europe was immune to the financial storms that started in the USA in the summer of 2007 and peaked with the collapse of Lehmann Brothers on 15 September 2008.

The excessive quotation of the euro was therefore the result of yet another instance of Europe's delusion of "diversity". It was illusory because it glossed over the shortcomings of our financial institutions. First the federal monetary authority has no federal fiscal counterpart equivalent to what they have in the USA. Secondly, there is a lack of financial and fiscal harmonisation, which is entirely beneficial to domestic tax havens.

The high degree of diversity in Europe resulting from the incompleteness of the European institutional project is costly. It has led to euroland members adopting measures that are excessively harsh. They have been heavily criticised across the Atlantic for linking recovery to exports, thereby penalising US external deficits. They will, in other words, exacerbate global imbalances in foreign trade because euroland fiscal policies are the result of criteria set out in the Treaty of Maastricht that are inflexible with regard to public finances and blind to balance of payments imbalances, the most accurate but neglected indicator of a country's overall financial situation, in both public and private sectors.

Greater fiscal integration in Europe would have made it possible to look at the sum of the public accounts of euroland members. Countries that suffer more heavily in the public sector would have been offset by those that are fiscally more virtuous. Since this is not case, however, and given the lack of even a symbol of federal fiscal unity, the only way forward is for everyone to be more virtuous, some excessively so. Overall, therefore, Europe ends up by adopting excessively austere policies which run the real risk of causing damage even beyond Europe's borders.

But is institutional weakness the only cause for recourse to such severe measures?

The main concern in Europe is not so much the devaluation of the euro. Lack of trust and expansive ECB monetary policies aimed at financing public debt of weaker countries have driven it down. Rather it is the reluctant and culpable (as well as deliberate) delay in responding to speculation against Greece by the

leaders of Belgium, Germany and the Netherlands, who, after protracted financial torment for Greece, adopted a rescue plan with funds from the more stable countries whose conditions are more onerous than those imposed by the IMF. The delay and the higher costs of aid increased the severity of fiscal policies adopted as a result of inadequate leadership and thwarted by political wrangling at a local level, which in turn was exacerbated by a string of elections that weakened and undermined the credibility of the voice of Europe. The result is more aggressive speculation against individual countries lacking a stable federal economic authority. The choice to adopt a defensive stance is perfectly understandable, but the costs have been driven up not only by institutional weakness, but also by real mistakes and delayed responses.

For their part, the USA and economists such as Krugman believe that restrictive budgetary policies are premature, because the state of the world economy, especially in Europe and the USA, is such that the visible hand governments have had in sustaining their economies cannot yet be withdrawn. In many countries, growth rates for the first quarter of 2010 are still close to zero. The banking sector is still ailing and unemployment in a number of areas may render such precocious recovery measures politically unsustainable.

Six months ago, at the end of 2009, a short-term policy of fiscal discipline would have been unthinkable. It all started when the European countries with the weakest current account of the balance of payments Greece and then Spain and Portugal, with net foreign debts between 80 and 120% of GDP, came under fire due to shortages of liquidity. A country in a monetary union or with a fixed exchange rate (Argentina in 2001) cannot adopt monetary policies to prevent a liquidity crisis caused by the withdrawal of foreign capital due to a loss of trust. Hence the interest-rate hikes and the disruption of public finances.

Responding, as we do in Europe, by cutting government exposure in the shortest time means not asking whether we are capable of recovering without public support for businesses and households and forgetting that public expenditure and social safety nets have prevented dramatic collapses in 2009. Collapses that would have strained some democracies.

Unfortunately, the speculation that targeted Greece in the first half of 2010 led to a conviction among many European governments that no public or private operator in today's financial markets is immune to a crisis of trust. All the more so for a Europe that is easy to prey upon as a result of being so

disorganised, but would be far less so if it were cohesive and stable institutionally. In this context, the policy adopted is not only to contain financial exposure but also to curtail the aggressiveness of financial operators by taxing transactions and financial profits. This solution neglects that Europe is home to numerous tax havens, starting with Luxembourg, that are the by-product of the lack of harmonisation.

There is one short-term solution which not everyone accepts, namely moderate doses of inflation to relieve the weight of public debts. In Europe today, such a policy, which was adopted by the Brown government, has been rejected by Germany and Great Britain under Cameron.

The long-term solution for Europe is to grow not only economically, but also and above all institutionally. A pipe-dream when overly restrictive austerity measures are implanted prematurely to compensate for deficiencies of leadership and community institutions.

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