

A Disintegrating Union?

Last week, two important events took place in the European Union. The first was the celebration of the 60th anniversary of the Treaty of Rome which created the European Economic Community (EEC). The Treaty was signed by six nations, the key ones being West Germany, France and Italy. The EEC envisaged free movement of goods, services and capital across the member countries and had evolved from the European Coal and Steel Community (ECSC), in existence since 1951. In the 1870 Franco German war, the basic dispute was about two major coal producing provinces, Alsace and Lorraine. European statesmen like Robert Schuman believed that the ECSC made war between west European nations, particularly France and Germany, “not only unthinkable but materially impossible”. The EEC evolved into today’s 28 nation (soon to be 27 – or even less?) European Union (EU).

Policymakers soon came to realize that a single market is not compatible with ever fluctuating exchange rates and hence created first the exchange rate mechanism (ERM) of the European Monetary System which limited inter se fluctuations, and later (1999) the single currency, the euro. Out of the twenty eight, only seventeen nations are part of the euro zone, and have accepted the obligations of strict limits on fiscal deficits and public debt.

The second major event involves UK, which has always had a less-than-smooth integration in the European economy. Mrs. Thatcher was famously distrusting of the Brussels bureaucracy and the generally social democratic economic philosophy. The pound was a member of the ERM but was ignominiously thrown out when the parity could not be maintained – nor did it participate in the euro. And, last week it has given formal notice to Brussels to withdraw from the European Union as a result of the Brexit referendum of June 2016. The complex divorce negotiations may well take a year or two. In the meantime, there is a possibility of the “United” Kingdom itself getting dis-united: Scottish leaders are planning another referendum on leaving UK – and,

mostly protestant Northern Ireland, currently a part of the UK, may well prefer to join the (mostly Catholic) Republic of Ireland, in order to remain part of the European Union.

If the UK is sure to leave the EU, there are question marks about other countries as well, not so much from the EU as from the euro zone. The two countries most likely to do so are Greece and Italy. Both of them are facing problems in maintaining the financial discipline imposed by the euro zone arrangements. One reason is the increasing gap between the economic and growth conditions in the northern countries led by Germany and the southern countries. The former are doing much better than the latter: a result of the protestant work ethic of the north and the more easy going catholicity of the south?

In Italy, standards of living have remained stagnant since 1999. It is also facing a major banking crisis with non-performing assets estimated at € 200 bn. It wants to form a publicly funded “bad bank” to help solve the problem, but this will require a higher fiscal deficit than currently permitted by the zone rules, which Brussels is not willing to relax. Its public debt as a percentage of GDP (133%) is already well beyond the specified limits. If the impasse remains unresolved, will, one day, Italy think of leaving the euro?

Greece has an even bigger problem, with its GDP down by a third since the sovereign debt crisis of 2008, and the fiscal austerity then imposed. According to the International Monetary Fund, one of the lenders to Greece, its debt, even higher than Italy's (180 % of GDP), is unsustainable and the only solution is a write-off by the European lenders, since the IMF's own charter precludes debt write-offs. Germany has vetoed the idea. Germany's rigid stance is ironic since it has been the largest recipient of debt relief, particularly after 1945 – and its post-war recovery would have been impossible without substantial Marshall Plan aid from the US.

The other side is that Germany is the largest creditor in the books of the European Central Bank with its TARGET 2 balance of € 800 bn, with Italy, Spain and Greece the largest debtors. Should two of the three quit the euro, will the balance be recoverable? No wonder a recent survey of reserves managers of 80 central banks, with aggregate

reserves of \$ 6 trn, pinpointed the instability in the monetary union as their greatest worry.

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