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Danger ahead for the mighty euro

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Illustration by Peter Schrank

**Euro-zone economies face external woes and internal tensions**

AT THE World Economic Forum in Davos in January 2001, the mood was sombre. The dotcom bubble had burst spectacularly, the Nasdaq stockmarket had crashed, and the American economy was tipping into recession. Yet most continental Europeans were breezily optimistic. The long years of being lectured about their inadequacies by the Anglo-Saxons were over. Europe had wisely skipped the dotcom mania, and its new currency, the euro, was giving the continent a boost. Some Europeans even dreamed of taking over as the motor of the world economy. But it was not to be, as Europe promptly fell into a deeper recession even than America.

Seven years on, the parallels are uncanny. Continental Europe has sensibly avoided America's subprime follies, it is argued. Its banks are in better shape, average euro-area unemployment of 7.1% is the lowest in almost 20 years, the euro is resurgent and, as Joaquín Almunia, the engaging European economics commissioner, insists, there is no sign of a recession. The commission will trim its forecasts later this month, but euro-area growth is likely to stay close to 2% this year. It is true that the European Central Bank (ECB) in Frankfurt has, like America's Federal Reserve, flooded the financial system with liquidity in response to the credit crunch. But unlike the Fed, it has not so far felt the need to bring down interest rates.

Just as in 2001, however, the outlook for the euro area seems to be deteriorating a lot faster than the optimists had expected. After all, the main reason that the ECB has been reluctant to cut rates is not because growth is so robust but because inflation has picked up to 3.5%—the highest in the euro's nine-year existence. Troubles in the region's two biggest export markets—recession in America and slowdown in Britain—are starting to bite. Exports to Asia have been strong, especially from Germany, but in most countries nervous consumers remain reluctant to spend.

And two bigger worries have emerged. The first is the strength of the euro. A weaker dollar is driving an American export boom; a stronger euro is likely to have the opposite effect in Europe. Mr Almunia says the euro is "overvalued" and adds that, although the impact has been moderate so far, "we are at the

limits, if not beyond them." It is a delusion to suppose that euro-area exports can continue to barrel on regardless of their cost.

The second worry is the housing market. Europe may have avoided the American subprime mess, but in several countries house prices have been even bubblier than in America. They are already falling in Spain and Ireland, and, beyond the euro zone, are starting to do so in Britain. A property bust may not produce an American-style mortgage meltdown, but it will surely topple economies heavily dependent on construction (which accounts for 15% or more of Spanish and Irish GDP, for example).

Indeed, Mr Almunia's home country of Spain appears especially vulnerable. He maintains that Anglo-Saxon commentators are excessively pessimistic about Spain's prospects. But the signs of a sharp slowdown are clear even to the re-elected prime minister, José Luis Rodríguez Zapatero, who has announced a fiscal stimulus to help Spain weather the "turbulence". Given that Spain has in recent years accounted for a big chunk of euro-zone growth and close to half of all jobs created in the euro area, its slowdown will be widely felt. And not just in economics. It will be a lot harder to sell the EU's ambitious plans to cut CO2 emissions in a faltering economy, for instance.

The political fallout will be felt in other ways too, because of the differential performance of euro-area economies. Mr Almunia admits that France and Italy are a lot weaker than Germany; soon enough, French and Italian leaders (especially if Silvio Berlusconi wins Italy's imminent election) will squeal ever more loudly about the euro's strength, the ECB's rigid monetary policy and, quite possibly, will demand that their industries be protected from "unfair" competition. Such pressure will be resisted by the Germans, who remain comfortable with the euro's strength and always hate criticism of the ECB.

The dark face of success

Even critics of the euro would concede that it has had considerable success, establishing itself in less than a decade as a genuine rival to the dollar as a world currency. But that success disguises two failings. The first is that some countries have adapted a lot better to the discipline of the euro than others. Germany and the Netherlands have cut labour costs and introduced enough reforms to make their economies more competitive. France, Spain and especially Italy have done less—and are suffering more, from both the euro's rise and the global slowdown.

The second failing is an ironic flipside of success. To qualify for the euro in the late 1990s, countries such as Italy and Spain had to make swingeing fiscal and structural adjustments. Yet by shielding weaker countries from a currency crisis, the euro now relieves much of the pressure on them to keep up reforms. In fact, these are more essential than ever now that countries have lost the option of devaluing their currencies to regain competitiveness and offset relatively slow productivity growth. As Mr Almunia sadly concedes, it has proved impossible "to compensate for the lack of market incentives for reform through policy co-ordination and peer pressure".

In truth, as the euro approaches its tenth birthday celebrations, it is facing the biggest test of its short life. If Europe follows America into recession, which is quite possible, the pain will be a lot greater in the Mediterranean countries than in Germany and northern Europe. Not surprisingly, the political response from the two regions will also be quite different. Even as it prepares to expand once more to take in Slovakia and later other countries from eastern Europe, the euro is about to show the world that it is not yet an optimal currency area—and the demonstration may not be a pretty one.