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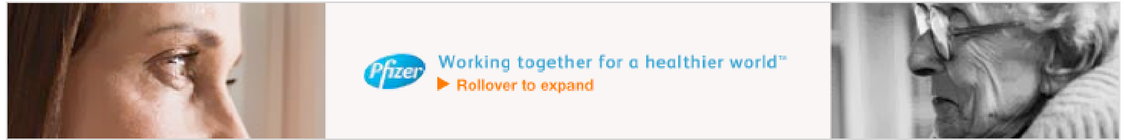

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A special report on the euro area

A tortuous path

Jun 11th 2009
From *The Economist* print edition

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From Bretton Woods to euro

THE idea of a single money as a path to European political union goes back a long way. In the 1950s a French economist, Jacques Rueff, wrote that "Europe shall be made through the currency, or it shall not be made." But the euro had pragmatic roots too. After the breakdown of the Bretton Woods system of fixed exchange rates in 1973 the Deutschmark emerged as the benchmark currency in continental Europe. The instability of floating currencies was a barrier to harmonious trade, but schemes to peg exchange rates frequently had to be redrawn because few countries could consistently match the Bundesbank's anti-inflation zeal. The might of German manufacturing forced frequent devaluations on others to keep their industries competitive.

Changes to exchange-rate pegs often caused tensions. François Mitterrand, who as French president was one of the signatories of the Maastricht treaty, is said to have remarked that "devaluations are never small enough to avoid losing face and never large enough to make a real difference to exports." As soon as Maastricht had been signed (with a British opt-out from EMU), those tensions resurfaced. In June 1992 the Danes voted narrowly against ratification, raising a question mark over the assumption that the path to EMU would be smooth. The Irish, in the only other scheduled referendum, voted in favour shortly afterwards, but Mitterrand announced a referendum in France for the following September, a risky gambit because French public opinion was cooling on monetary union.

Currency markets were also stirring. At the time all 12 EU countries, bar Greece, were in the exchange-rate mechanism (ERM), a system that tied currencies to each other within narrow trading bounds. Germany was at the scheme's heart: currencies were officially pegged to each other in a complex grid of bilateral rates but all were, in effect, tied to the D-mark. That became a problem when economic conditions in Germany and the rest of Europe diverged. To head off inflationary pressures caused by Germany's post-unification boom, the Bundesbank in July 1992 raised interest rates to 8.75%, a 60-year high.

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Those German rates caused strains in currency markets that worsened over the summer. In September first Italy and then Britain were forced to devalue, in Britain's case after spending billions of dollars trying to defend its ERM parity against speculators. In the following months Spain, Portugal and Ireland too had

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to let their currencies slide. France battled to hold to its parity and only just succeeded. Its referendum produced a narrow vote in favour of the Maastricht treaty.

Look at it this way

Different countries learnt different lessons from the crisis. Britain saw dangers in fixed exchange-rate schemes. Its economy started to pick up almost immediately after its ejection from the ERM. The French were confirmed in their belief that a monetary union was necessary both to prevent speculative attacks on currencies and to ensure that Europe's monetary policy was not made exclusively in Germany. Some German policymakers, previously sceptical of EMU, fretted that any repeat of the crisis would be a threat to the single market.

It was residual German scepticism that caused stiff tests to be set up for countries that wish to join the euro. The "convergence criteria" set out in the treaty called for would-be joiners to meet targets for inflation, bond yields, exchange-rate stability, budget deficits and public debt. The criteria were criticised as having little to do with a country's ability to cope once monetary policy was no longer tailored to national needs. Instead, they seemed designed to favour a core group of like-minded countries, centred around Germany, and to exclude others, particularly Italy, which it was feared would use EMU's low interest rates to relax fiscal discipline.

Things turned out differently. By 1997, the year in which the tests would be applied to a first wave of would-be entrants, Germany and others in the core group had trouble fitting into the Maastricht straitjacket themselves. The time scale for the fiscal targets had to be fudged, which let Italy and others slip through. France insisted that the "stability pact" proposed in the treaty be renamed "stability and growth pact". Germany demanded a cap on budget deficits of 3% of GDP. When both countries themselves later breached that limit, the rules had to be made somewhat more elastic.

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