CENTRE FOR EUROPEAN REFORM

# It's the politics, stupid!

**by Simon Tilford**

Many economists have been accused of being too gloomy about the euro because they underestimate the degree of political commitment that eurozone countries have made to the single currency. The ECB's success in buying time for the politicians has emboldened those who argue that when push comes to shove, policy-makers will do what is necessary to save the euro. The optimists tend to attribute continued scepticism to a poor understanding of the politics or to a refusal to acknowledge the significance of the steps already taken. In fact, those who claim that politics will come to the rescue irrespective of how bad the economics get are guilty of complacency. There is a gulf between the political objectives that member-states were pursuing when they joined the euro and where they find themselves now. This is the principal reason why their commitment to rectifying the flaws of the euro is so weak.

For the French, the euro was a way of regaining some control over monetary policy from the Bundesbank and of maintaining economic and political parity with a newly united Germany. There was next to no discussion in France over what a currency union implied in terms of the country's economic and social policies, and certainly no sense that by joining the euro France was effectively committing itself to a liberal economic agenda. The French pushed strongly for a broad euro including Italy and Spain, not out of any commitment to closer EU integration, but in an attempt to further dilute Germany's hold on the newly-created European Central Bank (ECB).

France's plans have backfired spectacularly. Far from helping the country maintain economic and political parity with a united Germany, the euro has increased German economic and political influence. On the face of it, it is not obvious why this would be the case. The French economy has outperformed the German one since the launch of the euro, France (unlike Germany) has very healthy demographics, and the French economy (unlike Germany's) is able to generate growth in domestic demand.  But when countries have no control over the currencies in which they borrow – as is the case in the eurozone – fiscal strength and a country's trade balance take on disproportionate importance: France is running sizeable budget and trade deficits.

Germany is now calling the shots in a way that was never foreseen by the French and has come as a profound shock to them: France is now routinely on the receiving end of lectures from German politicians on how to reform its economy. The country has little option but to pursue policies – pro-cyclical fiscal austerity – that threaten to deepen its economic downturn. At the same time, France does not have the kind of labour market institutions which have enabled Germany to deliver wage restraint. With the appointment of Mario Draghi, the ECB put some distance between itself and Germany, but the ECB remains constrained in what it can do by the need to keep Germany on board.

For the Italians, the motivation for joining the euro was largely national prestige – a determination not to get left behind. Whereas the European Exchange Rate Mechanism debacle of 1992 effectively killed off British enthusiasm for the euro, the Italian elite drew different lessons. For them, it was not the fixing of the lira to the deutsche mark that was risky, but the failure to make this link irrevocable. To the extent that the risks were acknowledged, the Italian elite calculated that fixing the lira forever would leave the country with no option but to squeeze out inflation and push through reforms aimed at raising productivity.

Things have not turned out as planned. Italy's economy is now in a full-blown slump. If it contracts in 2013 by as much as the Italian authorities now expect, the economy will be 10 per cent smaller than it was in 2007, and no bigger than it was in 1999. Despite running a primary budget surplus, Italy has no option but to run an extremely tight fiscal policy as investors are wary of lending to a major debtor that does not control the currency in which it borrows. As in other struggling euro countries, the ratio of public debt to GDP is rising very rapidly.

Far from gaining a seat at the top table, Italy is seen as resolutely 'peripheral', routinely lumped in with Greece, Portugal and Spain. It can only remain in the euro if it pushes through reforms of its economy and if it can rely on external support in the form of ECB financing and stronger demand for its exports from other eurozone economies. However, intractable political stalemate makes economic reform extremely unlikely, which further reduces the already slim chances of increased external support of one form or another.

For Germany, the euro was largely a quid pro quo for French acceptance of German unification. The Germans were more ambivalent about the euro than the French or the Italians: Germany was the only EU country aside from Britain to have a proper debate about the implications of joining the single currency. The German business community was generally positive, seeing in the euro a way of preventing other European countries from recouping competitiveness against Germany by devaluing their currencies. A sceptical German electorate was brought on board with a promise that the euro would be as strong as the deutsche mark and that the ECB would effectively be the Bundesbank writ large. There was little sense that the euro would require closer pooling of sovereignty, let alone mutualisation of risk in the form of a fully-fledged banking union or eurobonds.

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The euro has certainly enabled Germany to lock in competitive advantage. And while there was no sense that Germany signed up to the euro with a view to strengthening its political position in Europe, German policy-makers have taken to their new found status with something close to gusto. They routinely tell other eurozone countries how to run their economies, citing Germany as a model for the currency union as a whole. This approach has delivered politically for Chancellor Angela Merkel. For example, Germany's failure to bolster Mario Monti by opening the way for a degree of debt mutualisation ultimately paved the way for Beppe Grillo, but it played well with German voters. This is unsurprising: they did not sign up to risk mutualisation and are highly hostile to it.

When they joined the single currency, the key countries were not committing themselves to a federal Europe or to very liberal economic policies. This is a major reason why their commitment to rectifying the eurozone's underlying problems remains so half-hearted. Of course, the gulf between eurozone countries' motivations for joining the euro and the reality of membership does not mean that they will necessarily fail to put the single currency on a sound footing. But the Cyprus situation alone should make people cautious about claiming that the politics will always trump the economics in a currency union comprising countries with very different motivations for joining and divergent political cultures.

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