

The Euro After the French Referendum
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Financial markets are still absorbing the implications of the French referendum. While a negative outcome had been widely anticipated, the size of the margin was nonetheless a surprise. The question on investors' lips is what this means for the euro and the larger European project.

In reality, there is no single valid interpretation of the French "*non*." A few voters objected to the constitution as too long, too complicated, and too opaque. Others saw the referendum as an opportunity to embarrass the government of Jacques Chirac, special elections of this sort being a standing invitation for voters to register their disappointment with a sitting government. Others saw it as a chance to indicate their discomfort with the enlargement of the European Union to Eastern Europe and prospectively Turkey. Still others blamed the EU for the disappointing performance of the French economy. The defeat of the referendum was a classic protest vote – a catch-all of disaffected voters.

The one objection that most unified the opposition was the idea of the constitution as a symbolic step in the direction of political integration. French voters clearly signaled that they are not prepared to contemplate a federal Europe in which significant political control is ceded to Brussels by the nation state. For more than half a century, France along with Germany has been one of the dual motors of the integration process. If a majority of French men and women are now opposed to further political integration, then this clearly will not happen anytime soon.

This is a disappointment for French statesmen like Jacques Delors and Valéry Giscard D'Estaing who had always seen the euro as a stepping stone to a federal Europe.

The euro, in their view, encouraged movement in this direction by creating a more deeply integrated European economy. By increasing price transparency and reducing transactions costs, it stimulated cross-border business, especially in financial markets. This in turn encouraged individuals to think of themselves as residents of Europe as much as they think of themselves as residents of their own particular country. There is some evidence of this dynamic at work among the more economically mobile members of the younger generation who one encounters on the morning flight from Paris to Munich, and who are generally more favorably disposed toward the European constitution.

In addition, its advocates see the euro as creating a desire for stronger federal political institutions as a political counterweight to the European Central Bank. Ever since its advent, there has been the question of who will hold the powerful members of the ECB Board accountable for their actions. The answer can only be a more powerful European Parliament. The U.S. Congress holds the Fed accountable for its actions by calling its governors to testify, by making public statements, and in extreme instances by threatening to modify the central bank's statutes. Only a more powerful European Parliament could demand comparable political accountability from the ECB.

Now there is good reason to doubt that the European Parliament will gain additional powers anytime soon. Will this lead to a crisis for the euro?

The answer is "not in the short run." There is no crisis of confidence in the ECB as a maker of monetary policy. In turn, this means that there are few complaints about its lack of political accountability. European monetary policy, by any objective standard, is not that bad. Criticism of the ECB is evenly divided between those who would prefer a slightly looser and slightly tighter monetary stance. Those preferring a slightly tighter

policy observe that inflation in the euro zone continues to marginally exceed the 2 per cent upper bound of the ECB's target range. Those preferring a slightly looser policy point to the slow growth of the European economy and the strength of the euro, both of which create the possibility of deflationary pressure down the road.

These disputes receive extensive press coverage. They sell newspapers. But they are simply the standard fodder of monetary policy debates, nothing more. That half of the ECB's critics think its policy is too tight while the other half think that it is too loose is as it should be; it is an indication that its policy stance is broadly appropriate. And so long as this remains the case, Europe can continue with the monetary status quo, more power to European Parliament or not.

Indeed, aside from a few fanatics, not even die-hard opponents of the constitution advocate giving up the euro. One only has to think back to the earlier French referendum on the Maastricht Treaty, and to the chaos it precipitated in foreign exchange markets, to appreciate how much better off Europe is in these uncertain political times with its single currency.

The crunch will come when the ECB is faced with a major crisis. Imagine, for example, that the Italian public debt spirals out of control – not a wholly implausible scenario given the recent actions of the Berlusconi government. Eventually, investors could come to doubt the willingness and ability of the country to meet its obligations, leading to a sharp sell-off in Italian debt and a rise in interest rates that compounded the government's fiscal problems. The threat of an Italian default might then spread contagiously through European financial markets. The question is how the ECB would react, and what that reaction implied for the euro.

The first part of this scenario – alarming increases in the public debt of Italy or, for that matter, Greece, Portugal or Germany – is not implausible. Indeed, its plausibility has been heightened by recent reforms of the Stability and Growth Pact. Those reforms are another indication of the reluctance of governments to cede political control of their national affairs to the European Union. They respond to the unwillingness of the French and German governments to allow the European Commission to force changes in their fiscal policies. But the resulting reforms, while making the pact more flexible, also make it more complex and therefore more difficult to enforce. They make it less likely that its sanctions and fines will be applied with the speed and vigor needed to force fiscal imbalances to be corrected before they precipitate a crisis.

At this point the ECB will have a difficult choice. On the one hand it can stand aside and let events run their course. Doing so will teach the offending government a lesson. The latter will have to clean up its own financial mess, presumably at considerable cost to its constituents. In turn this will deter other governments from running similar risks in the future. The possibility that the ECB will respond in this way should not be underestimated. Doing so would be consistent with the no-bailout clause in its statute. It would be consistent with ECB officials' concern with moral hazard. It is also an implication of the fact that monetary union will not be accompanied by political union. If there is no willingness to shift additional responsibility for delicate national prerogatives like fiscal policy to the EU level, then governments will have to live with the consequences of their fiscal actions. The French referendum and the debate over the Stability Pact are reminders that monetary policy may now be an EU responsibility but that fiscal policy is still a national matter.

Alternatively, the ECB may worry that problems in the market for Italian debt will spill over to other financial markets and threaten the solvency of major banks. Fearing that this contagion could precipitate a meltdown, it would respond like the Fed responded to the collapse of the mega-hedge fund Long-Term Capital Management in 1998. It would inject liquidity into European financial markets and, if necessary, buy Italian debt directly. Doing so would prevent Italy's problems from spreading contagiously and precipitating a full-blown crisis. The innate risk aversion of central bankers means that the ECB would be reluctant to let an Italian crisis play itself out even if there was only a limited probability of it precipitating a financial meltdown.

Which response would be better? In reality, no one knows. Not having seen a debt crisis in a major European country in modern times, we can only guess at its consequences. We can only guess whether it would infect other European financial markets and threaten banking systems. The ECB would have to make a difficult call.

Either way, its decision would be strongly criticized. If the central bank responded aggressively to the Italian crisis, it would be criticized for fueling inflation and rewarding fiscal profligacy. If it stood aside and financial instability ensued, it would be accused of dereliction of duty – of neglecting its core responsibility for the stability of Europe's payments and financial systems.

At this point Europe's residents would rightly challenge the wisdom of leaving such important decisions in the hands of a set of anonymous monetary technocrats effectively accountable to no one. In other words, the absence of a political counterweight capable of holding the members of the ECB board accountable for their

actions and to sanction them for taking ill-advised decisions would matter importantly. Europeans would rightly question whether they wouldn't be better off without the euro.

None of this means that the euro will disappear soon or that it will disappear at all. A whole series of low-probability events would have to fall into place for this to occur. First a big European government would have to get into serious financial trouble. Then the ECB would have to make the wrong decision about how to react. The consequences of its error would have to be serious: a financial crisis if it did nothing, a major eruption of inflation if it responded aggressively. None of these events, much less the entire series, is assured. But if they do occur, we will have a reminder of the difficulty of attempting to run a monetary union without a political union.

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