

Publications

"Le Petit Euro Deviendra Grand" Happy Birthday Euro!

by Irene Finel-Honigman

In January 2002, the euro became the sole legal tender for the twelve member countries of the European Monetary Union. Jacques Delors, when asked to predict the future of the new currency in an interview in *Le Figaro*, quipped, "le petit euro deviendra grand." At the first year anniversary of full conversion to the euro, Delors' prediction proved accurate as the euro, undervalued since 2000, reached parity with the dollar. It is now necessary to examine what challenges the euro will encounter in a weaker economy, on the verge of enlargement and in a volatile global political environment.

In a burst of euphoria, *The Economist* described the launch of the European Monetary Union as "arguably the most momentous currency innovation since the establishment of the US dollar in 1792."^[1] Strongly overvalued, the euro opened at \$1.18 on January 4, 1999. By June 1999 it had dropped to \$1.03, and by January 28, 2000 it closed below the dollar for the first time. By September 2000, following the Danish referendum rejecting EMU, the euro had lost nearly 24% of its initial value, closing at \$0.83.

The slide was attributed to inflexible labor markets, a weakened German economy due to residual post-reunification and post-Kosovo costs, and to outflow of capital from EU multinationals into the US market, but also to a strong dollar and the unexpected productivity-driven boom in the American economy. Throughout 2001, in spite of the threat of recession, mergers and acquisitions continued at full speed as EU companies bought American assets.

In the summer of 2001 and following September 11, the currency rebounded, proving that, despite initial doubts as to its durability, resilience and confidence in EMU had not been eroded. Although perceived as under performing, EMU economies benefited from the weak currency, as exports and tourism soared.

The euro was not meant to upstage or usurp the supremacy of the dollar, but rather to offer a partner currency that could offset potential global downturns. In March 1999, *The Economist* charmingly described the relationship: "the mighty dollar needs to be balanced by the gallant young euro." Jacques Delors, an advocate for the single currency since 1988 and the architect of the Maastricht Treaty monetary policy, described the full conversion to the euro as the achievement of monetary integration and the next step toward European Union political integration which would create a greater sense of common values, identity and responsibility.

Since the European Payment Union in 1950, the theory and practice of achieving monetary integration prior to political integration has been a triumph of faith over experience. Following the currency crisis of 1992-1993, EMU was almost relegated to a historical footnote, resurrected only through Mitterrand and Kohl's political will and economic diplomacy. Despite drawbacks and seemingly endless bureaucracy, the EU has instituted reforms, transitioned from public to private ownership of major industries and banks, imposed fiscal discipline, and cut unemployment since 1999.

American economists Milton Friedman and Martin Feldstein continue to warn that monetary integration based on political will rather than economic rationale is doomed to fail and even create chaos in its wake. Robert Mundell, Nobel Prize in Economics in 1999, is one of the rare economists to foresee the advantages of monetary integration. In a seminal two-part article in the Wall Street Journal on March 24-25, 1998, he described EMU as “one of those epochal events that can only be understood in the context of long periods of history.”

Napoleon, Churchill, Jean Monnet and Adenauer all theoretically envisaged the advantages of a single European currency. However, in practice, monetary unions (such as the Zollverein, the Latin Monetary Union, the Scandinavian Monetary Union, the Gold Standard and even Bretton Woods) have been successful in the short term but neither economically nor politically sustainable. In each case one country and one central bank set the lead, but the powers of member central banks had never before been consolidated into a single institution with one monetary policy and one currency.

Since its inception in January 1998, the European Central Bank established its credibility by strictly adhering to the anti-inflationary Maastricht directive of “price stability.” Although the ECB’s policy of hyper-cautiousness and resistance to following the Federal Reserve helped bolster its initial credibility, maintaining rigid orthodoxy risks becoming counterproductive. To allow EU economies, especially the stalled German economy, to regain momentum, the ECB will have to demonstrate greater flexibility and focus on growth-oriented policies.

It now seems that the 1999-2002 period of dual currencies, which appeared at the time as too long and fragmented for preparing the general public, worked. Early information and education campaigns gave way to indifference as countries continued to transact in local currencies. Although little attention was paid till mid-2001, dual pricing and dual information had subliminally familiarized the general public by the time conversion occurred in all its aspects, technical (ATMs, vending machines), logistical (distributing 13 billion euro notes and 56 billion euro coins), and cultural (guaranteeing the value of the new currency, across social, demographic and generational lines).

Throughout 2002 the UK justified exercising its EMU opt-out clause on economic grounds. But as the UK gains prestige and political clout within the union and as Tony Blair prepares for a referendum within 18 months, the political dimension and repercussions of remaining outside the eurozone will have to supercede the question of synchronous business cycles and fears of losing a strong pound.

By fall 2002, the top economies such as France, Italy and Germany, suffering from the global downturn and weaker output, could no longer adhere to the rigid requirements of the Stability Pact, ironically imposed by Germany in 1998 to force all members to adhere to strict fiscal discipline. The Pact came under attack when the President of the European Commission Romano Prodi denigrated it as “stupid” in an interview in Le Monde in November 2002. The debate now divides economists and politicians into those who view the pact as an unnecessary straitjacket for Euroland and those who see it as a necessary deterrent for fiscal laxity and future enforcer for adherence to EMU criteria.[2]

Despite all the rhetoric to the contrary, the ten accession countries entering in 2004 will face a two-tier European Union between eurozone and non-eurozone countries. Within the decade, they will have to

meet the EMU criteria to enter the eurozone by imposing stringent economic reforms and discipline. The challenge for politicians will be to explain austerity measures to transitioning economies when the founding “rich” members have either outright rejected or modified their own rules.

Culturally, the impact of the loss of sovereignty and historical symbols in the conversion from national to supranational currency has not yet been fully absorbed. Since the Green Paper of 1996 emphasizing the psychological dimension of the changeover, the issue of the euro has been intrinsically linked to the elusive concept of European identity. A January 2, 2002, Financial Times editorial titled “Small change, giant leap” underscored the euro as a “symbol of Europe’s common purpose.”

For politicians, however, the underlying social and political challenge remains how to reconcile maintaining the social agenda and guaranteeing a sense of security, while boosting competitiveness, profits and the faith of the markets. The tumultuous elections of 2002 revealed that for disenfranchised, unemployed, less educated or rural groups the euro was another manifestation of supranational interference and the dilution of national pride and identity. Extremist parties in France, the Netherlands, Denmark, Belgium, as well as the Tories in the UK, shared an anti-EU, anti-euro platform. In summer 2002 the press described the public’s sense of feeling cheated by uneven pricing practices for consumer goods and services. The ECB dismissed the complaints as a false perception created by a one-time jump in prices caused by rounding upward in the conversion process.

Through the “long and arduous ascent of euro-man,” from Pierre Werner’s premature plan in 1970 for irreversible parity and one central bank to Chancellor Kohl’s final accomplishment of the European Monetary Union, Germany provided the monetary anchor. Whereas France lost the prestige of the franc fort, Germany lost its mantle of economic leadership and security provided by the Bundesbank and the deutschemark. Poorly adapting to the loss of a “guiltless symbol of national identity,” Germany has to redefine its role in a European economic landscape exacerbated by the Schroeder regime’s sporadic economic reforms and hobbled by a bloated government bureaucracy and rigid labor practices.

While a weaker euro allowed EU economies to coast along on exports, a stronger euro will put greater pressure on national governments to increase productivity and investment, to implement a single market in financial services and regulations, and to seriously address the issue of fiscal harmonization. The costs of enlargement cannot be underestimated but this should not hamper internal reforms and further harmonization.

When market conversion occurred in 1999, U.S. markets interpreted the final changeover to a consumer currency as a domestic, cultural and political event, rather than an economic one. In 2002, the US response was cautiously optimistic. At the one year mark, predictions of a weaker dollar abound, and interest in the euro is increasing as Asian and Latin American central banks bolster euro reserves.

The French economic historian Braudel’s definition of the impact of monetary and transactional convergence during the Renaissance is still valid: “the economy, the invading, mingling together of currencies and commodities tended to promote unity of a kind in a world where everything else seemed to be conspiring to create clearly distinguished blocs.”[3] In 2003, at a time of global uncertainty, the European Union takes on the daunting challenges of enlargement and political integration. As former-

U.S. Ambassador to France Felix Rohatyn commented in February 1999: "I do not know what the political outcome will be....but I know one thing: if the Euro succeeds, the rest will follow."

Notes:

1 *The Economist*, January 2, 1999, All subsequent references from *The Economist* are available from the author at ief2@columbia.edu.

2 "Bundesbank chief backs EU growth pact," *Financial Times*, November 18, 2002. All subsequent references from the *Financial Times* are available from the author.

3 Fernand Braudel, "Money" in *Structures of Everyday Life: The Limits of the Possible* (New York: Harper and Row, 1982).