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After the wrangling, Europe could end up with two monetary unions

by David Marsh

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‘I love Germany so much that I'm glad there are two of them.’ In the wake of the decision on the Irish bail-out, the ironic commentary on divided Germany, forged in the 1960s by French author François Mauriac, could apply in future to the European single currency: “I love the euro so much that I am happy to have two of them.”

The scenario outlined many times by the sceptics – and that euro proponents have regularly bombarded with ridicule and contempt – could actually come true. Namely, that sometime in the not too distant future the single currency in its present form may come to an end.

Not that the euro will simply cease to exist from one day to the next. It is more likely that fragmentation will take place between a hard core and a less hard periphery. Exactly how, and when, that will happen remains uncertain. I am also not going to make a judgment about where Ireland belongs in all this. In the last two years, after being led into an impossible position through indescribably irresponsible behaviour by the banks, the Irish have on the whole done the right thing to get out of the mess. Ireland’s tragedy over the last few weeks is that it is a small delivery van caught up in a traffic pile-up involving some juggernaut lorries. Whatever happens to the Irish, I predict that, by 2011-12, economic and monetary union (EMU) as we have known it in Europe since 1999 will be significantly different to what it is today.

We will see, sooner or later, the birth of two disparate twins. A lower valued "Euro-South" and a more expensive Euro-North "(or a "Debtor €" and a "Creditor €"). The Mediterranean members and other fringe countries will be in the first category, the solid, low-inflation nations around Germany will be in the second. There will be monetary, technical and institutional ties between the two groups. But in its essence, content, structure and above all internal solidarity, the euro will change out of all recognition.

A colossal irony. EMU advocates saw its broadening beyond the Germanic core (including the Benelux countries and Austria) as spreading German monetary and financial virtuousness across the whole of Europe. We are in fact witnessing a euro extension – but in very different fashion to that foreseen by the founding fathers, with the likely emergence of two disparate euro blocs.

It was not supposed to come to this. Next year sees the selection of a new president for the European Central Bank. Seven years ago, when Jean-Claude Trichet took over, the expectation was that, by the time of his retirement in 2011, running EMU would be a job fit for a super-star. The euro would be in the ascendancy worldwide. More larger European countries would be joining (the UK, Sweden, Poland). Europe’s currency would rival the dollar. The apogee of euro optimism came with the ECB’s 10th anniversary celebrations. In a ceremony in Frankfurt in June 2008, Trichet called the single currency ‘The most advanced feature of European unity and in many respects its emblem.’

He was right. Now, 2 ½ years later, as European politicians ponder his successor when he leaves office next October, the mood has darkened considerably. The next ECB president seems likely to inherit a monetary bloc in a permanent state of pain and anguish.

The illusion of security has been truly punctured. The Europe-wide fall in interest rates to German levels that accompanied the start of the single currency was used in many countries not to build up productive capacity and prepare economies for the challenges of globalisation, but to fuel consumption and speculative purchases of financial assets and real estate.

There had been many past warnings of the dangers of profligacy by many authoritative figures such as Hans Tietmeyer, president of the Bundesbank during the run-up to EMU in 1993-99. Tietmeyer spoke frequently in the pre-euro years of the risk that EMU states that generated higher inflation than Germany would suffer losses in competitiveness that could no longer (as in the past) be offset by devaluation but could be withstood only by lowering the internal prices of internationally-traded goods and services and, in the last resort, through higher unemployment. This was a strikingly accurate prediction of what has actually happened.

As Europe awakens from complacency, the atmosphere is likely to get still gloomier in 2011. The sobering truth is that, for a mixture of reasons – political, economic and psychological – the single currency bloc has become a zone of well-nigh intractable economic divergence and built-in monetary imbalances. Both for the better- and worse-off members of the euro area, the financing of these imbalances is creating burdens that are increasingly irksome for creditors and debtors alike.

EMU states face a difficult choice as they make up their minds on a successor to Trichet. The various candidates who have been mentioned are aware of the monumental challenges ahead. The task of running the euro may well be entrusted to a representative of a smaller state, just as it was in the first four years of the euro when the ECB president was Wim Duisenberg, the previous head of the Netherlands central bank. Filling the post may be tougher than expected. Few monetary decision-makers wish to go down in history as presiding over the fragmentation or break-up of the European currency.