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Europe delays the inevitable

The euro was always an unsustainable idea, says **Deepak Lal**

With the recent downgrading by Standard & Poor's of the sovereign debt of France and Austria, and the further discounts of the debt of the Club Med countries, the euro crisis could be reaching its denouement. This could be triggered fairly soon by the impasse on the "haircut" on Greek debt, which needs to be rolled over in late March. Or this slow-motion train crash of the euro zone could go on for some time, as its politicians continue to seek various palliatives without recognising the basic design flaw in the euro.

A lecture I gave in 1999 before the launch of the euro on "EMU and Globalisation" (Policy Series No. 17, Politiea, London; reprinted in my *Lost Causes* [in press]) emphasised how this was a misguided project, since the euro zone was not a natural "optimum currency area" and without a fiscal-cum-political union, a monetary union of such economically and culturally diverse countries was unsustainable. I had argued that its future depended on a contest between the "dinosaurs", who saw the euro as a means of maintaining the unreformed labour markets and generous welfare states of the "social market economy", and the "modernisers", who saw the need to create flexible labour markets and to curb the excesses of their burgeoning welfare states. Germany turned out, *par excellence,* to be a moderniser; the Club Med countries and France continued to be dinosaurs.

With the pre-financial crisis worldwide boom, and its reformed labour markets, Germany's real wage fell relative to those in the Club Med countries. Denied their traditional route of devaluation to regain competiveness, the Club Med countries ran trade deficits financed by the growing trade surpluses of Germany. This inflow of capital, in turn, fuelled a boom in non-traded services – particularly housing and banking – as their real exchange rates rose, and allowed their "entitlement economies" to flourish. With the global financial crisis of 2008, the unsustainability of the public and private debt accumulated during the earlier boom became manifest. The Club Med countries have found themselves in an actual or incipient sovereign debt crisis.

There is little hope that they can grow themselves out of the crisis, even if the private and public holders of their debt take sufficient haircuts. That is because, without devaluation, they cannot attain competiveness. The alternative they have been forced to accept, in order to keep the euro project alive, is an internal devaluation through massive and prolonged deflation to lower their real wages below those of their northern European peers, particularly Germany. This seems politically unviable as the riots in Greece (and their likelihood in Italy as signalled recently by Monti) attest. The break-up of the euro zone is imminent, unless the Germans and the other northern Europeans are willing to continually subsidise their southern neighbours — an equally unlikely prospect

In the mid-1960s, when I was a lecturer at Christ Church, Oxford, my senior PPE colleague was Roy Harrod. At lunch, after giving the last lecture before retirement of his "Currency and Credit" course, he said that he had spent the entire lecture attacking Britain's desire to join the European Economic Community (EEC). He saw the European project as a disguised attempt by Germany to establish the European hegemony it had failed to achieve through two World Wars. He asked rhetorically how he would be able to look upon the graves of his many friends and colleagues who had tried to prevent this outcome during the two World Wars.

With the euro zone moving towards some form of quasi-fiscal union to deal with the sovereign debt crises facing its southern periphery, this outcome is possible. But it would imply Germany accepting the continuous subsidisation of its southern neighbours for the political end of achieving a united Europe, with Germany as the hegemon and the Club Med countries (including France) as its vassal client regions. It is equally likely that southern nationalism will derail this project, as they realise their loss of fiscal sovereignty and become like Italy's Mezzogiorno – increasingly dependent on handouts. This could lead to the destruction of the euro – or an exit by the northern Germanic currencies around a new "hard" deutschmark (or perhaps a new "bismarck"?), leaving a southern-Med-euro zone, which could maintain the undervalued euro they need to regain competitiveness and thus growth.

But what of Britain? For nearly two centuries, it has sought to prevent any continental power securing mastery of Europe. But with the end of its Empire, the defeatist British establishment felt that if it could not prevent European integration under Franco-German hegemony, it should try and balance these old enemies within the EEC. In the referendum to join the EEC in the mid-1970s, the electorate were told that they were voting for Britain to be part of a competitive and integrated European common market of sovereign nation states. As, instead, the federalist ambitions of the eurocrats to create a United States of Europe were revealed, with Jacques Delors' push for European Monetary Union (EMU) in the 1980s, the lie behind the referendum claims was exposed, and Europe has since been a toxic divide in British politics.

However, Gordon Brown's refusal to join the euro will be seen as his greatest contribution to British prosperity. The fiscal mess he left his successors is worse than that of many Club Med countries; however, unlike them, with exchange rate flexibility and the ability to follow an independent monetary policy tailored to its needs, it should be able to complete reining in its entitlement economy and the accompanying fiscal excesses without damaging growth. This explains why British sovereign debt retains its triple-A rating — much to the chagrin of the less indebted French. David Cameron's refusal to join the quasi-fiscal union being promoted by Europe's new Iron Lady will hopefully begin to reverse the fatal mistake that post-imperial Britain made in the 1960s (see my column "Shrinking Albion", *Business Standard,* August 2010), when it chose to break its long cultural, commercial and familial links with its thriving ex-colonies grouped in the Commonwealth, to join an increasingly sclerotic Europe.