EURO: The second year

SERIAL TURNAROUNDS

by Jean-Jacques Rosa

Politicians have an uncanny way to go back on their word when the going gets tough, when they don't simply turn their doctrinal coat around, which is often for them, no more that a convenient, but not altogether essential, façade. This is precisely what Euro managers, national governments and directors of the European Central Bank have just done. During the long years of preparation for the Euro transition, our political and monetary experts successfully foisted on public opinion the absurd doctrine of an expensive franc and the need to align our policies to the Bundesbank's restrictive monetary management approach. All this, in spite of the resulting anemic growth rate as well as historically high unemployment records in our country. They solemnly explained that macroeconomic and exchange rate policies had become impotent, and that – contrary to evidence -- real interest rates had never been so low and that they could be reduced no further. Anyway, these rates, just like exchange rates, were said to have no effect on the economy.

But last January, the new monetary authorities in Frankfurt decided not to defend the Euro against other currencies -- principally the dollar of course, but also the yen and the pound sterling. Contrary to the theories upheld by supporters of an expensive franc, the effect was immediate, and beneficial. A devaluation of over 15% in one year goes a long way to explain the modest, but real, increase in economic activity as well as the beginning of a reduction in unemployment.

Critics of the doctrinaire monetary policies obstinately followed throughout the 90s, including this writer, were thus correct: monetary management does remain effective, and the policies adopted by successive governments in the past were a heavy burden for the French economy and bear the crushing responsibility for much of today's chronic unemployment.

Developments over the last few months have also disproved an important corollary of euro-monetarism, which considers unemployment to be solely a result of labor market and fiscal rigidities. The fact is that recent unemployment reduction did not depend on any liberal reforms of the labor market, as indeed no one could easily detect any signs that the 35-hour work-week regulation provides greater liberalization or flexibility.

In the same way, the Jospin-Strauss-Kahn policy approach has shown no sign of alleviating the ever increasing burden of taxation on labor ("social contributions") which continues to finance the laxist management policies of the retirement and health insurance systems.

The message is therefore clear, and it is an important one : macroeconomic policy must continue to play a role for it is an essential determinant of prosperity.

The sudden turnaround in the now Europeanized monetary policy has surprised most observers, including yours truly, with the exception of Michèle Saint-Marc, who has, on several occasions, insisted in these columns that the Euro would be a weak currency. This reversal can be explained by two factors. The first, which is economic, is the over-evaluation of European currencies prior to the Euro launch. Everything we knew about equilibrium exchange rates, and especially the "Big Mac" benchmark calculated by *The Economist* using the price of a McDonalds hamburger in different countries, pointed to the fact that the correct parity for the franc would be approximately 7 francs to one dollar, or, given the definition of the Euro, 0.95 dollars per Euro. As for the mark, parity at 1.05 dollars per Euro would ensure a balance between our respective economies (see "Euro" and "Big Mac", Le Figaro, April 9, 1999). The Euro at a value of one dollar therefore stands at midpoint of the equilibrium parity of France and that of Germany and constitutes a fairly good compromise. It is, to say the least, a late return to reason.

But are we to think that Mr. Duisenberg has suddenly seen the light, where the Bundesbank and the Banque de France failed to understand the realities of the situation and to fix the proper price for their respective currencies? This is highly unlikely. It seems more probable that elections profiling on the horizon of the main European countries between 2001 and 2003, and the subsequent pressures from certain governments' interests, have had the better of the governor of the European Central Bank. Few governments are eager to confront voters with unemployment levels at over 10 or 11% of the active population, growth considerably below potential, and the threat of deflation -- a situation which has resulted in the successive defeats of all outgoing majorities over the last few years, in France.

However, as has been clearly demonstrated by a German colleague, Professor Roland Vaubel of Mannheim University in a still unpublished study, France and Germany together control a voting majority on the ECB board. Furthermore, history has shown that French inflationary behavior is at average amongst other countries in the Euro area. This suggests that "French-style" monetary policy may be more easily accepted by the other partners as an equitable compromise.

The similarity between France and Germany's economic and political situations has probably caused them to relinquish the strong euro doctrine. And so much the better, because there is no reason to deprive ourselves of the pleasure of a return to reasonable monetary management. Of course, this may not suit the financial interests of some of the most conservative protagonists :

Capital funds are departing from Euroland en masse to look for more favorable interest and exchange rates elsewhere. But here again is proof that the so-called "dictatorship of capital markets" was nothing but an alibi for wrong-headed policies. Because growth is continuing in spite of their defection.

Should Euro-critics now admit their mistakes and sing the praises of the new currency? I do not think so. The Euro may be managed in a more rational way, but the basic concept is still debatable. I continue to believe that Europe is not an optimal monetary zone or governmental zone, as I demonstrated in " Euro Error".

Parity fixing as of January 1999 has not provided much in the way of benefits. The cost of exchange transactions has not changed, since national currencies still exist. And a single monetary policy will continue to apply the same interest and exchange rates to national economies in very different economic situations. Today, this common policy apparently suits France and Germany, but we will inevitably run into situations where electoral calendars will no longer be synchronized and where unforeseen crises may lead to situations where the two sides of the Rhine will be out of phase. A single monetary policy would appear, once again, to be less effective than "customized" national management. Where disagreement ensues, the difficulties for several sovereign states to manage a single currency in concert will be plain for all to see. And the need for a centralized European state will make itself felt.

For the moment, none of our political leaders defend the idea of building a very large Super State on the continent any more. On the contrary, everyone is only too keen to dissociate themselves from such a project, which explains their at least temporarily retreat on the issue of fiscal harmonization. Duly noted. But in that case, what is the point of a single currency? If the goal is not to make the franc, now the Euro, as solid as the old-style mark; if its management remains subject to electoral pressures; if it does not attract international capital; if it no longer inevitably involves us in the cogwheels of a Super State -- why on earth have we gone along with such an irrational approach?

The answer could be simple: political opportunism. German reunification had led economists to diagnose the need for a later fall in the value of the mark after an initial rise, given that German's production capacity would need to export less in order to feed a new and much larger domestic market. However, a strong mark has long been a fundamental political doctrine for a Germany who could only affirm its international role in the economic field. And since the post-war period, the Bundesbank has wielded exceptional power as an independent defender of that symbol of German strength. Moreover, a lower mark could have provoked reactions from European partners in the form of repeated competitive devaluations. Freezing exchange parities with neighbors, and renaming the "mark" the "Euro", solved two political problems for Germany. One, that the devaluation of the Euro would make less of an impression than devaluating the mark, and two, its neighbors' reactions would be neutralized in advance. Further, the power of the Bundesbank would be diluted within the ECB.

Successive French governments, with their centralizing and technocratic mind-sets, and also obsessed with the perspective of a united Germany playing the card of independent policy-making, quickly entered the game, even at the price of sacrificing their own economy during the preparatory period and hoping to construct a huge Continental state that in the future would finally allow the French elite to counter the almighty United States.

Have we thus endured ten years of economic sacrifice to resolve the German political dilemma, calm the imaginary fears of our political leaders with respect to Germany and flatter their unlimited thirst for power? Ten years, for this? Was it nothing but a con game? If this hypothesis should be confirmed, the repercussions will have to be dealt with. And they undoubtedly will be very serious ones.

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