

# The euro will run into trouble – but when?

**Any future Emu crisis could see a popular rebellion in the voting booths, compelling governments to change policies and pull out of the currency system, says Gerard Lyons. Savers could even start a run on the banks.**

Will the euro be a hard currency? The odds are heavily against it.

Next January a broad-based Emu will begin with 11 currencies. The lira is likely to be one of them, the pound will not. Fears about a weak euro have already led investors to move money out of the DM and into safe-haven currencies such as the dollar, pound and Swiss franc. This is fully justified.

The euro is being launched in a difficult economic climate. There is no locomotive for world growth and there is a deflationary fall-out from Asia. While the G7 put pressure on Japan to boost its economy, Europe is not immune to criticism. Policy in core European countries has been too tight, resulting in weak below-trend growth and high unemployment. By contrast, economies such as Ireland and Spain have benefited from falls in interest rates and bond yields.

When Emu starts there will be initial euphoria, boosting sentiment towards the euro. Whether this lasts depends on economic performance, policy and how international investors react.

The euro has several things in its favour including Europe's current account surplus and the fact that the countries within monetary union will form the world's largest single currency area and its largest single trading bloc. Thus the euro will be used widely.

According to the Bank for International Settlements (BIS), the EU currencies are involved on one side of 70% of all foreign exchange transactions and the DM on 30%. After January, intra-European currency flows will become local transactions and the percentage using the euro will be lower than for the combined EU currencies but higher than for the DM. According to BIS, the euro will initially be used in 56% of exchange transactions and 22% of trade flows – far less than the dollar but more than the yen.

The behaviour of international investors could change. In the last 20 years rising intra-regional trade in Europe has boosted the importance of the DM and higher intra-Asian trade has helped the yen. Last year's collapse of the dollar peg in Asia could boost the role for the yen there. And it should provide another reason for eastern European countries to tie their currencies to the euro, ready for close future trading links.



If the single currency is a success, international investors will increase the amount of assets held in euros. That does not mean the euro will inevitably appreciate as this will be partially offset by a similar rise in liabilities held in euros.

Financial markets expect economic policy to be positive for the euro as the European Monetary Institute establishes its credibility by keeping interest rates high. I disagree. The absence of inflation and poor growth in Germany will limit the need for higher interest rates.

Politics has been the driving force behind the mad dash to a single currency. By rushing the process, rather than being patient, Europe's politicians may have built up problems for the future. For a monetary union to succeed the countries entering it should have economic convergence. Economies that converge react in similar ways to shocks and to policy changes, reducing internal tensions within the monetary union.

The Maastricht criteria, which must be met to qualify for Emu, only ensure a minimum degree of convergence. This would not be a problem if monetary union were flexible, with built-in shock absorbers. Unfortunately, Europe will not have America's monetary, fiscal and labour flexibility.

Unlike the US Federal Reserve, the European Monetary Institute will not be politically accountable and will have a narrow mandate to achieve low inflation. The Federal Reserve has to achieve low inflation and stable employment, leading to balanced policies. Europe's Fiscal Stability Pact, aimed at preventing prodigal governments from destabilising the euro, could actually create a problem by limiting the room

for policy flexibility. And Europe's labour market is rigid.

The inability to respond to shocks could result in wide regional variations in economic performance, with pockets of high unemployment. Nationalist tendencies, which the architects of Emu hoped to avoid, may thrive. And this will trigger demands for domestically orientated policies.

In the ERM crisis it was the financial markets that reacted to obvious signs of problems by attacking vulnerable currencies. In a potential Emu crisis the general public might be the catalyst, either

by forcing a national government to shift economic policy and consider leaving the system, or by triggering a run on the banks in the country facing problems by moving their savings somewhere else in Emu where there was no fear of devaluation.

The economic climate in Europe spells bad news for the euro. At some stage it will run into trouble. The question is, when? A century ago there were three monetary unions in continental Europe. All eventually failed, but only after a long time.

Germany's 19th monetary and political union held together for 50 years, right up to the first world war. A Latin monetary union of five countries, led by France, survived from 1865 until World War I. And a three-country Scandinavian currency union lasted from 1873 to 1920. The lengthy lifespans of both the Latin and the Scandinavian examples demonstrate the importance of reserving judgement on the success of a monetary union until its performance can be measured in an economic downswing or when there is a deflationary shock.

In a difficult economic climate a monetary union that is not a political union finds it hard to survive. For a monetary union of large sovereign states to survive it must become a political union. This may have to be the ultimate choice if Emu is to succeed.

The euro looks hard but a weak economic performance and policy tensions will give it a very soft centre. ●

*Dr Gerard Lyons is chief economist and executive director of DKB International.*