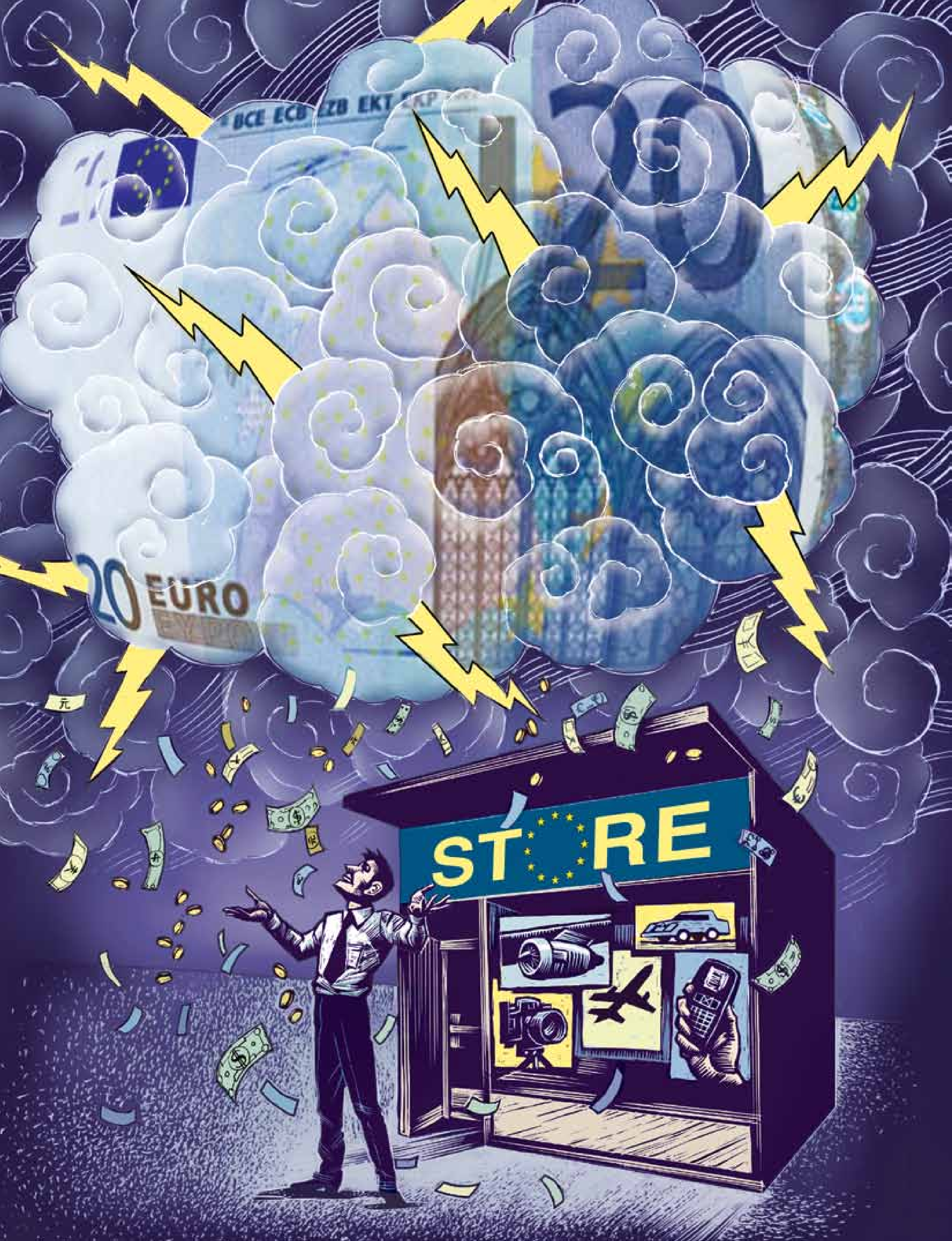
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20 EURO
STORE

Amid grey clouds, opportunity in the euro zone

The storm in the euro zone shows no signs of blowing itself out. The European Union's belated decision to create a 750 billion euro rescue package has done little to calm the markets.

The euro has continued to fall against the dollar. And dismal economic news has continued to multiply. Euro zone unemployment is now 10.2 percent. The European Central Bank warns that European banks face more than $239 billion in write-downs before the end of the year. The crisis is taking its toll on Europe's vaunted social model, and people have taken to the streets to express their fury. Some public-sector workers have gone on strike.

Europeans have at least found a silver lining in all these storm clouds. The lower euro will help give the euro zone a rush of adrenalin. Individual countries may no longer be able to devalue their way out of a crisis. But the decline of the euro will have roughly the same impact on the whole euro zone.

David G. KKlein

By Adrian Wooldridge

Most European business European policymakers

Most European business leaders have welcomed the euro's decline. EADS, Airbus' parent company, calculates that a 10 percent decline of the euro translates into an additional billion dollars in profits. Daimler AG has seen sales of its Mercedes-Benz cars increase by more than 20 percent in the first four months of this year. The attitude of Areva, a French nuclear energy company, toward the euro's decline could be summed up as, "Bring it on." Many luxury goods makers, which play an important role in France, Italy and Spain and sell much of what they produce to rich Americans and Asians, are rubbing their hands in glee. The European tourist industry looks forward to a bonanza as Americans flock to Europe to spend their once-again mighty dollars.

European policymakers are equally positive. They point to O.E.C.D. data which suggests that a 10 percent decline in the value of currency produces three-quarters of a percentage point of extra growth. They bristle at the suggestion that the euro's decline is a sign of weakness. The euro has been severely overvalued for the past four years. It has not so much declined as returned to its proper value, judged on the basis of purchasing power parity, they say. The euro is now in much the same position against the dollar as it was when it was launched, at 1.18 euros to the dollar.

This is all very reasonable. But we should guard against overestimating the benefits that the cheaper euro can bring to the union. There are two big constraints on the benefits of the euro's decline. The first is that the bulk of European trade takes place within the euro zone (which is one reason that the euro was introduced in the first place). Even Germany, which is Europe's most successful exporter, lists France as its number one trading partner. America, a far bigger economy, is number two. The euro's decline may make no difference to the prices that many European companies can charge.

The second is that while the euro's decline makes exports cheaper, it also makes imports more expensive. Most European companies have to pay more for oil and other basic commodities (which tend to be priced in dollars). This means that some European companies are caught in an unexpected trap: they are paying more for their raw materials, but they are selling almost all their products in the euro zone.

There are still other wrinkles in the good news story. Some companies have locked themselves into hedging arrangements that will prevent them from taking advantage of the lower euro for a year or two. Some companies benefited from the higher euro. Banks such as Santander of Spain or Banca Intesa of Italy used the high euro to purchase companies that were based outside the euro zone at rock-bottom prices. We are unlikely to see many more British financial institutions bought up by Santander, for example. And some companies operate in niche markets that are not particularly sensitive to price. Germany in particular abounds in small and medium-sized industrial companies that are market leaders in their fields. Some tailor their products for particular customers. Others, such as RUD in industrial chains, Oerlikon in vacuum and engine technology, and Otto Bock in orthopedic technology, are so dominant that they set standards in their fields.

The biggest problem for European business, however, is that the piecemeal gains that Europe will reap from the lower euro will be swamped by the impact of sharp cuts in public expenditures. Ireland has reduced public-sector salaries by up to 10 percent. Greece is in the process of cutting them by 15 percent. Spain has announced that it will cut them by 7 percent and may have to make further cuts as the crisis plays out.

This will not only reduce demand in countries that are heavily dependent on their state sectors; it could also lead to a wave of strikes that will disrupt a wide range of businesses. Europe could easily lose another three to four million jobs in the next three years. In Spain, which already suffers from 40 percent youth unemployment, an entire generation of people may be lost to the labor market. This generation, condemned to long-term idleness, could provide combustible raw material for parties of the far left or right.

The euro's travails have removed one of European business's most prized assets — certainty. For the most part, European businesses regarded the European project of ever closer integration as a road map to the future. They also regarded the euro as a source of price stability in a quickly changing world. But the euro's precipitous fall has opened up fault lines in the European elite. The Franco-German relationship — the engine of European integration — is in the worst state that it has been in since the euro's founding. Angela Merkel, Germany's chancellor, and Nicolas Sarkozy, France's president, once partners, now appear to have a strained working relationship.

Eurocrats have drawn sharply different conclusions from the crisis. Some argue that the only solution to Europe's problems lies in more Europe — increasing the powers of the European Central Bank, creating a single tax-raising power and allowing the European Union to issue bonds. Members of this school insist that the euro is protecting Europe from yet more instability, particularly a crisis of competitive devaluation.

Some argue that the only solution lies in a looser federation — in loosening the bonds that have linked a highly productive Europe to some of its less productive cousins through what some are now calling Europe's "Instability and Lack of Growth Pact," a play on the Stability and Growth Pact that was key to the establishment of the euro. And some argue that Europe needs to rethink the role of its central bank. They worry that the E.C.B.'s exclusive focus on fighting inflation is counterproductive in a deflationary world and believe that the E.C.B. should model itself on the Federal Reserve Board in the United States, dedicating itself to both promoting growth and holding prices steady.

The euro's fall has also highlighted the problems at the heart of the European economy: Europe's faltering competitiveness. Europe remains heavily dependent on two great engines of job creation and growth — a handful of world-class companies, such as Daimler, and the public sector. Almost all Europe's job creation since 2000 has come in the public sector. But the world-class companies are not creating new jobs. Indeed, many of them are busily shifting not just manufacturing but also research and development to the developing world. And the public sector will be contracting for years to come.

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Europe has failed to make the leap that America made in the 1980's to a more innovative and entrepreneurial style of capitalism. Europeans are much less keen on establishing start-ups than Americans: only 4 percent of German residents are classic entrepreneurs, compared with 11 percent of Americans, according to the Global Entrepreneurship Monitor. And far fewer of those start-ups become big businesses. A list of America's biggest companies includes plenty of companies that have only been around for a few years, such as Google and Facebook. America's biggest company, Wal-Mart Stores, was founded in 1962 and went public only a decade later.

In contrast, the list of Europe's biggest companies has scarcely changed in decades. Only 5 percent of European companies that were created from scratch since 1980 are in the top 1,000 E.U. companies by market capitalisation, according to Janez Potocnik, the E.U.'s former commissioner for science and research and now commissioner for environment. The comparable figure for America is 22 percent. More worrisomely still, many of Europe's high-tech companies look tired. Some of its software heavyweights are thought to be past their primes, while some of its high-tech heroes are looking winded and slow.

This is partly due to cultural attitudes. Europeans tend to be more risk averse than Americans, thanks to a combination of higher tax rates and a punitive attitude toward bankruptcy: Germans are prevented by law from becoming CEOs if they have ever been bankrupt, for example. Such a law in the United States would have stymied many of America's most successful high-tech entrepreneurs. And, deserved or not, Europeans are developing a reputation for being much keener on la dolce vita than on hard work. In the late 1960's, Europeans worked more weeks per year than Americans; today they work 35 to 40 weeks per year while Americans work 46 weeks per year. Europeans are also much more suspicious of business. Forty-two percent of Europeans agree that entrepreneurs exploit other people's work, compared with just 26 percent of Americans, according to a Flash Eurobarometer poll.

These cultural leanings are reinforced by structural factors. The venture capital industry, though growing, is still small by American standards: last year European start-ups received 2.2 billion euros in start-up capital, less than their American equivalents were given in the first quarter of this year alone. The European market remains fragmented compared with the American one: entrepreneurs have to grapple with a patchwork of legal codes and an expensive and time-consuming patent system. The long-awaited unification of European patent law has been held up by bureaucratic quibbles, such as Spain's insistence that all rules should be written in Spanish. In many countries, the tax system and labor laws discourage companies from growing above a certain size. America has at least 50 times as many angel investors as Europe, thanks, in part, to the tax system that leaves more money in individual pockets for investment.

The storm over the euro zone will at least bring some good if it forces Europeans to grapple with these deeper issues of competitiveness. How can countries compete if they remain low on The World Bank's annual "Doing Business" survey? How can Europe kick-start its innovation machine if it fails to tackle patent laws? Europe's social model depends on using the dividends of growth to support a prosperous lifestyle; but the model is now threatening to snuff out the growth on which transfer payments depend.

Yet so far the euro zone's problems have been a distraction rather than a help. We have heard endless discussion about the details of rescue packages and financial architecture. Almost nobody in the European establishment has dared to mention words such as "entrepreneurship" and "deregulation." Even so, a discounted euro is a start.

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