'The birth of the euro' from EUROPE (December 2001-January 2002)

Caption: On the eve of the entry into circulation of euro notes and coins on January 1, 2002, the author of the article relates the history of the single currency's birth.

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The birth of the euro

By Lionel Barber

On January 1, 2002, more than 300 million European citizens will see the euro turn from a virtual currency into reality. The entry into circulation of euro notes and coins means that European Monetary Union (EMU), a project devised by Europe's political elite over more than a generation, has finally come down to the street.

The psychological and economic consequences of the launch of Europe's single currency will be far-reaching. It will mark the final break from national currencies, promising a cultural revolution built on stable prices, enduring fiscal discipline, and lower interest rates.

The origins of the euro go back to the late 1960s, when the Europeans were searching for a response to the upheaval in the Bretton Woods system, in which the US dollar was the dominant currency.

The first step came at the Hague summit in 1969 when the founders of the European Union ─ France, Germany, Italy, Belgium, Luxembourg, and the Netherlands ─ ordered a feasibility study on monetary union.

The goal of a single currency had been mentioned obliquely in the 1957 Treaty of Rome, the Union's founding treaty. But it took an inspirational intervention in 1970 from Pierre Werner, Luxembourg's prime minister, to produce a three-stage plan for achieving monetary union within a decade.

The first oil crisis and the collapse of the Bretton Woods system in 1972-73 sabotaged the Werner plan, but Europe's search for currency stability received a fresh wind in 1979 with the creation of the European Monetary System (EMS).

This time the plan was the result of intense cooperation between Valéry Giscard d'Estaing, president of France, and Helmut Schmidt, chancellor of Germany, supported by Roy Jenkins, a former British treasury secretary who had come to Brussels to serve as president of the European Commission.

The EMS was built on the concept of stable but adjustable exchange rates, which led to the creation of the so-called "snake", which allowed currencies to move up and down within certain limits. Once again, an oil crisis intervened to put pressure on the system. Then came a further blow with the election of a Socialist French government in 1981 led by François Mitterrand.

There is a view, shared widely among European political analysts, that the decisive moment for EMU arrived in 1983 ─ a full eight years before the Maastricht Treaty negotiations, which set down a precise timetable for launching the single European currency.

In 1983. France faced another devaluation of the franc. President Mitterrand had flirted with "Socialism in one country", refusing to accept that this was an out-of-date notion in an increasingly integrated European economy.

Jacques Delors, his centrist finance minister, told him the hard truths of economic interdependence. The Socialist government resolved to pursue a *franc fort* policy based on a sound currency that would commit to preserve its value against the deutsche mark without engaging in competitive devaluations.

Delors went on to be chosen as president of the European Commission in 1984 and took up the office in Brussels the next year. After a hesitant start, he launched the program for creating a single European market that would lead to the free circulation of capital, goods, and services by 1992.

Alongside the 1992 program came the influential "Cecchini" report written by experts in the European Commission, which argued that a single currency would enhance the benefits of the single market because it would save transaction costs.

In 1989, with the fall of the Berlin Wall, the single market project took on a new political dimension. Delors, supported by Mitterrand and Chancellor Helmut Kohl of Germany, pressed for economic and monetary union (EMU) as the essential counterpart to the single market.

In essence, Delors proposed a grand bargain: In return for Europe (especially France) giving its blessing to German unification, Germany would be expected to exchange national monetary sovereignty — that is the deutsche mark — for a single European currency.

The surrender of the deutsche mark was a huge political sacrifice for Germany. The deutsche mark was the symbol of postwar Germany's economic renaissance as well as its self-respect after the chaos of the Weimar Republic and the trauma of Nazism.

Chancellor Kohl saw EMU as a means of anchoring a united Germany into a united Europe, one in which Germany would no longer be a front-line state but would fit alongside a newly democratic Poland and a more stable, democratic Eastern Europe liberated from the Soviet bear-hug.

President Mitterrand saw EMU as a strategic opening to break the monetary hegemony of the German Bundesbank through the creation of a supranational bank — the European System of Central Banks — in which France would have parity of influence with Germany.

Jacques DeLarosière, former governor of the Bank of France and later head of the International Monetary Fund, is said to have remarked that EMU once and for all would release France from Frankfurt's dominance. This meant that he would never again have to receive a call from the Bundesbank effectively dictating to him the level of French interest rates.

Despite Mitterrand's strategic calculations, the Maastricht Treaty barely passed in a September 1992 referendum in France. The *petit oui* from the French population came amid a period of tremendous currency turmoil as speculators attacked currencies that they believed could not sustain parity with the deutsche mark.

The currency turmoil was exacerbated by the after-effects of German unification. The German government took the fateful decision to pay for the spiraling costs of unification not through higher taxes but through borrowing. The Bundesbank raised interest rates in response, regardless of the knock-on effect on other countries' economies.

As a result, several of the weaker European economies were forced to raise interest rates to protect the value of their currencies against the deutsche mark, the anchor currency in the EMS. Yet the Portuguese escudo, the Spanish peseta, the Italian lira, and the British pound still fell in value against the deutsche mark. The nadir came on "Black Wednesday", September 15, 1992, when the pound and lira left the EMS's exchange rate mechanism (ERM). Other currencies such as the escudo and the peseta were forced to devalue but stayed in the ERM.

In August 1993, after the French franc came under intense pressure, EU finance ministers agreed to a radical reform of the ERM. The bands of fluctuation were expanded, allowing a currency to exceed or lag the value of the deutsche mark by 15 percent, thus thwarting speculative attacks on attempts to maintain near-parity.

In retrospect, the 1992-93 ERM crisis delivered two important lessons that paved the way for the successful launch of the euro on January 1, 1999 when exchange rates between the successful members of the single currency were fixed irrevocably.

First, in an era of free capital movement, there could be no halfway house between free-floating currencies and a fixed regime. The ERM system of fixed but adjustable rates was simply not credible in the face of targeted speculation, especially as the weaker economies had clearly not achieved the correct level of "convergence" with their more powerful counterparts.

Second, the ERM crisis forced the French and the Germans to reaffirm their political commitment to monetary union. Despite the radical overhaul of the exchange rate mechanism, the strategic goal of EMU remained intact. As such, the 1993 crisis underlined how the EU took a pragmatic approach to achieving a political end.

Between 1993-98, all countries in the EU made a formidable effort to restore their public finances in order to meet the Maastricht Treaty’s entry criteria for economic and monetary union. These criteria included reducing their budget deficits to 3 percent or lower of gross domestic product; reducing the stock of public debt toward the goal of 60 percent of GDP; reducing inflation to a level determined by the best performers in the ERM; and securing exchange rate stability.

In addition, the center-right coalition government in Germany ─ partly to assuage domestic public opinion and the Bundesbank ─ unveiled proposals for a so-called “Stability Pact” to enforce budgetary discipline in the future euro zone.

Arguments over the precise terms of the pact led to several titanic clashes between the French and the Germans. The French wanted more political discretion over fiscal policy; but the Germans wanted to export their stability culture, primarily through the creation of an independent central bank and a set of automatic penalties against fiscal miscreants.

In mid-1997, the terms of a deal were reached but only after a scare created by the election of a Socialist-led government in Paris, which had previously voiced doubt about the Stability Pact. At the Amsterdam summit, Lionel Jospin, the Socialist French prime minister, struck an agreement that renewed the agreement, now called the Stability and Growth Pact.

In May 1998, the heads of government decided that eleven countries ─ France, Germany, Austria, Belgium, the Netherlands, Luxembourg, Finland, Ireland, Italy, Spain, and Portugal ─ had met the Maastricht criteria. Some countries only squeezed into the EMU club thanks to a liberal interpretation of the entry criteria. For Italy, however, with its huge public debt and its rocky record in the management of public finances, it was an historic achievement.

One last conflict arose over the selection of the president of the new European Central Bank. Wim Duisenberg, the long-serving head of the Dutch central bank, was the firm favorite, strongly supported by the Germans. But at the last moment, President Jacques Chirac of France put forward Jean-Claude Trichet, governor of the Bank of France.

Once again, the dispute highlighted that national differences could not be subsumed in the new supranational monetary union. In the end, Chirac forced a compromise whereby Duisenberg gave a less than cast-iron commitment to step down around halfway through his eight-year term, say in mid-2002, after the entry into circulation of euro notes and coins.

It was a less than perfect deal that took some of the gloss off the launch of the euro on January 1, 1999. In the intervening years, the euro has been a technical success but something less than a star on the currency markets. The dollar’s strength overshadowed the euro, which also suffered from heavy investment outflows into the US, especially during the dot-com boom.

Now that the US economy has come to a juddering standstill, the euro has recovered some of its value. Some are predicting a long-term turnaround. But this would not necessarily benefit Europe’s economies, which have used a weaker exchange rate against the dollar and yen to boost exports.

In the final resort, it may be time to reexamine some of the deals that underpinned the Maastricht Treaty’s provisions on economic and monetary union. The Stability Pact has already been tweaked to take more account of the economic cycle. The organization of the ECB ─ in particular the sharing of executive seats and the composition of the governing council ─ may also be revised as the EU proceeds with enlargement to Central and Eastern Europe.

In sum, after a tumultuous decade, the euro is entering the post-Maastricht era, when it will become the currency of choice not just for the twelve-member euro zone but also for many of the EU's neighbors. The next chapter in a process of truly historic proportions is about to begin.

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