Supplementary Reading for

Chapter3 Borders and Barriers

How Long Can the Euro Last?

By Heather Stewart

From *The Guardian*

June 5, 2005

When the people of Europe said 'non' and 'nee' to their new constitution last week, the euro bore the brunt of investors' anxiety - and some are now beginning to wonder whether it is time to think the unthinkable: could governments stung by the public's rejection of the European project press the self-destruct button, and blow the single currency apart?

Strains have been showing for some time. While some members of the currency zone, such as Ireland and Spain, are growing at a healthy rate, Italy and Holland are in recession, and France and Germany are struggling with 10 per cent unemployment. The stability and growth pact, the agreement which was to prevent profligate governments going on inflationary spending sprees, has collapsed. And there is little sign so far of the economic 'convergence' that was meant to follow monetary union.

'In the Nineties the dominant theme was fiscal and political convergence on a grand scale. The reality has been that convergence hasn't really happened,' says Ian Stewart of Merrill Lynch. 'We are having simultaneously boom and bust in housing markets; collapsing exports in Italy, booming exports in Germany. The zone remains very diverse.' The premium paid by recession-hit Italy on its government debt, over the rate paid by Germany, has doubled over the past two months, as investors have begun to see cracks in the euro-area.

Stewart believes the markets are simply waking up to the fact that divergences like these are inevitable in any single currency zone; but the poorest-performing states are having to grapple with anti-euro sentiment among workers feeling the full force of global competition.

Rumours that national governments are considering their options were given fresh impetus last week by a story in German magazine *Stern* that finance minister Hans Eichel had discussed with Bundesbank boss Axel Weber the possibility of leaving the single currency. Both men dismissed the story as 'absurd', but it reinforced the jittery market mood about the health of the euro-project.

In the Netherlands, a downturn that began in 2001 after the hi-tech bubble burst is being blamed on the single currency. The Dutch are nostalgic for the days when the guilder was second only to the Deutschmark in strength - and frustrated that the eurozone's spending rules have been broken with impunity by France and Germany while Amsterdam has stuck strictly to the pact. 'The public is rather hostile in the Netherlands about the euro,' says Prof Arij Lans Bovenberg of Tilberg University. 'We have been through a boom-bust cycle; we're currently in the bust.' He believes the euro itself is not to blame, and points the finger at government policies for fuelling the boom. But because the slide into recession followed euro-entry, voters have often blamed monetary union. Their argument has been echoed by the director of the Dutch central bank, Jan Hendrick Brouwer, who told Amsterdam newspaper *Het Parool* in April that his calculations suggested the guilder was undervalued by 5 to 10 per cent against the Deutschmark when the two were locked into monetary union.

Not everyone is unhappy: Spain, which has grown strongly in recent years, was first to vote 'si' to the constitution. Many Spaniards saw euro-membership as the final step in rejoining Europe, after many years of isolation under Franco. It also helps that joining has helped tackle inflation, and cut borrowing costs dramatically. 'When we entered the euro, our mortgage rates went down from 12 per cent to 2 or 3 per cent,' says Prof Juan José Dolado, a Madrid-based economist with the Centre for European Policy Research.

However, Spain and Ireland are lucky. There are enormous differences between the performance of individual member-countries while the economy of the eurozone as a whole is simply not growing very fast. It expanded at an anaemic rate of less than 2 per cent last year, and is expected to be weaker still in 2005. Meanwhile the Frankfurt-based European Central Bank, keen to establish a reputation for cracking down on inflation, is unwilling to cut rates to below their current 2 per cent to kick-start recovery.

There has long been a stand-off between the ECB and Europe's capitals, with Frankfurt calling for member-countries to tighten their budgets and reform labour markets, and governments demanding an interest rate cut.

Danny Gabay of Fathom Consulting, says 'storming the tower in Frankfurt' and demanding an instant rate cut would certainly help boost economic growth. But until labour markets are made more flexible so that wages can do the job that interest rates and exchange rates once did in offsetting differences within the eurozone, growth is unlikely to take off. 'The answer to us is obvious: it's structural reform,' Gabay says. 'But the French are digging a big hole and burying their heads in it.'

That's partly because 'structural reform' of the kind economists are prescribing for France and Germany is very painful in the short term - particularly when it's difficult for laid-off workers to move freely between countries when times get hard.

The euro's founders had hoped that the tensions created by forging a monetary union without political union would generate competition between member-states. In the short term, though, the main consequences have been insecurity, joblessness and protectionism. With last week's no-votes putting the kibosh on economic reforms that might have boosted the eurozone's growth prospects, the pressures of co-existing with one interest rate and 12 different labour markets could become harder and harder to bear. Investors will inevitably be wondering how long the single currency will be able to take the strain.

Euro visions

Netherlands Hostility to the single currency was partly to blame for last week's 'nee' vote. The public felt that prices shot up after they joined and rue abandoning the guilder, symbol of the Netherlands' dominance of the global trading system in the past.

Italy Mired in its third recession since joining, and with businesses suffering badly from low-cost overseas competition, Italy is the prime candidate for pulling out of the euro. Welfare minister Maroni sparked a sell-off in the single currency last week by describing it as a 'disaster', and calling for the return of the lira. Silvio Berlusconi has a good reason to criticise the single currency, because opposition leader Romano Prodi led Rome into monetary union, before running the European Commission.

France The constitution referendum was not seen as a rejection of the single currency, but high unemployment and economic insecurity raise the risk that the government will use a surge in public spending to win over the electorate, undermining the credibility of the currency.

Ireland. The days of the Irish punt are long forgotten: strong growth and lower interest rates have made euro-membership a boon for the Emerald Isle, despite an initial surge in inflation. And far from feeling threatened by the expansion of the EU, Ireland has embraced it, welcoming 100,000 migrants from eastern Europe over the past year.

Germany. The euro is increasingly being blamed for Germany's lacklustre economic performance - more than half the population now say they would like the mighty Deutschmark back. Finance minister Wolfgang Clement said last week that Germany was 'paying a not inconsiderable economic price', because real interest rates are higher for eurozone states, where inflation is low, than for high-inflation countries. Clement said that a single interest rate across the eurozone, 'in my opinion does not reward enough the contribution Germany is making to European stability'.

Read the article and answer the following multiple-choice questions:

1. In the first paragraph of this article, the unthinkable refers to the fact that
   A. investors are no longer interested in the euro.
   B. governments want to do away with the euro.
   C. the public has rejected the European project.
   D. terrorists may press the self-destruct button.

2. According to the author of this article, the stability and growth pact has collapsed because
   A. Ireland and Spain are growing at a healthy rate.
   B. There is no sign of the economic 'convergence' in Europe.
   C. it failed to prevent European governments from spending too much.
   D. France and Germany are struggling with 10 per cent unemployment.

3. The major theme of the nineties was fiscal and political convergence, but the reality now is
   A. exports in Italy are collapsing.
   B. the theme turned out to be a failure.
   C. Investors have seen cracks in the euro zone.
   D. There is both boom and bust in housing markets.

4. After a story was published in German magazine *Stern*, the European people
   A. seem to be unaffected by the rumours.
   B. are considering leaving the single currency.
   C. are more concerned with the health of the euro-project.
   D. seem to have the anti-euro sentiment among themselves.

5. According to Prof Arij Lans Bovenberg of Tilberg University, the reason why the public is hostile in the Netherlands about the euro is that
   A the euro itself is to blame.

B　the guilder was undervalued.

C　they are currently in the bust.

D　they have been through a boom-bust cycle.

6. Although countries like Spain and Ireland are lucky, the eurozone economy as whole is

A　growing very slowly.

B　growing not very fast.

C　growing at a rate of 2 percent.

D　expected to grow faster in 2005.

7. In paragraph 9 of this article, the phrase “stand-off” probably means

A　a distance.

B　maintenance.

C　jumping stand.

D　a course away from shore.

8. According to Danny Gabay of Fathom Consulting, the key to the economic growth in the eurozone lies in

A　a structural reform in the eurozone.

B　he flexibility of the labour markets.

C　offsetting differences within the eurozone.

D　forging a monetary union without political union.

9. Due to the insecurity, joblessness and protectionism that currently exist in the eurozone, investors are now

A　feeling that they may not be able to make money.

B　feeling a bit uneasy about the eurozone.

C　turning a cold eye toward the eurozone.

D　wondering how long the euro can last.

10. Which of the following statements is true?

A Ireland is a little unhappy about the single currency.

B Romano Prodi believes that the single currency is a disaster in Italy.

C In France, the credibility of the single currency has been undermined.

D The German public believe that they are not paying a considerable price for the euro.

Reference Key:

1 B 2 C 3 B 4 C 5 C 6 B 7 A 8 A 9 D 10 C