Special report

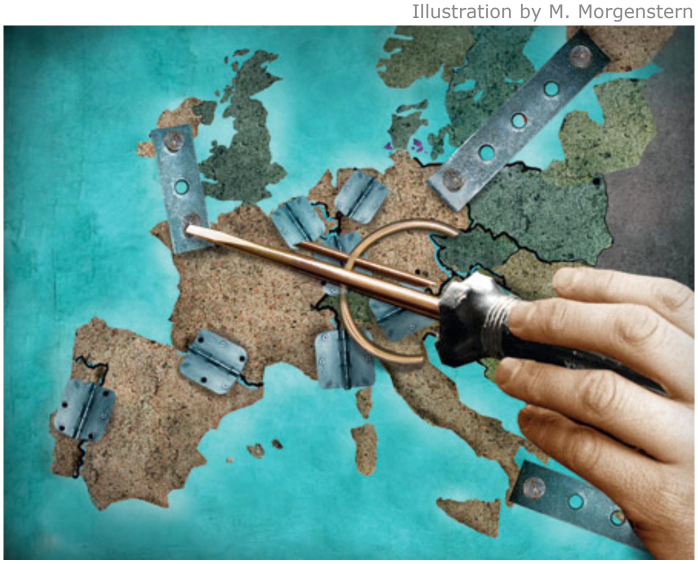
A special report on the euro area

Holding together

Jun 11th 2009
From *The Economist* print edition

The euro area, sorely tested by the financial crisis, has survived intact and is likely to expand further, says John O'Sullivan (interviewed here)

Illustration by M. Morgenstern



Correction to this article

IN THE mid-1980s *Rolling Stone* magazine published an essay by P.J. O'Rourke, a conservative American humorist, with the splendid title "Among the Euro-Weenies". In it the author poured scorn on Europe, an annoyingly fractured continent with its "dopey little countries", "pokey borders", "itty-bitty" languages and "Lilliputian" drinks measures. The mosaic of countries made the visitor feel claustrophobic: "You can't swing a cat without sending it through customs," he complained.

He will not have been aware, or cared much, that plans were already in train to give "Europe" the continental scale it so painfully lacked, as well as a currency that would rival the dollar. In 1986, the year of Mr O'Rourke's visit, the European Economic Community (as the European Union was then known) expanded from 10 to 12 countries, with the addition of Portugal and Spain. Its members had spent most of the 1970s erecting non-tariff barriers to internal trade, and the early 1980s battling over who should pay for its joint budget (a fight which, to be fair to the others, Britain started). With that settled, there was a fresh desire to make progress towards a genuinely open free-trade block.

The first fruit of that effort was the Single European Act,

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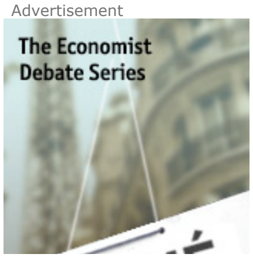
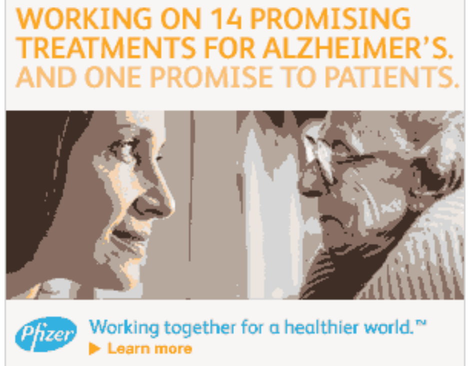


an agreement to dismantle barriers to internal trade by the end of 1992. A rider to the act sketched out an ambition to complement the single market with a single currency. Few took that seriously, least of all British politicians, who had signed up to the act with enthusiasm because they were keen free-traders, but dismissed the grander kind of Community rhetoric as "euro-guff".



An idea whose time had come

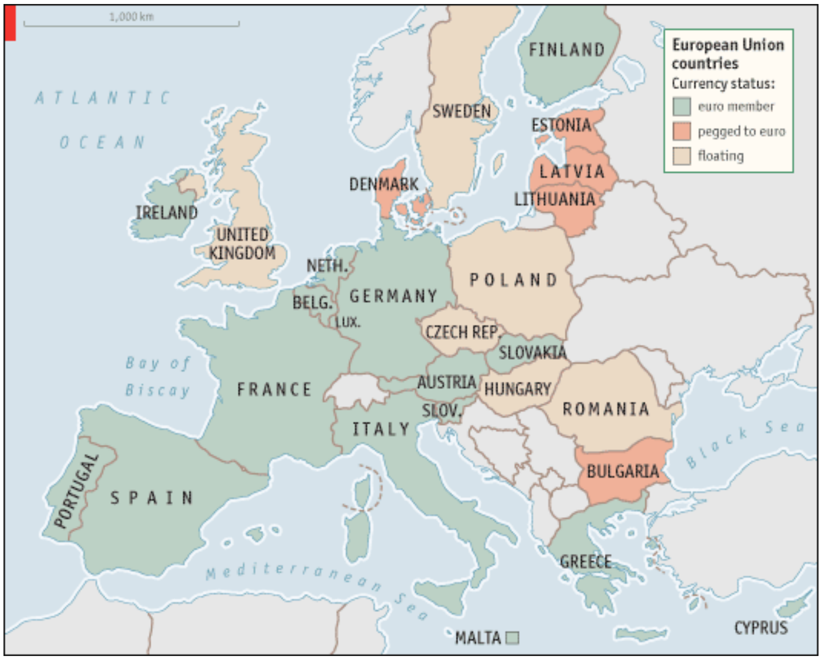
Yet by the time a 1991 European summit was held in the Dutch city of Maastricht, a plan for economic and monetary union (EMU) was written into a new EU treaty, to be ratified by member states later. That the proposal had gained ground so swiftly was a surprise to many. The British government had thought that a committee of EU central-bank governors, charged in 1988 with studying if monetary union was feasible, would quash the idea. Instead the group, chaired by Jacques Delors, then president of the European Commission, the EU's executive branch, gave it qualified approval.

The Delors Report concluded that EMU could work if control of the single currency was kept from meddling politicians and left to independent technocrats at a European central bank, to be modelled on Germany's Bundesbank. The report gave warning, however, that to prevent large trade imbalances, reforms would be needed to make prices and wages more flexible and workers and capital more mobile.

EMU's route from rhetoric to economic blueprint was a familiar one, if unusually swift. The push behind trade integration in Europe has been primarily political rather than economic. The EU itself was born of the catastrophe of two world wars, collisions of competing nation-states. It was designed to avoid a repeat of such conflicts by forging "ever closer union" in Europe. Economic ties were viewed as much as a means to co-operation as an end in themselves. The Delors Commission between 1985 and 1994 marked the zenith of this sort of integrationist zeal.

After many a flap (see article), EMU eventually metamorphosed into a bird of much grander plumage. On January 1st 1999 the currencies of 11 countries were fixed against a new currency, the euro, which became the unit of reckoning in wholesale financial markets. In 2002 euro notes and coins came in and the old paper currencies were phased out. Since the single currency's launch five more countries have joined the euro area. In a unique economic experiment, 16 countries with a combined population of 329m have handed over monetary sovereignty to an entity at arm's length from national politics: the European Central Bank (ECB).

So far the experiment has worked fairly well. The ECB has fulfilled its remit to maintain the purchasing power of the euro. Since the currency's creation the average inflation rate in the euro area has been just over 2%. Fears that the euro would be a "soft" currency have proved unfounded. It is unquestioningly accepted at home and widely used beyond the euro area's borders. (Several countries, including Montenegro and Kosovo, use the euro as their currency without formally belonging to the euro zone.) The switch from old currency to new went remarkably smoothly, though consumers in many countries complained, perhaps predictably, that they were charged higher prices as merchants rounded up to new price-points in euros. But this caused barely a blip in the official inflation figures.



So far the euro has brought neither greater prosperity nor political union. Job-creation improved but productivity increases slowed, leaving the region's trend growth rate much the same as before EMU. In its early years the euro fell against the dollar, but it has since more than made up for its early losses. It has quickly established itself as a global currency without becoming a true rival to the greenback's status. For much of the euro zone's first decade Germany, its largest economy, was in the doldrums, but after a long period of wage restraint its export industries started to lift the economy. Spain, Greece and Ireland proved more dynamic, each enjoying a consumer boom.

All seemed well until the present financial crisis struck. This reawakened worries about the imbalances that have built up inside the euro zone. Germany's huge current-account surplus is matched by big deficits elsewhere, particularly in the Mediterranean countries that German policymakers had been so keen to exclude from joining. It remains an open question how these will be resolved.

The financial crisis is proving by far the biggest test to date for the euro zone. This special report will look at its effects on the euro area and consider whether such a disparate group of countries can continue to share the same monetary policy. It will ask whether the crisis will spur economic reform and whether it will attract more members to the club or, conversely, whether some of them might be thinking about leaving. Lastly, it will examine the idea that in the longer term a multinational currency area will require greater political union to function properly.

Correction: the original map on this article did not include Montenegro or Kosovo. Sorry. This was corrected on June 18th 2009.

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