



Euro Wreckage: the chickens come home to roost

Joachim Fels of Morgan Stanley may be the 'first' of the major investment bank analysts to throw down the gauntlet on the frailties of EMU (and implicitly, the Euro). Our friend, Bernard Connolly, has long railed against the EU and its monetary offspring, the ECB and the Euro. Fels' criticisms repeat many of Connolly's observations from years past. Worry about dissolution may not seem such an "outlier" in the future.

We expect other analysts will join the club of skeptics that now surrounds the EU---particularly as regards monetary unification. Whether the 'divergence trade' now becomes the trade *du jour* is something we will only learn with the passage of time. So far, those who have played the "divergence" trade have not been rewarded, but the early participants in a "macro trade" often have to show great patience. Even the Parmalat affair has not resulted in widening credit spreads in Italy, at least until now. But, as this scandal unfolds, we wonder if other European scandals will now make their appearance. It takes a lot to pry out the first stone in a wall. After that, it gets much easier. We wonder if the end of the beginning has now come to pass. Parmalat will be a huge hickey---but we believe that it cannot be a singular event. Who knows where the next episode will occur? In our view, it is the coexistence of bottoms-up events coupled to a new macro paradigm that often provides the catalyst for unraveling previously held, strong convictions. Credit worthiness is a judgment call in the last analysis, and judgments need to be made on firms and on countries! One day, the analysts scoff at any suggestions that something seriously can be wrong. The next day, few escape the cloud of suspicion. Remember 1997 in Asia. The Tigers turned into Mangy Cats in very short order!

The EU-ECB-Euro nexus has been a fascinating experiment in geo-economics. At heart, the unification of Europe made political union rather than economics its *raison d'être*, but the vehicles of persuasion have been monetary economics and commercial policies. The presumption has always been that creating the pre-requisites of an Optimal Currency Area could be a top-down affair---i.e. ---by eliminating barriers to cross-country trade and finance, both product and factor markets could be unified much as they are in an economic union (such as the USA), yielding the presumed benefits of low or non-existent transaction costs. But, Europe's success in eliminating factor market barriers is anything but total, even within the borders of the separate, member states. German and French labor markets don't clear through the operation of the price system. What passes for acceptable levels of unemployment in Europe would be intolerable in the U.S.

With regard to rules of investment, the nationality of ownership is still a part of the decision-making process. Any doubt on this is resolved by thinking phones and/or electric utilities. In addition, the EU now faces accession by the countries in East Europe that will require an agreement on agriculture and on a timetable that clearly precludes resolving many internal factor market imperfections. There are many obstacles to true union.

In the U.S., we often resolve distributional issues by just growing faster, but European growth, particularly in the past six years, has been anything but stalwart. Europe also has large issues of economic demography to face---aging 'native' populations and younger immigrants, both legal and illegal. Europeans are often bemused by the 'simplicity' of American politics with regard to these issues, but other than having larger States, Europe has not fashioned self-sustaining solutions either. We are bemused by how much paper is used in covering up such issues. In the final analysis, Europe appears unwilling to give up the notion of a Nation State. That should not really be a surprise. Who else has easily given up that notion outside of Europe?

When Secretary of Defense, Donald Rumsfeld, set off a fire storm last year by opining on the difference between Old and New Europe, he outraged many "Atlanticists." Yet, even Old Europe does not have its Political House in order---let alone the absence of a unified view as between Old and New Europe. Indeed, there is not even real unity on Economic Policy among the original EU States. The Stability and Growth Pact



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proved to be neither stable nor good for growth when push came to shove.

The inability of EU member states to fashion a Constitution does not seem surprising to Americans familiar with our own arguments over Federalism. Most American historians and political scientists who study our constitutional period come away amazed by the political sophistication of the Founding Fathers. **The Federalist Papers** repeatedly addresses these issues with a frankness that Europe avoids. Avoidance, however, is not political leadership. As one colleague commented to me about Europe's difficulties in creating a Constitution, 'Chirac and Schroeder are hardly Hamilton and Madison!' One result is clear. The UK's accession to EMU is probably far beyond reach ---even under Blair. As the contradictions become more evident, the job of persuading the Brits to give over their sovereignty to a Brussels bureaucracy will become impossible, even for a politician of Blair's stature. Even the City has found it profitable not to be a Euro-Area, so who is left in the UK to really provide support for giving up Sterling?

All of this seems to be coming to a head just prior to the next meeting of the G-7 in early February. The Europeans are schizophrenic about their Euro. They love the idea that they are creating a rival to the Dollar, but they are appalled that their floating Euro is now bearing much of the burden of adjustment in the world's international payments system. Unfortunately they can't have a 'strong currency' and be the region that does the 'adjusting,' all at the same time. As it stands, the EU now finds itself between a rock and a hard place. They are coming to the G-7 hoping that the U.S. will help them out. The setting for such realignment is not propitious. Having divided New and Old Europe over Iraq, the EU finance ministers will find they are short of paper sufficient to cover up the breach in foreign policy. Europeans have always thought American politicians either naïve or arrogant. They regard their Social Market Economy as a huge step forward as compared to American capitalism, even if fixing their body economic is proving a very difficult task. At the same time, European leaders profess high regard for Eastern Wisdom. Perhaps they should remember the most famous epigram of Deng Xiao-ping: "Black Cat, White Cat? What does it matter? What counts is who catches mice?"

What Europe needs are political leaders who could translate that wisdom into a EU context. The EU needs to ask itself, 'Weak Euro, Strong Euro? What does it matter?' What counts is whether the EU economy grows sufficiently and generates jobs. How long will it be until even the Germans come to think that the ECB will have to rescue Europe's bacon? It is delicious for a naïve American to ponder the Bundesbank leading a revolt on monetary policy at the ECB with its new, French President? Or maybe the French will wish to disrupt the ECB's placidity by changing the rules for monetary policy?

What Fels is saying---and we suspect more will join him---is that faltering growth and weak employment are an inconsistent basis for a strong Euro. Since fiscal policy in the EU is dead, the ECB is the only union-wide policy institution. Sooner or later even the ECB will have to fire its guns because in the EU, it is the only gun left.

The ultimate joke would be twisting Churchill's wonderful maxim on American decision-making to apply to those wise, old Europeans...the one about America always making the right decision, after it has tried all the wrong ones!