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No shelter in euro storm for Club Med

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WITH a European summit to be held on December 9, Thursday's headline in France's leading paper, Le Monde, read "10 days to save the euro". Unfortunately, Le Monde has now run that headline four times in as many months, yet the euro looks shakier than ever.

The European Financial Stability Fund, whose resources were to be bolstered to cover Italy's financing needs, is running low on cash, with barely enough in its kitty to cover one year of Italy's expected refinancing. And with Italy and Spain responsible for one-third of its funding, and France risking a credit downgrade if it increases its exposure to the EFSF, the fund's prospects of securing even half the financing it was promised seem remote.

As for the European Central Bank, since May last year it has been forced to buy more than E200 billion of bonds of the countries under pressure, all the while denying it intends to underwrite those countries' borrowing needs. But with the EFSF seriously constrained, it is not clear what alternatives to the ECB exist for refinancing Italy's still mounting, and unsustainably costly, public debt.

Doubtless, European leaders are scrambling to find other options. Ideally, they would like to shift the burden on to the International Monetary Fund, as they can provide resources to the IMF without jeopardising their own credit ratings.

And the possibility of the IMF tapping funding from other states, not least China, makes it even more attractive. But it is far from clear how accommodating other IMF members will be. After all, those with long memories will remember the US, in the lead-up to the collapse of Bretton Woods, trying, but failing, to get the IMF to socialise the losses it was bearing in shoring up the dollar.

Much has changed, but that even the US, at the apogee of its power, could not

dictate terms to other IMF members highlights how dangerous it is to assume the eurozone's wishes will become a reality. Little wonder the eurozone leaders' credibility is frayed to the breaking point.

Persistent pressures on the bond rates of fiscally prudent countries such as Austria and The Netherlands, and the failure of Germany to place the entirety of its most recent bond issue, show markets are beginning to think the unthinkable: the euro's demise.

That they would is easy to understand. The euro doesn't face only an immediate crisis of refinancing and bringing under control the Club Med's debts. It also faces an even more severe problem of restoring the competitiveness, and hence ultimate viability, of the Club Med economies. This requires a reduction of 20 per cent or more in their labour costs relative to those in Germany.

But especially in Europe's distorted labour markets, so large a fall in real wages is virtually unachievable without a combination of devaluation and inflation. Yet the euro removes the first of those instruments while the mandate of the ECB rules out the second.

With those excluded, the only option would be a prolonged period of austerity, in which high unemployment forced nominal wages down. But it is questionable whether the Club Med's fragile political systems could bear the resulting strains. Markets therefore discount this option's credibility, implying that sooner or later the euro must implode.

But it is equally clear that a world without the euro is a possibility the eurozone's leaders cannot envisage. This is partly because of the immediate problems of moving to any successor, including those of preventing a meltdown in banking systems as the Club Med countries default on their way out. The drastic loss in prestige and electoral carnage that could follow from abandoning the euro adds to the fear of a plunge into the unknown.

Yet that resistance also reflects the fact the euro was never merely an abstract political goal. Rather, however misconceived it may have proved, it was a response to three pressing requirements.

First, from the late 1960s on, the Europeans wanted to protect their economies from American monetary irresponsibility. Of course, the roots of that desire

stretch back to Charles de Gaulle's resentment of the US dollar's status as the world's reserve currency. But Gaullist rhetoric would have carried little weight without the wild gyrations in American monetary policy, all too frequently exacerbated by irresponsible fiscal policies. Those were viewed as forcing on to individual European currencies instabilities that weakened and distorted Europe's economy.

Second, across the same period, frequent exchange rate realignments within Europe made it difficult to sustain stable economic policy settings and created recurring uncertainties.

Obviously, those misalignments reflected differences in policy and in the structure, flexibility and resilience of individual economies. But there was a widespread belief that monetary union would stabilise expectations, reinforce the credibility of commitments to an anti-inflationary stance and ultimately force the pace on painful micro-economic reforms.

Monetary union, with a genuinely independent central bank, would therefore act as both an anchor and astraitjacket for the European economies, and especially for the weaker among them.

Third, political elites in France and Germany saw the euro as crucial to achieving a balance of power within Europe.

French president Francois Mitterrand, for example, considered the deutschmark "Germany's atomic bomb" that subjected France to "the tyranny of the mark", most dramatically in 1992-93 when the Bundesbank raised German interest rates to 60-year highs. As British prime minister John Major put it years later, after that experience "the whole French establishment wanted a single currency as a means of tying down Leviathan, of binding the Bundesbank".

For his part, German chancellor Helmut Kohl saw a single currency as a small price to pay for French acquiescence in German reunification, especially if that currency's governance could be built on the Bundesbank model.

That a lesson of Europe's monetary traumas was that "Germany's export interests depend not merely on a functioning internal market (within Europe) but also on the avoidance of currency devaluations within it" made that option even more acceptable. So did the scope for fiscal rules that would limit budget deficits and

public debt, disciplining the all too lax governments of France and southern Europe.

In retrospect, this logic's weaknesses seem as obvious as its strengths. Yet they do not arise from the difficulties identified at the time, including the possibility, rightly stressed by Bank of France governor Jacques de Larosiere, of "permanent disequilibria (within Europe) as a result of divergent evolutions in productivity and prices". Nor do they lie in the widespread evasion, by Germany too, of the promised fiscal disciplines.

Rather, the trouble with the project is that it rests on so fragile a base of political legitimacy: it demands vast sacrifices that were never frankly explained to, much less accepted by, those from whom they would be extracted. When the crisis struck, Europe's leaders could therefore neither articulate a credible vision of how it would be overcome nor secure a mandate for the resources and institutions overcoming it requires.

What began as muddling through has therefore degenerated into a rout. But however lamentable that is, it would be wrong to downplay the real risks the euro's collapse would create.

For even putting aside the practical issues, the single currency's demise would shatter the goalposts that have framed expectations in Europe for more than a decade, leaving both economic policy and the political balance in Europe without bearings.

All too aware of these implications, Europe's leaders are far from throwing in the towel.

Rather, they will persevere for as long as possible with a course of action that imposes enormous costs on the European economies, though it could also force adjustments, notably in labour market regulation, that are greatly overdue.

Born of the global turmoil that began in the late 1960s, the euro was intended as a shelter from the storm. Today, with its crisis nowhere near resolution, it risks proving a death trap for those it shelters. But, as Henry Kissinger once observed, statecraft lies in "rescuing an element of choice from the power of circumstances".

Whether Europe's leaders can do so remains as uncertain as it has ever been.