INTRODUCTION: THE STORY OF THE EURO

> *The Euro, probably more than any other currency, represents the mutual confidence at the heart of our community. It is the first currency that has not only severed its link to gold, but also its link to the nation-state.*
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> Wim Duisenberg, President, European Central Bank, 2002[1]

The Euro, according to its supporters – and they abound in their millions, within and beyond Europe – is one of the Old Continent's brightest and grandest success stories. The supranational money at the heart of Economic and Monetary Union (EMU) launched in 1999 has become the second most important international currency after the US dollar – and one day could supersede it. The European single currency, with a unified monetary and interest rate policy across the sixteen-country EMU area, is breaking down barriers between people, companies and markets – a central component of post-Cold War Europe following the fall of the Berlin Wall and the reunification of Germany. During the international financial convulsions of 2007–08 the single currency protected Europe from still worse fall-out from the credit crisis that started in the US and then spread to the whole world.

The Euro's advocates extol how it enhances economic performance and social integration across a continent that not long ago was beset by Eurosclerosis and divided into Communist and capitalist blocs. The independent European Central Bank (ECB), running the Euro from Frankfurt in Germany, has become an institution of world-wide renown. The Euro area makes up one-fifth of the global economy and a population of 320 million – in economic size, roughly equivalent to the US. EMU's members include three of the world's top seven economies – Germany, France and Italy[2] – as well as the Netherlands, Belgium and Luxembourg, the three other founders of the original six-nation European Economic Community that started in 1958. The success of the Euro lies in its diversity, its devotees say: the other ten Euro adherents, with highly disparate pedigrees, all joined what is now the twenty-seven-state European Union (EU) over the past three and a half decades. Ireland, Cyprus and Malta were formerly under British dominion. Slovenia and Slovakia were Communist countries up to the end of the Cold War. Austria and Finland were neutral. Greece, Portugal and Spain (in 2008, the world's ninth largest economy) were dictatorships up to the 1970s.[3]

Confirming its long-held ambivalence over European integration, Britain has decided – resolutely, maybe obdurately – to remain outside EMU. Two of the other top ten economies in the European Union – Sweden and Poland – remain, too, on the sidelines, although for different reasons; formerly Communist Poland is one of the Central and Eastern Europe states that are candidates to join in the second decade of the twenty-first century. If the Euro performs well, all the non-adherents, including Britain and the other long-time EU member that has chosen non-Euro status, Denmark, will be under growing pressure to join. Indeed, in many ways, the Euro knows no boundaries. Vast numbers of people outside the Euro area have high regard for the solidity and sheer convenience of the European monetary unit. In cash terms during 2008 there were 15 to 20 per cent more Euros in world-wide circulation than dollars.[4] In Asia, Latin America and the Middle East, the Euro supplies a template for a wide range of regional monetary unions that may be established in coming years.

Underlining its international influence, the European Central Bank's authority is second only to that of the Federal Reserve Board in Washington, repository of the no-longer-so-mighty dollar. The ECB's achievements in supplying vast quantities of much-needed liquidity to international banks in the wake of the sub-prime mortgage crisis that erupted in the US in August 2007 earned the respect of many previous critics. As the world grappled with the fall-out of the credit upheaval, as well as the interlinked challenges of an explosion in oil prices and a substantial economic slowdown, the ECB appeared, to many, as a safe harbour in a storm. According to a widely-held notion, the world has moved to a new tri-currency system in which America, Europe and China parley over power; the monetary future of the globe is in the hands of a triumvirate of central banks in Washington, Frankfurt and Beijing.

Yet the rosy assessment of the Euro does not provide anything like the full picture. According to another much more negative yet still plausible view, EMU is a flawed project and the consequences will haunt Europeans for years to come. Introduced above all for political reasons, the Euro, it is claimed, has failed to bring about sufficient economic convergence among its disparate members. The incongruous membership, the Euro's critics say, is too diverse and lacks the necessary economic flexibility to prosper as a single currency area.[5] Especially in the wake of the post-2007 downturn, which by late 2008 had turned into a full-scale recession, the perils of running a single monetary policy for a group of countries at different stages of development are growing steadily more visible. A prime aim of the decades-long struggle towards monetary union has been to shield Europe from US financial vicissitudes. However, according to the Euro-sceptical viewpoint, the single currency has made Europe more vulnerable to international monetary turmoil, by extending the global links between Europe's now-widened capital markets and the US – and also by exacerbating unhelpful sources of rigidity in the continent's economic management. The rise in the Euro's popularity among investors and banks reflects far less Europe's innate financial attractiveness, far more the profligacy of US politicians presiding over a steady decline in the dollar, progressively weighed down in the 2000s by America's deteriorating finances, with both the internal budget deficit and the current account deficit running at around 5 per cent of GDP in 2008.[6] Even the astonishing rise in circulation of cross-border Euros is a negative factor, on this view, since it partly reflects the tendency of international criminals to hold their illegitimate gains in large-denomination Euro banknotes, which are seen as more convenient and secure than dollars.

The negative interpretation of the Euro's speedily-won status is that pride goes before a fall. Rather than catalysing European renewal, the Euro is holding back Europe's efforts to repair its position in a world where economic dynamism is migrating to America and Asia. Still worse, emerging divisions threaten the fifty-year-old process of post-Second World War European unification. EMU economies – although growing together in many ways – display wide and sometimes increasing imbalances. At the heart of the matter is Germany, Europe's strongest economy, which by 2008 had substantially (though not wholly) recovered from the trials of reunification eighteen years previously. Fixed European exchange rates provide disproportionate support for Germany's export-orientated economy by making its industrial sales extremely competitive throughout most of Europe, increasing Germany's export surplus to record levels, and deflecting its attention from the necessary task of stimulating domestic demand – an outcome that would help both itself and its neighbours.

Ironically, one of the reasons why so much of Europe favoured the single currency plan when Germany was reunified was to counter Germany's forecast resurgence. Merging the previously dominant D-Mark with more fragile currencies was forecast to bring a more healthy European equilibrium. That argument was turned on its head in 2006–07. Less competitive countries such as Italy, Spain and Portugal – which can no longer devalue their way out of trouble – needed greatly to improve their economic performances against a newly energised Germany. Although the whole of Europe was weakened by the after-shocks of the US mortgage crisis, Germany seems likely to fare better in coming years than economies that had previously been stimulated by lower interest rates, such as Spain, Ireland and Greece – hard hit when borrowing conditions started to deteriorate in 2007. Britain, which relied on heavy consumer borrowing and a buoyant banking climate for its sixteen-year phase of continuous growth after 1992, has also been badly affected by the credit crunch. However, in the light of the Euro's track record so far, the UK would be well advised not to see EMU membership as a solution to these ills, but to maintain a highly cautious line over membership in the coming decade.

The arresting truth about the Euro is that extreme judgements on its track record and prospects, both positive and negative, can be defended with equal robustness. It is too early to say whether the ten year-old experiment will end in success or failure. The Euro has brought, and will continue to bring, substantial benefits – economic, political and social – to people and states within and outside EMU. Equally, the Euro has exposed shortcomings in economic policy among member countries that – because they can no longer be rectified by devaluation – need to be corrected by painful longer-term adjustments, through lower wage rises, increased working hours and job losses in uncompetitive businesses and sectors. For the broad mass of the European electorate, the Euro's introduction has coincided with a period when the notion of 'Europe' – in stark contrast with most of the previous post-war era – has become a byword for unpopular economic restructuring and belt-tightening.

All this adds up to an extreme set of challenges for the single currency and the political structures behind it. In view of the overarching hopes and expectations that have been invested in the Euro, mere survival is not enough. EMU must provide a genuine route for European countries to improve their economic performances, in a century that will see increasing strength from China, India and other fast-growing developing economies. If that is not the case, the gap between the more and less successful members of monetary union will widen further. And the Euro will face the danger of fragmentation, with either strong or weak countries separating from the system and reintroducing – despite all the costs and upheaval – some form of national currency management more suited to their economic requirements.

One reason for the fascination of the Euro – and the welter of contradictory opinions and forecasts that surround it – is that it marks a comprehensive break with the past. In the 4,000 years since money was invented as a means of exchange, a unit of account and a store of value, monetary policy has always been the stuff of sages, the arena of experts; currency management has seldom formed the vanguard of high politics. The coins of nations provide a guide to the march of events and the fluctuations of statehood, but they are no pioneering force. The members of that most mysterious of communities, the fraternity of central bankers, are called upon for counsel during upheaval, or to restore equilibrium when political and military turmoil wreaks economic disorder. But, in normal circumstances, they work behind the scenes, in response to change. They are followers of transition; they do not fashion it.

The Euro put an end to all that.

An avowedly historical approach to the Euro, such as this book takes, is necessary because the project has been so long in gestation – a chronicle that extends back well beyond the fall of the Berlin Wall, the formation of the European Community, and even the First World War. In a honeycomb of documents in state archives, and in the complex testimony of scores of politicians and officials who accompanied the single currency's journey, lie the secrets behind decades of intricate political infighting that led to the Euro's birth. Yet the fusion of European currencies decided in December 1991 by European leaders at Maastricht in the Netherlands, and launched eight years later for a founding group of eleven European Union countries, was not – in contrast to many past monetary reconfigurations – a product of military upheaval or social insurgency. Money no longer fought a rearguard action behind the lines; it marched to the fore, the spearhead of the new Europe. The new currency and the European Central Bank behind it were themselves the agents for forceful change.

The motivations of the Maastricht treaty were manifold; the diversity of objectives beguiling. A European money would bridge the past, the present and the future, healing social wounds, strengthening political bonds, and reviving economic fortunes. Maastricht brought to a new plane all the international monetary stabilisation efforts put into effect in Europe over hundreds of years. Most of them had ended in failure; all the more reason why the leap forward decided in the Netherlands was prepared with devotional care.

One great aim of EMU was to take further the process of European integration and recovery started after the Second World War with the 1947 European aid programme of US Secretary of State George Marshall. Despite many false starts, interruptions and setbacks, the economic building blocks of the Continent – coal, steel, industry, trade and finance – were progressively fused together. In a process which Britain supported but decided not to join, European cooperation continued with the establishment of the European Payments Union (EPU) in 1950[7] and the European Coal and Steel Community (ECSC) in 1951. The 1957 Treaty of Rome, signed by the founder members of the European Community, pledged to drive Europe on to 'ever closer union' as a means of rebuilding peace and prosperity.[8] The six-nation customs union of the European Economic Community was merged in 1967 with the two other European Communities – the ECSC and the European Atomic Energy Community (for developing nuclear power) – under a single executive body, the European Commission. The European Community (as it became known) took a further leap towards liberalised trade in 1986 when governments decided on a free-trade European Single Market that was then progressively implemented up to 1993. 'A single currency for a single market' became Maastricht's clarion call.

The currency market principles underlying the Maastricht decision marked an important ideological divide among the industrial countries that take the lion's share of the global economy. For the US, Britain, Japan and many other economies (including most of the British Commonwealth as well as many developing nations), floating exchange rates had become the norm during the previous two decades, although nearly always combined with certain amounts of currency management through exchange rate pegging, mainly against the dollar. This had been the case since the 1971–73 break-up of the post-war system of fixed exchange rates established at the monetary conference of Bretton Woods in the US in 1944. Under floating, the free flow of funds on financial markets allowed currencies largely to find their own level, steered only sporadically by central banks' foreign exchange intervention. Supporters of the system believed that floating, although sometimes inconvenient, was the best way of tailoring exchange rates to individual countries' economic circumstances, allowing maximum leeway for growth, trade and investment.

Continental Europe, led by France and Germany, had joined the general move to floating with greater or lesser degrees of reluctance, and held a generally negative view about the consequences of the new system. According to prevalent strands of opinion in these countries, fully floating rates represented an invitation to speculation and distortion that was inimical to sound economic management and rising welfare. To avoid these outcomes, floating