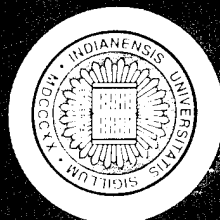


ECONOMIC AND MONETARY INTEGRATION IN THE
EUROPEAN UNION:
AT WHAT COST?



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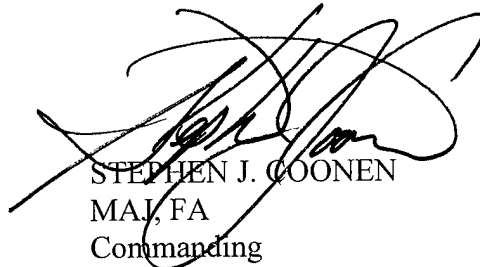
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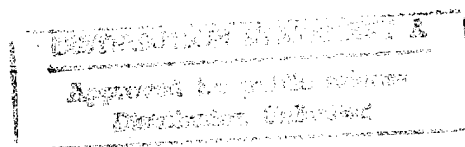
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**ECONOMIC AND MONETARY INTEGRATION IN THE
EUROPEAN UNION:
AT WHAT COST?**

Stephen J. Coonen



Submitted to the faculty of the University Graduate School
in partial fulfillment of the requirements
for the degree
Master of Arts
in the Department of West European Studies
Indiana University

December 1995

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Economic and Monetary Integration in the European Union: At What Cost?

Introduction

Ever since the Treaties of Rome established the European Economic Community, economic and monetary union (EMU) have been one of the desired ends of European integration.¹ Indeed, governments of varying political persuasions of each member state have supported the principle of EMU throughout the decades as witnessed by the series of treaties and agreements they have ratified within the European Union (EU). Despite the general consensus on economic and monetary integration, why then are there still large and perhaps insurmountable obstacles to its achievement? Will short term national political considerations continue to be an inevitable disruption to the integration process? Or, does the precisely mapped-out time table and somewhat rigid convergence criteria for EMU upset the evolutionary nature of the integration process? Was, for example, the exit of the pound and the lira in 1992 from the Exchange Rate Mechanism (ERM) a reaction to forces of this kind? In other words, what are the costs for the member states of the EU and for the EU as a whole in their attempt to establish total economic and monetary unification? This thesis will attempt to answer these questions.

The EU is attempting to swiftly proceed into the final phases of total economic unification. The overall success that the member states have witnessed in the earlier stages of integration, with the establishment of a free trade zone, a customs union, and a

¹While EMU was not specifically mentioned in the Treaty, the Treaty did call for coordination and cooperation of macro-economic policies.

economic and monetary union. The Maastricht Treaty establishes the framework for the final phase of economic integration. Total economic unification refers to both *economic* and *monetary* unification, entailing a single market and single currency, as well as the accompanying economic, monetary, and fiscal policies. The Maastricht Treaty refers to this integration process as EMU.

The integration process consists of a number of factors which simultaneously advance significant obstacles as well as opportunities. In general, obstacles tend to exist in the short term along nationalist lines or within specific industrial sectors. Opportunities, on the other hand, tend to arise in the long term and transcend intra EU boundaries. By observing the success of the integration process in the past to date one can submit that the long term benefits outweigh the short term costs. Historically, this dichotomy has led to an evolutionary integration process of "two steps forward and one step back".²

The Maastricht Treaty specifies a number of factors concerning monetary unification. Principally, two factors present both obstacles and opportunities for the member states and EU institutions: the convergence criteria and the political willingness of member states to surrender national monetary sovereignty and to concede to fiscal restraints. The convergence criteria consists of a number of measures which member states must satisfy in order to proceed to the final stage of monetary union. Paradoxically, they also present some formidable obstacles to achieving EMU. First, the convergence

²This is not merely a cliché, assuming a federalist's approach to integration. Earlier attempts at EMU in the 1970s and the shift to intergovernmental from institutional decision-making with rules of unanimity in the late 1960s serve as examples. This characterization is applicable as well today with the collapse of the ERM. However, should one assume the anti-federalist perspective, the integration process might perhaps be best viewed as two steps backwards, one step forward.

they also present some formidable obstacles to achieving EMU. First, the convergence criteria may be unattainable for a number of states in the foreseeable future. Second, the convergence criteria, when coupled with the lifting of capital controls, places an enormous strain on the ERM which in turn could also preclude certain states from entering the final stage of EMU.

The convergence criteria also place monetary and fiscal restrictions on states. While in the short term this surrendering of national monetary sovereignty and fiscal freedom makes it difficult for states to react to asymmetrical economic shocks, in the long term, monetary union provides for a more stable stronger currency, reinforces confidence, and increases competitiveness.³

Yet, this political dimension of EMU is increasingly important as the common market nears completion. There are other factors to consider as the EU strives for complete economic integration. Today, member states have made unemployment the most crucial issue. This issue and others have significant political implications. Again, the integration process creates opportunities as well as potential obstacles in creating the single market. Governments lose a certain degree of economic sovereignty, such as through the harmonization of social, employment, and tax laws which in the short term may adversely affect their relationship with the electorate. Conversely the citizens of Europe profit from improvements in the freedom of movement of labor, capital, services, and goods, and the benefits of a more competitive economic environment. The EU

³This boldly assumes that the EU develops acceptable "federalist" mechanisms to effectively transfer funds to regions which may experience asymmetrical economic downturns. This is discussed in greater detail in chapter three.

Commission argues that the economic environment under EMU will also reduce unemployment. However, it may also reduce wages in high wage states within the EU. In this regard, monetary integration directly impacts economic integration. Additionally, another political factor for consideration lies in interpreting the criteria to determine which governments are making "continuous" and "significant" progress and which ones are not.

Lastly, one should consider the ability to sustain EMU after it is achieved. Historically, monetary unions among sovereign states have proven unsuccessful if not preceded by a substantial amount of political integration. The dispersal of "federal" funds and the European Central Banking System also present potential monetary and fiscal obstacles for sustaining EMU.

The intent of this thesis is to describe and analyze the different stages of economic and monetary integration in order to explain why this process may become increasingly conflictual and to clarify the costs and benefits of the integration process. One can hardly appreciate the logic of monetary and economic integration and its long term economic benefits for the whole of Europe without also recognizing that EMU also imposes short term costs for certain regions, states, or industries. It is often difficult for national governments to preserve the stimulus towards EMU while simultaneously coping with crises. Subsequently, the focus will be on the possible negative and positive effects of deeper monetary and economic integration. Since the ratification of the Maastricht treaty and the European Monetary System (EMS) crises during 1992 and 1993, there have been numerous studies on monetary unification, but few make a conscious effort to combine it

with economic integration or take into account the current political environment.⁴ This study combines these features.

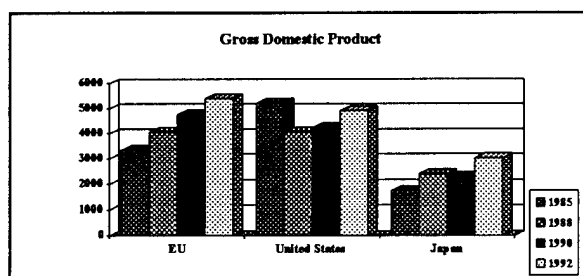
What follows is a brief overview of the different stages of Economic and Monetary Integration to support the proposal that the decision-making process may become more difficult as the number of issues and their complexity increases and as the number of member states increases. A brief history of the European Monetary System from the collapse of the Bretton Woods system to present is also presented to provide an historical basis of EMU and illuminate potential pitfalls and benefits of monetary unification.

Chapter two, "The Road to EMU: Economic Conditions," is an overview of Europe's economic challenges: unemployment and the lack of significant economic growth. These challenges directly influence the ability of the EU member states to achieve EMU. Chapter three, "The Road to EMU: The Maastricht Treaty and Convergence Criteria," analyzes the convergence criteria, the progress of the member states in meeting the criteria, and presents the costs, opportunities and challenges of EMU. I also consider the political implications in interpreting the Maastricht Treaty and the role of public opinion. Chapter four, "Sustaining EMU", evaluates factors impacting on the sustainment of EMU. I discuss the historical record of monetary unions and the question of European fiscal federalism. Chapter five summarizes the previous chapters and proposes a likely outcome to the EMU process.

⁴There are of course exceptions to this trend, most notably the July 1993 issue of *Economics and Politics* where several contributors such as Barry Eichengreen, Jeffery Frieden, Geoffrey Garrett, Benjamin Cohen, Jürgen von Hagen, and Michele Fratianni couple political and economic factors with monetary integration. In addition, both von Hagen and Fratianni have continually maintained that the main impetus behind monetary union (MU) was deeper political union (PU).

Stages of Economic Integration

In order to understand the desired end state of the Union, one should first examine the origins of European integration. The overall enterprise is earmarked with exceptional success. Since the establishment of the European Economic Community (EEC), most of EU members have witnessed unprecedented economic growth and wealth per capita.⁵ (See figure 1 and table 1.) While



In billion ECU

Figure 1. Source: Eurostat

EU GDP per Capita

State	GDP per capita 1991 \$	World Ranking
Luxembourg	30,950	2
Sweden	25,487	5
Finland	24,400	6
Denmark	23,676	8
Germany	21,248	12
France	20,603	13
Austria	20,379	14
Belgium	19,295	16
Italy	18,576	17
Netherlands	18,565	18
United Kingdom	16,748	19
Spain	12,461	25
Ireland	10,782	29
Greece	6,498	38
Portugal	5,626	42

Table 1. Source: *The Economist's World Factbook*, 1993

this phenomenal economic growth is attributed to several factors, such as recovery from World War Two and the provisioning financial assistance for reconstruction under the Marshall Plan, much of the tremendous economic growth can also be ascribed to the effects of liberalizing trade through the creation of the EEC. There is strong economic evidence indicating that the international liberalization of the flows of factors of

⁵In addition member states of the EU share some of the highest levels in health, education, and quality of life standards in the world. Austria, Belgium, Denmark, Finland France, Germany, Ireland, Luxembourg, the Netherlands, Sweden, and the United Kingdom have an adult literacy rate of 99.0 %. All EU states have life expectancy of 75 years or more and tend to have low infant mortality rates. EU citizens enjoy a relatively high consumption of consumer goods such as TVs, telephones, micro-waves and dishwashers. They have the most books published per year and relatively low crime rates. *The Economist, World in Figures*, 1994 edition, 1993.

production increases economic growth.⁶

Additionally, should one consider the intentions of the EU's founding fathers, which were to prevent another European-wide armed conflict, then the entire enterprise has been utterly successful. Today, it is largely unthinkable that any of the EU's members would enter into armed conflict with any other member. It is important to keep these enormously positive facts in mind when observing the problematic elements of integration factors. What follows is a brief historical overview of the progressive stages of European economic integration: from the European Coal and Steel Community (ECSC), to the Treaty of Maastricht, which provides the final framework for complete economic and monetary integration. In each stage the number of issues and their complexity increases. This trend, coupled with growing membership (See table 2.) creates an environment where the decision-making process within the EU is increasingly more complicated.⁷

Dates of Accession to the EU

1957	Germany
	France
	Italy
	Belgium
	Luxembourg
	Netherlands
1973	United Kingdom
	Denmark
	Ireland
1981	Greece
1986	Spain
	Portugal
1995	Austria
	Sweden
	Finland

Table 2

The legal foundation of the Union is a series of treaties and agreements which follow a logical sequence of phasing-in additional steps towards deeper integration. (See table 3.) The intent of economic integration is to improve

⁶See for example Grahame F. Thompson's *The Economic Emergence of a New Europe?*, 1993 or Dennis Swann's *The Economics of the Common Market*, 1992.

⁷The decision-making process has been somewhat facilitated by implementing voting on the basis of qualified majority instead of unanimity. The SEA already established that decisions affecting the economic sphere could be made by a qualified majority. Unanimity is now only required for admitting new members, treaties, and agreement on general principals of the Union.

economic growth and prosperity through the classical economic concepts of free movement of goods, services, capital, and labor. This in turn increases competition and helps to more fully realize the beneficial effects of specialization along the lines of comparative advantage.

Year	Phase of Integration	Implementing Treaty or Agreement
1951	ECSC	Treaty of Paris
1957	Free Trade Area	Treaties of Rome
1968	Customs Union	Treaties of Rome (1957)
1986	Common Market	Treaties of Rome (1957) & Single European Act
1992	Economic and Monetary Union	The Maastricht Treaty

Table 3

European Coal and Steel Community: The origins of European economic integration lay, oddly enough, in national strategic concerns (primarily French) of constraining Germany's war-making capabilities.⁸ The European Coal and Steel Community (1951) provided the first intra-European institute with a supranational decision-making body. The organization oversaw the production of steel and coal. During this period pan-europeanist leaders of the member states continued to develop plans for further integration culminating in the Treaties of Rome.

Free Trade Area: The six founding states signed the Treaties of Rome (1957)

⁸Derek Urwin, *The Community of Europe*, London: Longman, 1991, pp. 43-88, offers an excellent detailed account of the political questions of this era and their corresponding implications.

which established the economic community and provided the original base for total economic integration. With this blueprint the member states rapidly established a free trade area, by eliminating internal tariffs among the member states. Through this elimination of tariffs, goods could be sold between member states without paying duties. However, individual states still maintained varying tariff levels on goods entering their territory from outside the free trade area.

Customs Union: In 1968, eighteen months ahead of schedule, the member states established a customs union by arranging a common external tariff for goods coming into the community from outside members. Both the free trade area and the customs union were agreed to in 1957 under the provisions set forth in the Treaty of Rome, but additional time was needed to implement the customs union in order to phase in the free trade area to minimize the impact of short term shocks to certain industries. With the complete elimination of tariffs between states and a common external tariff, intra-EEC trade increased substantially.

Common Market: Trade increased even more between member states with the passing of the Single European Act (SEA). (See figure 2.) The goal of creating a common market was also provided in the Treaty of

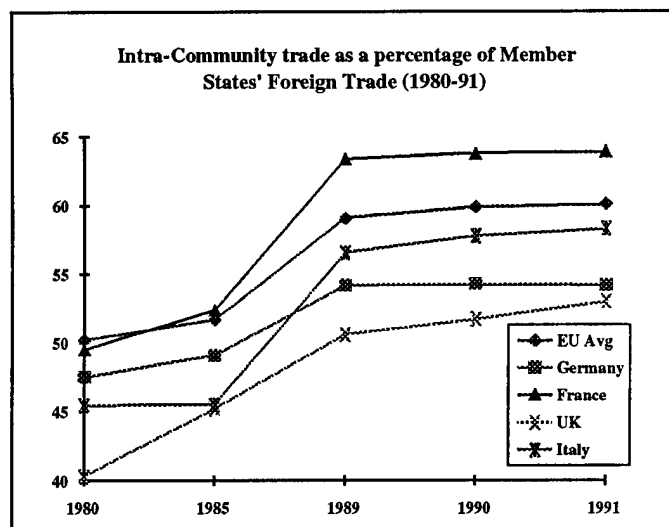


Figure 2. Source: Eurostat

Rome⁹, but additional measures were needed. In 1986, member states passed the SEA, providing the guidelines for the free movement of factors of production (goods, services, capital, and labor). The act entailed 282 directives for member states to implement in order to create the single market. The directives applied to taxes, capital markets, public procurement, standardization, and other items which distorted the free movement of the factors of production. For example the SEA called for the lifting of capital controls to permit capital to flow across borders without governmental interference. In 1994, the European Commission reported that 87 percent of these directives have been implemented.¹⁰ This harmonization process entailed an increasing number of more complex issues, from social laws to tax laws, from industrial standards to educational standards. One can readily observe the higher degree of difficulty with this stage compared to earlier stages by the fact that it is easier to harmonize custom duties than taxes or health and safety standards.

Economic and Monetary Union: With the ratification of the Maastricht Treaty in 1992, the EU entered the final phase of economic integration. Most importantly, the treaty established a program for creating a single European currency, which will be discussed in greater detail below. The treaty also addressed issues concerning the free movement of peoples, such as social policies and border controls, and other internal

⁹The 1957 treaty states: "The Community shall have as its task, by establishing a common market and progressively approximating the economic policies of Member States, to promote throughout the Community a harmonious development of economic activities, a continuous and balanced expansion, an increase in stability, an accelerated raising of the standard of living and closer relations between the States belonging to it."

¹⁰But only half of the 282 measures have been passed by all 12 member states. 'The European Union Survey', *The Economist*, 22 October 1994, p. 15.

procedural considerations. Primarily, the treaty marked the final effort for complete economic and monetary unification by establishing the criteria for a single currency and for fully completing the common market.

Each stage of this evolutionary process, from a free trade area to total economic unification, is progressively more difficult to achieve agreement and implement. This affects both the decision-making process and the process of implementation. (See figure 3.) Initially, as with any liberalizing measure, there is an inherent degree of resistance because of short term adjustment costs for certain interest-groups. As one moves towards deeper integration these measures increasingly influence affairs of the state and its

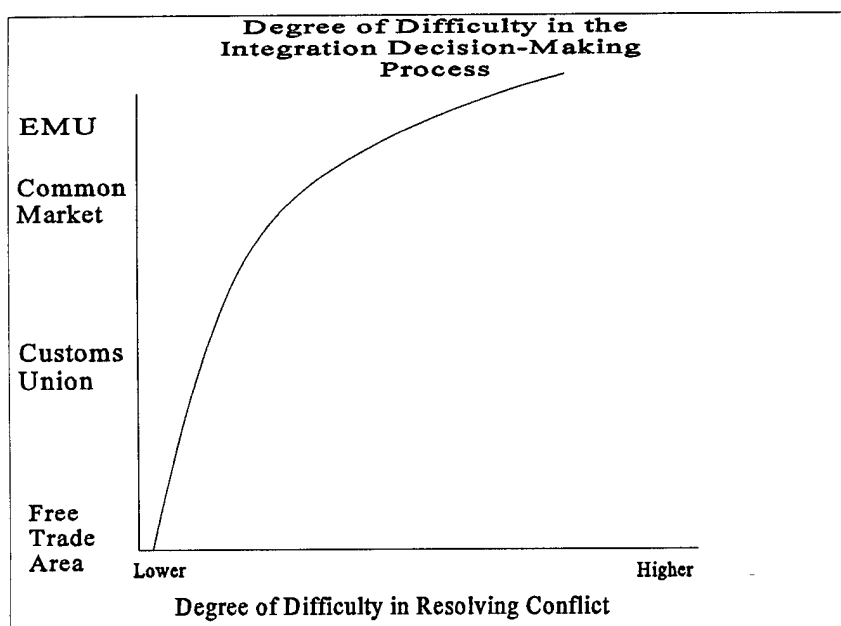


Figure 3

citizenry. States must coordinate and agree to an increasing number of more complex issues which are, at times, equally controversial. Another important aspect is the difficulty states have in surrendering an

increasing amount of national sovereignty with each step of deeper integration.

Despite these obstacles, member states have consistently demonstrated their

political will to proceed with integration by signing and ratifying the treaties and intra-governmental agreements that make this process possible. This is not to say that the historical process of integration has not been plagued with disagreement, but the simple fact that states have reached agreement and have displayed a great deal of flexibility in their compromises, demonstrates an undeniable source of strength. On the other hand, since the issues are increasingly complex and controversial, its precisely in *implementing* later agreements and treaties where one will most likely witness an increasing degree of resistance in resolving conflict.

Stages of Monetary Integration

Economic integration as described above does not necessitate monetary integration until the final phase. Indeed, European leaders could have elected to stop short of monetary integration and still have enjoyed the economic advantages of a common market. Yet, with the Maastricht Treaty, the peoples of Europe resolved to proceed to the final phase of complete economic integration by accepting a plan to shed their national currencies for a European one. However, this final phase involves much more than simply exchanging old coins for new ones. It calls for coordinated and converging fiscal and economic policies and the surrendering of national monetary authority. In return, the peoples of Europe will more fully enjoy the economic advantages associated with the common market.

Several economists contend (Eichengreen, Fratianni, von Hagen) that the sum of the economic advantages and disadvantages is rather small and therefore assert that

the primary drive behind the establishment of a single European currency is not for economic concerns, but rather for political reasons.¹¹ This is supported by Garrett, who suggests that Germany conceded to EMU for political, rather than economic reasons.¹² From an economic vantage point, Germany certainly has the most to lose in establishing a monetary union with states possessing weaker currencies and credibility problems.¹³

Whether the drive behind MU is political or economic, it has nearly a thirty year history. (See Annex 1 for the stages of EMU.) Since the late 1960s there have been serious discussions within the EU about establishing a monetary union.¹⁴ However, unlike economic integration which has transpired in logical sequences of

¹¹Michele Fratianni, 'What Went Wrong with the EMS and European Monetary Union', Working Paper 1.16, University of California, Berkeley, February 1994, Barry Eichengreen, 'European Monetary Unification', *Journal of Economic Literature*, Vol. XXXI, September 1993, pp. 1321-57, Interview with Jürgen Von Hagen on 2 November 1994 and lecture at the International Institute of Graduate Studies, Geneva, 1 December 1993.

¹²Garrett offers several political reasons for Kohl's acceptance of EMU, such as to gain support for rapid German reunification, to pacify U.S. pressure for closer European integration in order to quell fears of Germany emerging as Europe's hegemonic power, and to share the cost of integrating Central European states with other EU members. Geoffrey Garrett, "The Politics of Maastricht", *Economics and Politics*, July 1993, pp. 111-117. Eichengreen and Frieden suggest that Germany conceded to EMU in order to gain a greater voice in foreign affairs issues. Barry Eichengreen and Jeffrey Frieden, "The Political Economy of European Monetary Unification" *Economics and Politics*, July 1993, p. 86. Considering the Maastricht Treaty was signed by the heads of state on 10 December 1991, one could speculate that Germany's bold recognition of Slovenia and Croatia on 15 January 1992 was an extension of this process.

¹³Garrett cites two economic advantages for EMU: Monetary union provides greater price stability than the EMS, especially after the removal of capital controls as mandated by the SEA. This is critical for Germany since it is a large exporter. Secondly, a single European currency (dominated by Germany) could serve as a counterweight to the dollar and yen. Geoffrey Garrett, "The Politics of Maastricht", *Economics and Politics*, July 1993, p. 112.

¹⁴Even at this early date, monetary union was closely linked to broader political concerns. Barry Eichengreen and Jeffrey Frieden, "The Political Economy of European Monetary Unification" *Economics and Politics*, July 1993, p. 86. There was also talk of establishing EMU since the late 1940's starting with the European Payments Union, however, none of these proposals had broad consensus until the Werner Report of the early 1970s. Kenneth Dyson, *Elusive Union*, 1994, pp. 58-89.

increased integration, efforts towards monetary integration have varied throughout this period in its scope and level of success. It is useful to look at this earlier period (1960's to 1980's) because many of the problems which have plagued integration efforts in the past continue to disrupt the process of monetary integration today. In fact, several of these elements have increasingly made monetary systems based on pegged currencies, such as the EMS, unsustainable.

Technical advances in the financial services industry permit actors in this arena to transfer enormous sums of capital with the push of a button and at minute costs. These operations may radically affect exchange rates and limit the central banks' ability to cope with them.

The sheer sum of capital which is exchanged through an increasing number of financial instruments on a daily basis dwarfs the central banks' reserves.¹⁵

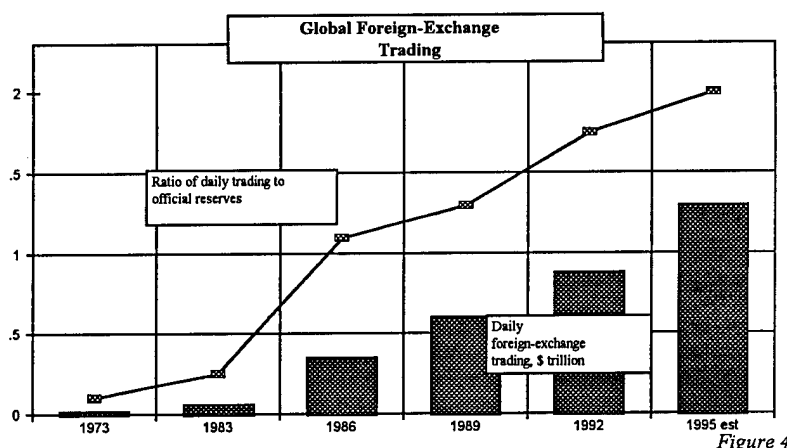


Figure 4

When this is coupled with

the global trend of the gradual removal of capital controls, exchange-rate systems

¹⁵The ten biggest financial centers have seen trading volume increase by an average of 47% since April 1992, suggesting that the total net daily currency trading has jumped to about \$1.3 trillion, from \$880 billion in 1992. In 1973 only \$10 -20 billion of currency was traded. During the same period central banks' reserves have hardly kept pace. In the early 1970s, foreign exchange reserves of the rich industrialized economies were about eight times larger than the daily amount of currency trading; today, it is about half. *The Economist*, 23 September 1995, pp. 63-4. This is also the source for figure 4.

based on pegged rates or target zones are increasingly difficult to sustain.¹⁶

Subsequently, the members of the EMS may find themselves increasingly frustrated by these trends. This in itself threatens the possibility of EU member states reaching the final stage of EMU because it works against the achievement of the convergence criteria for stable rates of exchange. This is discussed in greater detail in chapter three.

In 1968-9 structural changes in the international political economy forced the member states of the EEC to reevaluate their prior opposition to EMU. In this environment, Europe decided to launch the initiative as it witnessed an international monetary crises and the crumbling of the Bretton Woods system. The perception of Germany as a growing relative economic power also influenced this decision.¹⁷ The Bretton Woods system was doomed to fail because of its reliance on U.S. gold-convertible dollars for global liquidity and to sustain stable exchange rates. The growing number of dollars held outside the U.S. would eventually become much greater than the U.S.'s gold reserves and therefore destroyed the confidence in the dollar's convertibility.¹⁸ These faults in the system were apparent by the late 1960s.

The first efforts towards MU materialized with the acceptance of the Werner

¹⁶Barry Eichengreen, *International Monetary Arrangements for the 21st Century*, 1994, pp. 64-73. Furthermore, Eichengreen argues that because of these trends future monetary systems will either be based on monetary union or floating exchange rates.

¹⁷The CAP and the growing awareness of the need for monetary cooperation in response to increasingly interdependent economies also provided a further impetus for an EEC initiative. Kenneth Dyson, *Elusive Union*, 1994, pp. 72-76.

¹⁸Dennis Swann, *The Economics of the Common Market*, 1992, p. 198.

Report in 1971, proposing MU by 1980 with freely convertible currencies at fixed rates of exchange. The plan was based on the assumption that the Bretton Woods system of fixed exchange rates would continue and that European economies would converge thus facilitating economic policy coordination and monetary integration. The Werner system called for a 'snake within a tunnel', in which the European currencies were allowed to fluctuate within a narrower band than against the dollar.¹⁹ However, when the Nixon administration suspended the convertibility of U.S. dollars to gold in 1971, it effectively terminated the Bretton Woods system and destroyed the effectiveness of the dollar as Europe's anchor currency. The shocks of this collapse and the ensuing oil crisis caused Europe's economic policies to diverge;²⁰ the resultant havoc ended with only Germany, the Benelux countries, and Denmark remaining within the system by the end of 1977.

There are several similarities with this system and the current plan for EMU. Both systems were exposed to abnormal economic trauma which resulted in a European-wide recession. In the first case, the economic crises was triggered by the oil crises. The ensuing increases in energy costs led to an inflationary period of little or no economic growth. Under the current European Monetary System (EMS), the

¹⁹This plan was abandoned in March 1973 when Germany, France, Belgium, the Netherlands, Luxembourg, and Denmark decided to float collectively while maintaining the reduced level of fluctuation among themselves. Dennis Swann, *The Economics of the Common Market*, 1992, p. 198.

²⁰Swann cites Kruse on the role of the oil crisis during this period. Kruse suggests that the main factor contributing to the early demise of EMU was the failure of national authorities to coordinate. "It must be stressed that these differences in national economic policies and trends antedated the events of October: the oil crises did not produce them but merely intensified and highlighted them." Dennis Swann, *The Economics of the Common Market*, 1992, p. 200.

economic situation was aggravated by German reunification. Calls for coordination of national economic policies in both the 1970s and the 1990s were also questioned, "...the member states continued to make decisions principally on the basis of national interest rather than according to the dictates of economic and monetary unification."²¹ Italy's and the UK's early departure from the ERM are good examples of this in the 1990s. Recent counter-examples are France's and Spain's fight to remain within the exchange rate mechanism (ERM) at a great cost to employment. One might also suggest that the fiscal and monetary policies of Germany after reunification did not necessarily take into consideration the 'dictates of economic and monetary unification'.²²

Both systems were also exposed to speculative attacks which drove some member states out of the exchange rate bands.²³ A significant difference, however, was the amount of speculative capital that was brought to bear against the ERM in the 1990s. Another significant difference was that states resorted to capital controls in the 1970s attacks; with the implementation of the SEA which eliminated the use of capital

²¹Dennis Swann, *The Economics of the Common Market*, 1992, p. 198.

²²Germany's political leaders chose to finance reunification by borrowing funds on international markets rather than by instituting a heavier tax burden on Germany's citizenry. In addition, Chancellor Kohl offered a very generous exchange rate for the East German mark for intra-German monetary union which created a sharp increase in Germany's monetary supply. As a result of these policies interest rates were substantially higher throughout Europe, prolonging its recession. Subsequently, while these decisions

²³In 1972 the pound encountered heavy speculative pressure and was allowed by U.K. authorities to float out of the narrow band. Ireland and Denmark followed suit, however, Denmark rejoined. In 1973, Italy was forced out of the "snake" and France in 1974. Dennis Swann, *The Economics of the Common Market*, 1992, p. 198. The speculative attacks in 1992-3 are discussed in chapter three.

controls in 1990 this was no longer an option.²⁴ Lastly, both regimes recognized early on that the date for the final stage might not be achieved.²⁵

During 1977-8 new, less ambitious, plans were recommended with the primary goal of establishing a European zone of monetary stability. In March 1979 the EMS went into effect and continues to operate today as one of the preconditions for EMU. The EMS established the European Currency Unit (ECU) as the unit of currency for the EU budget, as the divergence indicator for exchange rate fluctuations, and has also increasingly gained unofficial acceptance in private transactions.²⁶ More importantly, the EMS established an ERM permitting members's currencies to fluctuate up or down within 2.25 percent of each other, subsequently assisting in the stabilization of exchange rates. The EMS also allowed for currency realignments through negotiations; since its inception until the exchange rate crises of 1992-3 there were twelve realignments, eleven of which occurred prior to 1 January 1987. Thus there were five years of relative stability within the system prior to its near fatal crash in 1992-3.

The SEA ushered in a new era of initiatives to launch Europe towards greater integration and went into force in July 1987. Perhaps most significant for MU was

²⁴Resorting to capital controls went against the spirit of the Werner system but was perceived as a necessary evil to remain within the snake. In July 1972, Germany's economic and finance minister, Karl Schiller resigned over Germany's implementation of capital controls and was replaced by Helmut Schmidt. Kenneth Dyson, *Elusive Union*, 1994, p. 85.

²⁵Already at the Paris Summit in 1972 the heads of state failed to reassert that EMU would be achieved no later than 1980. Dennis Swann, *The Economics of the Common Market*, 1992, p. 199.

²⁶Dennis Swann, *The Economics of the Common Market*, 1992, p. 204. The ECU is determined by the collective share of GDP and exports, and by the state's size.

that the SEA directed the removal of capital controls by mid 1990, thus precluding members from again resorting to this tool as they had in the 1970s.

During the Hanover Summit of the European Community (EC) of 1988, the heads of state elected to investigate the possibility of completing the EMU by appointing a committee under Jacques Delors, President of the Commission. The Delors Report was an important precursor to the Maastricht Treaty because it proposed a stage-by-stage plan for MU.

The decision to implement stage one of EMU in July 1990 and to begin preparatory work for an inter-governmental conference on EMU was accepted in June 1989 at the Madrid Summit. Stage one specified the removal of capital controls²⁷ (called for by the SEA) and closer coordination and cooperation of central banks and national economic policies. In stage two, under the Delors plan, a European System of Central Banks would be created to begin the transition to the formulation and implementation of common monetary policies from independent national ones. In stage three exchange rates would be locked and a common currency introduced.

The inter-governmental conference was highlighted by a series of compromises to placate different national concerns. Certain governments had a number of apprehensions over the Delors plan. These reservations were in turn reflected in the Maastricht Treaty. The U.K. government insisted on an option to opt out of EMU

²⁷Dyson suggest that this was a watershed event recognized early by the Commission as a way to strengthen supra nationalism. The removal of capital controls would drastically change the relations between EC monetary authorities and foreign exchange markets. This in turn, ensured that reform of the EMS would be given urgent attention at the highest level. Kenneth Dyson, *Elusive Union*, 1994, p. 121.

and that dates would be indicative but not binding. Both Germany and the U.K. insisted that progress towards MU be measured by the degree of convergence in matters such as rates of inflation, interest rates, and budget deficits.²⁸ Additionally, Germany demanded that the European Central Bank would exercise a large degree of independence.

In December 1991, the European Council signed the Maastricht Treaty. By October 1993 the individual member states had ratified the treaty and it went into force on 1 January 1994, thus putting into effect the plan for complete monetary and economic unification.

²⁸In other words the 'economist' rather than the 'monetarist' approach was to dominate the plan for MU. Dennis Swann, *The Economics of the Common Market*, 1992, p. 220.

Chapter Two

The Road to EMU: Economic Conditions

One simply needs to consider recent EU summit meetings of the heads of states to determine where their overriding concerns lay: unemployment and monetary union.²⁹ Both issues directly reflect the overall health of the European economies and consequently the member states's ability to achieve the final stage of EMU.

The unemployment crisis is indicative of general economic conditions which have only relatively recently begun to appear as an abrupt departure from Europe's earlier economic success. There are a series of other economic issues which either directly or indirectly affect unemployment; lack of economic growth and loss of competitiveness on an international scale. These problems tend to suggest deeper structural deficiencies within Europe's economies other than mere cyclical difficulties. Subsequently, this chapter provides an overview of the economic challenges facing Europe

An analysis of EMU cannot be addressed in isolation of these fundamental economic issues.³⁰ The fact is that as a state's social financial obligations increase due to high rates of unemployment coupled with an ageing population accustomed to generous

²⁹During the Cannes Summit in June 1995, the European Heads of State made the unemployment crisis their most important issue, as it has been since 1992. *The European Councils, Conclusion of the Presidency 1992-1994*, 1995. During the most recent summit in Majorca in September 1995, MU came to the forefront following comments made by the German Finance Minister, Theo Waigel, suggesting that certain states will not qualify for MU.

³⁰Although neglecting current macroeconomic tends to be the case in literature presenting the different aspects of EMU.

pension schemes, tax revenues tend to decrease unless new taxes are imposed, in turn fueling the reluctance of employers to employ the unemployed; and thus raising the prospect for kindling a vicious circle of increased unemployment and increased deficits. Consequently, national leaders find themselves increasingly hard-pressed to reduce their budget deficits and lower their public debt; both of which are preconditions for MU. The convergence criteria also limits the use of traditional counter cyclical macroeconomic tools: exchange rate realignments or monetary measures designed to alter interest rates. Thus, paradoxically, while EMU is desirable for its potential salubrious effect for curing Europe's economic ills,³¹ these same ailments threaten the EMU's implementation, or its sustainment should EMU be achieved. The monetary and fiscal preconditions specified under the Maastricht Treaty for the EMU will be discussed in the next chapter.

Europe's Economic Challenges:

Employment

Since the oil crisis of the 1970's Europe has experienced a steady increase in its rate of unemployment. Prior to this period, European states had traditionally maintained

³¹In the European Commissioner's White Paper *Growth, Competitiveness, Employment: The Challenges and Ways Forward into the 21st Century*, 1994, pp. 64-67, the Commission cites EMU as one of the main macroeconomic policies to enhance growth and employment. On the other hand, the House of Lords Select Committee on the European Communities question the validity of the Commission's assumption that "the continuation of the EMU process is a key element to secure a stable macroeconomic framework enabling the achievement of higher sustainable growth." *Seventh Report From the European Communities Committee*, 1994, p. 28. In oral evidence given on 18 January 1994 to the House of Lords Select Committee on the European Communities, Christopher Johnson, UK Representative of the Association for the Monetary Union of Europe, stated, "We do not believe that unemployment should be added to the list of criteria, [EMU convergence criteria] but the others on the list are unlikely to be met as long as unemployment remains as high as it is now. The EMU project cannot be blamed for unemployment, nor can it in itself offer a solution." *Ibid.*, p. 74.

unemployment rates which were below three percent. Today the unemployment rate hovers at just over ten percent,³² despite the fact that Europe has experienced positive GDP growth since the beginning of 1993. This lack of work for Europe's employable citizens has increasingly become a major concern for European leaders. The rise of unemployment is not only overwhelming the social welfare state, political leaders and security strategists are beginning to perceive this rise in unemployment as a potential threat to Europe's political stability.³³ Additionally, in regards to our concerns here, unemployment, and its implied host of other economic afflictions, risks blocking the road to EMU. Or, conversely, the efforts to meet the EMU preconditions may produce unbearable domestic unrest if trends in employment are not reversed beforehand.³⁴

The high rates of unemployment, the lack of substantial economic growth, and the loss of international competitiveness, all suggest the existence of structural economic deficiencies within Europe. When these deficiencies are combined with increased internal

³²Unemployment rates range from 3.9% in Luxembourg to 22.1% in Spain. Additionally, throughout the EU a fifth of those under 25 years are jobless. *The Economist*, 30 September 1995, p. 57.

³³With the end of the cold war several security analysts have scanned the security spectrum in search of new security threats such as mass immigration, scarce water resources, the environment, and economic difficulties. Sir Michael Howard specifically identified Europe's economic woes as a potential security threat during a presentation at the International Training Course on International Security and Arms Control at the Institute des Hautes Etudes Internationales de Geneve in October 1993. A possible indicator of this trend is the increase of political support for extremist political parties in Europe. Also, "regardless of the form it takes - low-paid, low quality jobs or overt unemployment - the present unemployment problem of member countries is serious. It brings with it unraveling of the social fabric, including a loss of authority of the democratic system, and risks resulting in the disintegration of the international trading system." OECD, *The OECD Jobs Study*, 1994, p. 29. These concerns were again reiterated during the last EU summit at Cannes on 26-27 June 1995, *The Reuter European Community Report*, 27 June 1995.

³⁴For example, aid packages to stimulate short term growth may not be an available option due to the debt and deficit criteria. Japan, for example, has recently announced a spending plan designed to boost its economy, the sixth since 1992. The plan calls for \$136 billion, equivalent to Denmark's GDP, which in turn raises its annual deficit by 1.7% of GDP. One can hardly imagine any EU state implementing a plan of similar scale while simultaneously attempting to meet EMU deficit and debt preconditions. Despite the possibility that the long term gains of pursuing an economic policy of austerity may be worth the short term pain, the electorate may not perceive this pain as a necessary element of enhancing long term prosperity.

competition produced by the single market, one can anticipate a certain degree of national domestic unrest and waning political support for EMU. To a large extent this tendency has already been witnessed by the narrow support for and the difficult ratification process of the Maastricht Treaty, as well as GATT, as well as a recent Eurobarometer poll indicating waning public support for a common currency.³⁵

In response to Europe's employment crisis the Commission of the European Union (EU) published a White Paper in 1994 titled *Growth, Competitiveness, and Employment: The Challenges and Ways Forward into the 21st Century*, in which the member states made contributions. The White Paper immediately points out that the "one and only reason" this paper was undertaken was unemployment,³⁶ however it also illustrates the overall weakness of Europe's economic health. In general the White Paper addresses the issues and offers possible solutions, primarily through greater regulatory and labor flexibility and through improved training, education, and investment. It represents an interesting dichotomy between the pursuit of neo-classical liberal practices and the traditional Keynesian belief in the use of macroeconomic policies.³⁷ The Commission

³⁵EUROPINION N° 5, <http://www.cec.lu/en/comm/dg10/infcom/epo/eo/eo5/eo5.html>, July 1995.

³⁶European Commission, *Growth, Competitiveness, Employment: The Challenges and Ways Forward into the 21st Century*, 1994, p. 9. This was again emphasized by the new EU President of the Commission Santer, who told a group of British industrialist on 17 May 1995 that his number one priority is "competitiveness and jobs". *The Reuter European Community Report*, 17 May 1995.

³⁷There is also a battle being waged between these two schools of economic thought. See for example, David Simpson, *The End of Macro-Economics?*, 1994, who asserts that macro economist have largely failed in their endeavors to guide the economy and recommends a return to classical economic principles. Simpson argues that the use of aggregate concepts are misleading and have contributed to the implementation of unsuccessful and sometimes harmful policies. He also cites a host of other quandaries for the macro economist. Also see Paul Krugman, *Peddling Prosperity*, 1994. On the side of the macro economists see for example Robert J. Gordon, *Is There a Tradeoff Between Unemployment and Productivity Growth?*, 1995 and Robert A Levine and Peter J.E. Stan, *Macroeconomic Strategy for the 1990s*, 1993.

recommends a melange of deregulation and liberalization while it simultaneously calls for government intervention.

Perhaps the greatest challenge is that leaders remain focused on these economic issues as the EU member states come out of recession. The urgency to properly address these critical matters risks fading with the re-establishment of economic growth, only to reemerge during the next cyclical downturn when states are less capable financially to cope with them. In such an environment, there would be potential, albeit small, for the EU to stagnate or possibly disintegrate, even worse would be a catastrophic economic upheaval of significant proportion to cause political collapse in certain states.

I. Unemployment

For the last 25 years Europe's unemployment rate has steadily risen. (See figure

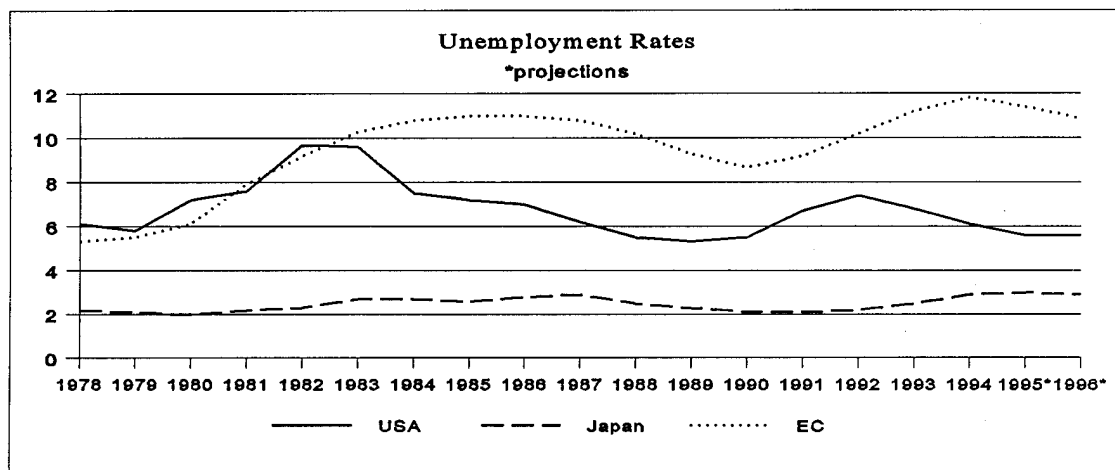


Figure 5. Source: OECD Economic Outlook #56, December 1994

5.)³⁸ Even though EU member states are experiencing economic growth, its unemployment rate is not falling substantially. (See Table 4.) In Germany, Europe's economic powerhouse, Austria, and Belgium the rate of unemployment has actually increased despite economic growth.

An additional characteristic of Europe's unemployment consists both of cyclical unemployment and structural unemployment (or long term unemployment).³⁹ Europe's long term unemployment rate has been on a steady upward incline since the oil shocks of the

Rate of Unemployment

	latest	year ago	Annual % chg GDP
Austria	6.7	6.6	2.7
Belgium	14.9	14.7	3.5
UK	8.2	9.3	2.8
Denmark	10.5	12.4	3.6
France	11.4	12.5	3.0
Germany	9.4	9.3	2.2
Netherlands	6.9	7.2	2.2
Italy	11.3	11.5	4.0
Spain	22.7	24.3	3.2
Sweden	8.2	8.5	4.8

Source: *The Economist*, 30 September 1995
Table 4

³⁸An article published by *The Economist*, 1 July 1995, pp. 26-27. Suggests that Japan's unemployment rate may be substantially higher than revealed by official statistics. It is suggested that the rate may be approaching 10 %. Several individuals who want jobs but are not registered as job seekers are not counted. Additionally, the labor ministry has traditionally paid employment-support subsidies to weak firms not to fire workers they want to lose.

³⁹Cyclical unemployment is associated with the rise in unemployment during downturns in economic cycles. Structural unemployment is usually defined as those who have been out of work for 12 months or longer. In the EU more than 40 percent of the unemployed had been out of work for 12 months or more in 1992, compared with a third in Oceania, around 15 percent in EFTA and in Japan, and only 11 percent in North America. *The OECD Jobs Study*, 1994, p. 12. The EU Commission also adds a third category: technological unemployment, in that technological progress is eliminating jobs in certain industries. European Commission, *Growth, Competitiveness, Employment: The Challenges and Ways Forward into the 21st Century*, 1994, p. 11.

1970's and now accounts for nearly half of total unemployment.⁴⁰ Because of this high rate of structural unemployment, many have concluded that Europe's high wage costs, generous welfare benefits, stifling tax burden, and weak capital investments have largely contributed to an environment of high structural (as opposed to cyclical) unemployment. Thus, in order for the member states of the EU to rectify the unemployment dilemma they must address both cyclical employment through economic growth and structural employment by substantially modifying Europe's economic and labor environment.

The Commission's White Paper makes a series of recommendations to reduce unemployment. They further propose a target of creating 15 million new jobs by the end of the century.⁴¹ Their recommendations were targeted at both the national and Community level.⁴² The progress made at the Community level is aggressive and innovative. The recommended ventures would serve to make the EU more competitive, assist in economic growth, and improve the employment environment. Yet, the resolution of the fundamental impediments to growth in Europe's economic environment depends on

⁴⁰European Commission, *Growth, Competitiveness, Employment: The Challenges and Ways Forward into the 21st Century*, 1994, p. 54.

⁴¹This proposal was not endorsed by the Brussels European Council Presidency and instead suggested "significantly reducing the number of unemployed by the end of the century." The UK's witness rejected the idea of a target - "which is not in the gift of governments to deliver." *House of Lords, Select Committee on the European Communities, "Growth, Competitiveness and Employment in the European Community"*, April 1994, p.7.

⁴²At the Community level, the Commission wants to: 1) Ensure the completion of the single market. The Commission assesses that the single market has thus far added 0.4 percent annually to the Community's GDP and has created 9 million new jobs. 2) Develop trans-European networks (TENs) in transport and energy. This not only helps in lowering unemployment, but compliments the single market. To date 26 projects are called for or already under way. 3) Develop information highways. This represents a bold initiative as it entails privatizing public telecommunication monopolies, establishing common standards, and creating a network system. European Commission, *Growth, Competitiveness, Employment: The Challenges and Ways Forward into the 21st Century*, 1994.

national governments and publics who resist the necessary changes required, and therefore indirectly jeopardize the EMU process.⁴³

At the national level the EU member states continue to flounder. The Commission's recommendations were given more concrete form at the Essen Summit in December 1994. The Essen five-point plan calls for (1) the need to reduce non-wage labor costs; (2) introduce greater flexibility in organizing jobs and wages; (3) invest in better vocational training; (4) target assistance to the young and long-term unemployed; and (5) member states report annually on their employment policies.

However, according to EU Commission officials and UNICE, the European employers' federation, national governments have not converted this plan into action. One of the reasons for this inaction is that recent economic growth has reduced the level of urgency. Another reason is problems of intra governmental coordination. According to a senior Commission official, "One of the greatest obstacles is the lack of contact between departments at national level - finance, employment, social security, education, and training;" "...member states are preoccupied with "just managing the day-to-day crises. There is no evidence of radical rethinking of policies."⁴⁴

⁴³Consider, for example, the sacking of France's Finance Minister, Alan Madelin, because his insistence on substantial reform was not appealing. Subsequently, the OECD has characterized France's 1996 budget as "meager" compared with other OECD member countries and questions its ability to meet the EMU deficit criteria. *The Financial Times*, 25 September 1995.

⁴⁴*The Financial Times*, 15 May 1995.

II. Labor Costs and the Social-Welfare System

Europe's labor costs are characterized as being high and inflexible. They are the highest in the world. (See Figure

6.) Labor costs have effectively contributed to structural unemployment by pricing many European workers out of the international market. Rigid labor costs and high minimum wages make private sector employers reluctant to hire new workers,

subsequently, new jobs growth in Europe is largely dependent on the public sector.⁴⁵

In a survey conducted by the German Chamber of Commerce and Industry in November 1993, about 30 percent of over 10,000 German companies are considering plans to shift a portion of their production outside of Germany, within the next three years. They cite decisive disadvantages for Germany as an industrial site, including "costly wages, climbing payments for employee benefits and rising government fees on industry".⁴⁶ Daimler Benz, serves as an example. In 1997, it will begin producing about

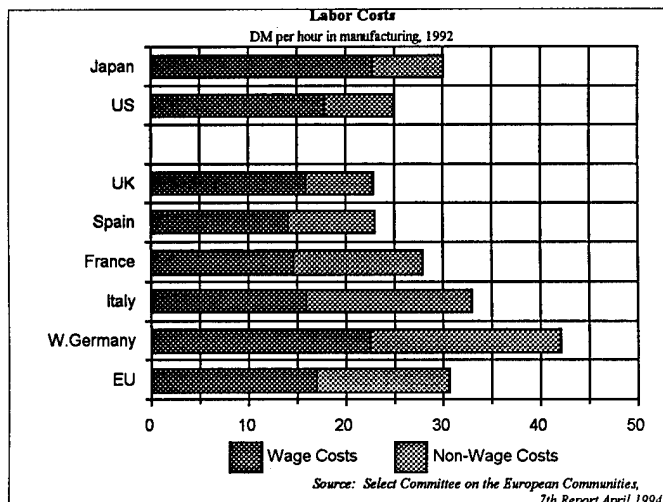


Figure 6

⁴⁵According to an OECD global jobs study more than 80% of the 35 million jobs created in the U.S. since 1974 came from the private sector. In Europe, by contrast, two thirds of the 10 million jobs created during the same period were in the public sector. 'So Far to Go', special supplement to *The Wall Street Journal*, 30 September, 1994, p. R4.

⁴⁶Many of the respondents said that exporting operations were part of their long term strategy to strike a balance between foreign and domestic operations. German investments abroad have created 70,000 jobs and that number will rise to 250,000 over the next three years., *The Wall Street Journal*, 9 November 1993.

65,000 all-activity vehicles in Tuscaloosa, Alabama, of which about half are to be shipped to Europe. The cost to Europe is 11,500 jobs.⁴⁷

Non-wage labor costs include social security contributions and taxes paid by employees and employers to finance social expenditure. The OECD suggests two ways to reduce non-wage labor costs in order to stimulate growth: cutting social spending and/or shifting the tax base for social spending away from payroll taxes to other taxes, of which the former would also assist in meeting the EMU deficit criteria.⁴⁸

Coupled with Europe's unemployment dilemma are the rising costs of maintaining the other portions of the social-market economy. While the costs of maintaining the social welfare state are rising, Europe's population is aging and the size of its work force is declining. The aging of the baby boom generation is apparent: in 2005, 21 percent of the population will be over sixty. Former President of the EU Commission, Jacques Delors, concedes that "social systems as they function at present will be profoundly affected, in so far as the elderly are recipients of services and social payments partly supplied by the state."⁴⁹ Even the richest states find themselves in a position of either reneging on their

⁴⁷'So Far to Go', special supplement to *The Wall Street Journal*, 30 September, 1994, p. R4.

⁴⁸OECD, *The OECD Jobs Study*, 1994, p. 35. The OECD's study on taxation, employment and unemployment indicates that there is no link between taxes in general and unemployment. Countries such as Sweden, whose taxes represent over 50 percent of GDP, have a much lower rate of unemployment than countries such as Australia whose overall tax ratio to GDP is much lower. On the other hand, the ratio of taxes to GDP is much greater in Europe (44%) than in the U.S. (32%) or Japan (33%) and Europe's unemployment rate is substantially higher than the U.S.'s or Japan's. (Or maybe it is not. See footnote 34 above.) Still, the OECD suggests that by more specifically targeting non-wage costs, unemployment may be lowered.

⁴⁹Jacques Delors, *Our Europe*, 1988, p.105.

pension promises or defaulting on their public debt.⁵⁰ The cost of maintaining the social welfare state imposes higher non-wage labor costs, which in turn raises the barrier to hiring; it becomes a vicious circle for both national deficits and unemployment.⁵¹

There are other factors

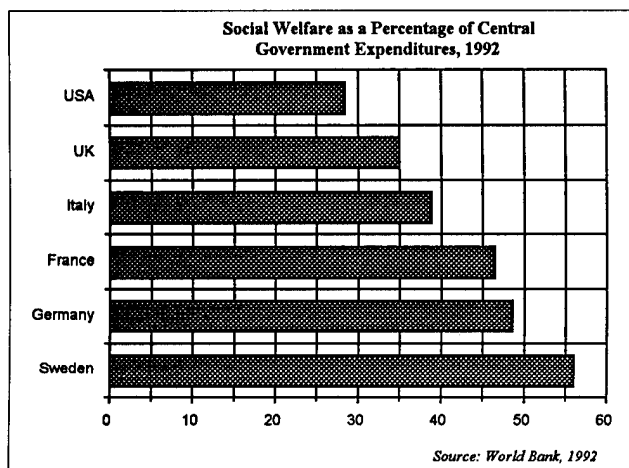


Figure 7

which also influence

employment without *directly* impacting on national budgets: an inflexible labor force and labor regulations. However, they directly influence the ability to sustain EMU, in that they influence labor mobility. This is discussed in greater detail in the next chapters, suffice to say here that inflexible labor and overregulation are disincentives for employment.

Interest rates are not only a MU precondition, they are also a critical factor influencing growth and employment. The European Communities Committee of the U.K.

⁵⁰According to OECD estimates, most industrialized countries have substantial unfunded pension liabilities. In Germany, for example, this liability (the sum that would have to be set aside today to cover the value of future benefits minus trust-fund balances and all future social security taxes) amounts to 160% of the value of the economy's annual output. *The Wall Street Journal*, 11 September 1995. Italy, for example already pays more than fourteen percent of its GDP in pensions. The dependency ratio (the proportion of people over 65 to those of working age) is expected to rise from 20 percent to 48 percent between 1990 and 2040. This would equate to a rise in the public debt of over 200 percent of GDP at the current value of state pensions. *The Financial Times*, 17 June 1995.

⁵¹Not only do high non-wage labor costs lower the willingness of employers to hire they also are used to finance unemployment benefits. Generous unemployment benefits are seen as another culprit contributing to higher levels of unemployment. The implication is that these benefits serve as an incentive for the unemployed to remain on the public dole. Given the growing number of long term unemployed, the system as been referred to as a "social hammock", which is easy to get into, but from which it is difficult to get out. Again the *OECD Jobs Study* recommends a better balance between work incentives and temporary income support.

House of Lords submit that both short and long term real interest rates in the EU have been high in both absolute and relative terms over a long period, especially after German unification.⁵² While this has helped quell inflationary pressures it has retarded potential growth in EU member states and has negatively affected employment. First, it has reduced the level of investment by making capital more expensive. Second, it has translated to higher exchange rates for the ERM members, subsequently lowering their international competitiveness with the EU's trading partners. One of the reasons for this perhaps artificially high rate of exchange is due to efforts to meet the convergence criteria for monetary unification and is discussed in the next chapter.

Over the last twenty years Europe has largely been able to cope with higher unemployment, but not without an increasing amount of stress on the states' social welfare systems. While the Commission's White Paper, the OECD's Job Study, and the five point Essen plan offer several recommendations that would help to reverse the rising trend in long term unemployment, the measures would be politically unpopular among large segments of the states's electorate making their implementation difficult and questionable. Consequently, not much has been done at the national level.⁵³

⁵²House of Lords, *Select Committee on the European Communities, "Growth, Competitiveness and Employment in the European Community"*, April 1994, p. 24.

⁵³The Essen five point employment plan was only recently agreed to. Thus despite the apprehension of certain Commissioners and UNICE, it is perhaps normal that national governments have not yet implemented anything in such a short period of time. On the other hand several European states have implemented plans to increase employment by reforming their labor markets. The United Kingdom started reforms since the early 1980s by reducing the power of unions. Employment flexibility has increased substantially and part-time and self employment growth has been very strong. In Spain reforms liberalizing conditions for justifying lay-offs were amended to the Basic Employment Law in April 1994. Italy has also implemented a number of labor market reforms since 1991. OECD, *OECD Economic Outlook*, #56, December 1994, p. 24. Italy also just recently raised its minimum retirement age.

Europe's Economic Challenges:

Growth and Competitiveness

Most European economist and political leaders believe that the rate of economic growth has been generally too slow. The European Round Table believes that a growth rate of 3.5 percent annually is required to have a significant impact on reducing the levels of unemployment.⁵⁴ Even though the EU states are currently witnessing higher rates of economic growth, they are still tormented by other persistent factors which limit their growth potential. Not only does growth affect levels of employment, it also directly influences MU efforts.

There have been a plethora of new literature dealing with the notion that states are in economic competition with each other. One of the most illusive notions of competitiveness is its definition.⁵⁵ The U.S. President's Commission on Industrial Competitiveness defines it as "the degree to which a nation can, under free and fair market conditions, produce goods and services that meet the test of international markets while

⁵⁴The potential rate of growth in the Community (the rate of growth at which the Community can grow for many years without over heating) has fallen from 4.5 percent annually in real terms 25 years ago to just over 2 percent now. However, a real rate of growth of two percent annually is needed just to maintain the current level of employment in the EU and 2.5 percent is needed to prevent unemployment from rising. *House of Lords, Select Committee on the European Communities, "Growth, Competitiveness and Employment in the European Community", April 1994, p.23.*

⁵⁵Paul Krugman lampoons the idea that states are in competition with one another, rather he suggests that firms are in competition with each other. His attack of this concept perhaps has its origins in his definition and the definition commonly accepted by others. He is especially critical of Thurow for his extremist position in describing it as "*The Coming Economic Battle Among Japan, Europe, and America.*" Additionally, Krugman faults Delors for not addressing Europe's primary economic problems in the White Paper: taxes, regulations, unemployment benefits, and the unsustainability of the EMS. Yet, the White Paper does address these problems and the Commission offers possible solutions. Paul Krugman, 'Competitiveness: A Dangerous Obsession', *Foreign Affairs*, March/April 1994, pp. 28-30.

simultaneously maintaining or expanding the real income of its citizens."⁵⁶ European leaders recognize that they face competitiveness problems which affect Europe's capacity for sustained economic growth. One of the main points of the White Paper was on Europe's relative decline in competitiveness. The EU Commission cited the following weakness:

- The loss of global market share,⁵⁷
- Market gains in 'sunset' industries and deteriorated performance in high value-added markets, and
- Low level productivity rates from declining investment.

While these problems exist, the SEA is designed to enhance Europe's competitive base and could help alleviate its competitive deficiencies. As impediments to intra-EU trade are lifted, the cost of trade declines and directly enhances efficiency. Competition between European firms will intensify, thus increasing efficiency as well. Furthermore, the EU's competition policy has been genuinely effective and is increasingly enforced.⁵⁸

⁵⁶Jeffrey A. Hart, *Rival Capitalist: International Competitiveness in the United States, Japan, and Western Europe*, 1993.

⁵⁷The loss of global market share is often blamed on the low wages in Eastern Europe and the newly industrialized countries (NICs) in Asia. This however can be misleading. The OECD in its job study states that exports from low wage countries are too small to account for a significant part of either current unemployment or falling relative wages of the low skilled. On the other hand these countries often offer great potential as a large and growing market for OECD states. OECD, *The OECD Jobs Study*, 1994, p. 28. For example, even though the 1993 average hourly labor cost in manufacturing in the Czech republic was \$1.14 compared to Germany's at \$24.87, the current account balance is positive in the EU's favor and Germany leaders desire to open the EU up to the east, as opposed to shutting its borders.

⁵⁸The EU's Competition Policy along with its enforcement capabilities has gone far in pushing a more competitive environment in Europe. The number of cases that pass the judicial arm of the EU are truly mind-boggling. For a detailed study of the EU Competition Policy see EC Commentaries, *Competition*, 9 February 1995. The EU Commission has leveled large fines to enforce its policies, such as the \$301.2 million, against 33 cement producers and nine cement groups for what it describes as blatant cartel activity. *The Wall Street Journal*, 1 December 1994. There are several other examples demonstrating the EU Commission's proactive

I. Investment

Since the cost of labor is high, investments in capital formation, needed for economic expansion and job growth, are siphoned off to areas outside the Union. (See Annex 2.) This scarcity of capital is reflected by the fact that while in 1970, the capacity utilization rate was around 85 percent and the unemployment rate was near two percent; today the capacity utilization rate is again around 85 percent, yet the unemployment rate now stands at around ten percent.⁵⁹

Another investment factor stressed in both the White Paper and the Essen plan is investment in job training and education. Factors of increasing productivity - investment in plant and equipment - is only one of a number of factors. Technological change, defined broadly to include organization of production as well as engineering, contributes nearly twice as

Contributions to Increasing Labor Productivity, 1929-1982	
Contributor	Percentage Contributed
Capital	25
Advances in Knowledge	36
Improved Resource Allocation	10
Education per Worker	18
Economies of Scale	12
TOTAL	100

Table 5. Source: See footnote 60

role in enforcing its competition policy, such as obliging the French to open their airports to other EU carriers.

⁵⁹From a lecture on the "Economics of Europe" presented by Professor Roy Gardner, Indiana University, 24 October, 1994. Conversely, *The Economist* states that Europe is not plagued by a shortage of capital relative to the U.S. Instead they cite recent IMF statistics which illustrate that Europe has enjoyed similar growth in both capital stock and real GDP as in the U.S.; yet the U.S. has roughly half the unemployment rate as the EU. In Europe the amount of capital invested per worker is nearly double that of America's. With higher capital per worker, European output was boosted more by increased labor productivity than by higher employment. In the U.S. it was just the opposite. The primary reason for this type of investment reflects Europe's high labor costs and inflexible labor market. *The Economist* therefore asserts that even policies to increase investments will not affect the EU's job crisis unless measures are taken to lower the cost of labor and increase its flexibility. *The Economist*, 20 May 1995.

much to labor productivity as capital investment according to Levine and Stan. Worker education is almost as important as new capital equipment.⁶⁰ (See table 5.) Traditionally, most EU states have a solid educational base; their secondary school system is considered to be better than that in the U.S. While investment in research and development and education are fundamental means of increasing productivity, the bottom line is capital investment, especially venture capital, which is required to translate research and development and educational talents into real economic growth.

Venture capital, so closely associated with emerging high-tech industries, is difficult to obtain for small and medium size enterprises trying to start-up in Europe.⁶¹ The same dissuasive forces that cause private capital to leave Europe are the same ones that keep foreign investment out. Consequently, EU states have seen a negative flow of direct investments since 1975.⁶² (See table 6.) At the same time national governments continue to pump money into dying or inefficient industries, albeit this is changing with privatization.⁶³ (See annex three.) In addition, the EU Commission cites needed reform in subsidizing these "sunset" industries in its White Paper and redirecting these assets

⁶⁰Robert A Levine and Peter J.E. Stan, *Macroeconomic Strategy for the 1990s*, 1993, p. xiv. Laura Tyson, in *Who's Bashing Who: Trade Conflict in High-Technology Industries*, 1992 and Lester Thurow in *Head to Head: The Coming Economic Battle Among Japan, Europe, and America*, 1992 make similar assessments.

⁶¹Many European entrepreneurs must search for capital outside of Europe. In 1993, 4.9%, or \$245 million, of all new European venture capital was allocated to companies that were either new or in the planning stages, compared to 24.2 %, or \$750 million. 'So Far to Go', special supplement to *The Wall Street Journal*, 30 September, 1994, p. R5. Bucking this trend in the short fall of venture capital, France announced during the winter of 1995 that it is opening a European wide small capital stock exchange similar to the U.S.'s NASDAQ.

⁶²OECD, *The OECD Jobs Study, Part I*, 1995, pp 118-9.

⁶³Hugh Mosely and Günter Schmid show that the bulk of state aids in most countries is devoted to declining industries undergoing adjustment (steel, coal, shipbuilding, agriculture). "Public Services and Competitiveness", *European Competitiveness*, ed. Kristy Hughes, 1993, pp. 215-6.

towards education and high-tech industries.

EC Direct Investment Flows in million U.S. dollars										
	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
Outflows	18232	19728	23292	40370	62579	76556	91210	100934	89113	86618
Inflows	14234	7366	14179	19239	36634	55155	74428	86040	62434	69820
Net	-3998	-12362	-9113	-21131	-25945	-21401	-16782	-14894	-26679	-16798

Table 6. Source: *The OECD Jobs Study, Part 1, 1995*

II. New Technologies and High-Tech Industries⁶⁴

There is a growing consensus on the changing global economic environment which suggest that new technologies are determining the success of economic growth and the level of a nation's competitiveness. The traditional view that resource endowments determine a nation's ability to achieve economic growth are less important than before. Competitive advantage is increasingly established by the application of new technologies and not necessarily according to the laws of traditional comparative advantage. Comparative advantage will be man made through the use of new technologies.⁶⁵

This shift also coincides with EU plans to improve its competitive position to enhance growth. The EU Commission stresses a need for increased research and development and for creating an economic environment in which new technologies can

⁶⁴High-technology industries are identified as one in which knowledge is a prime source of competitive advantage, thus requiring substantial investment in knowledge creation. Laura Tyson, *Who's Bashing Who: Trade Conflict in High-Technology Industries*, 1992, p. 18.

⁶⁵ Laura Tyson, *Who's Bashing Who: Trade Conflict in High-Technology Industries*, 1992 and Lester Thurow in *Head to Head: The Coming Economic Battle Among Japan, Europe, and America*, 1992.

flourish.⁶⁶ The following industries are largely regarded as those which should be developed to ensure competitiveness and growth in industrialized states.⁶⁷

microelectronics, computers plus software, biotechnology, new metals-science industries, telecommunications, and civilian aviation.

Shares of Global Corporate Profits and Sales, 1987-1992						
Industry	U.S.		Japan		Europe	
	Profits	Sales	Profits	Sales	Profits	Sales
Energy equipment and services	99.6%	92.7%	.8%	1.0%	-.4%*	6.3%
Aerospace and military technology	71.6	75.8	0	.4	18.4	23.8
Data processing and reproduction	65.1	73.2	10.7	22.2	24.2	4.6
Electronic components and instruments	65.0	61.8	30.5	35.8	4.5	2.4
Beverages and tobacco	63.0	63.4	3.6	16.4	33.4	20.2
Health and personal care	61.9	48.9	8.2	20.3	29.9	30.8
Leisure and tourism	60.3	45.7	7.4	16.3	32.3	38.1
Forest products and paper	59.7	51.0	7.0	17.4	33.3	31.6
Energy source	50.4	45.8	2.6	13.5	47.0	40.7
Metals-nonferrous	45.7	30.2	11.9	30.8	42.4	39.0
Recreation and other consumer goods	44.0	33.2	46.4	60.7	9.7	6.1
Food and household products	42.6	32.6	7.8	21.7	49.6	45.7
Electrical and electronics	41.1	21.4	25.7	50.7	33.2	27.9
Chemicals	41.0	28.2	13.3	30.3	45.7	41.5
Industrial components	38.2	24.5	32.5	44.7	29.3	30.8
Automobiles	23.6	37.0	31.0	35.3	45.5	27.6
Machinery and engineering	19.2	18.9	34.4	46.3	46.3	34.9
Appliances and household durables	16.5	7.6	74.4	66.6	9.1	25.7
Metals-Steel	2.3	10.1	51.2	57.0	46.5	32.9
All Industries	47.7%	37.7%	15.5%	31.5%	36.8%	31.1%
*Europe's businesses in this sector had a net loss Source: <i>The Wall Street Journal Europe</i>, 16 February 1994.						

Table 7

These industries are also nearly the same as those that the EU has recognized as critical to improving their global competitive position. Table 7 indicates that in all of these industries

⁶⁶Creating this environment is suggested by deregulation. Milton Friedman suggests in a recent *Wall Street Journal* editorial on 1 August 1995, that there is a direct inverse correlation between the number of regulations and the rate of real growth. Both the Commission and Thurow focus on the shift from product technologies, which are easily copied, to *process technologies* such as flexible manufacturing stations, just-in-time (JIT) inventories, or statistical quality control.

⁶⁷Lester Thurow in *Head to Head: The Coming Economic Battle Among Japan, Europe, and America*, 1992, p 30. These industries are similar to those identified by Tyson.

Europe is well behind. However, it remains questionable as to what extent governments can influence the development of these high tech industries.

Summary

We again return to the EMU/Employment paradox, where the unemployment crisis may stall states from proceeding to the final stage of EMU because of the political pressure to run annual deficits and accumulate national debts exceeding MU preconditions. While EMU is desirable for economic growth, economic growth is practically a prerequisite for MU. EMU is regarded as one of the primary vehicles to deliver the macroeconomic conditions required for economic growth, and subsequently increasing employment. The macroeconomic policies required by MU provide the foundation for sustained rates of higher growth. Both the OECD and the EU Commission submit that "rigorous budgetary policies" provide economic stability. By reigning in on massive government deficits and debts, required for the establishment of a single European currency, the long term results will be sustained lower interest rates and increased investments. This in turn will produce higher sustained rates of economic growth. Conversely it also requires the support of Europe's constituents as they will ultimately be required to carry the burden of reform.

The fact that the Czech Republic's minister of industry and trade, Vladimir Dlouhy, could boldly taunt Western Europe about its competitiveness problems, should serve as an indicator of the extent of the EU's economic challenges. He encourages the EU economies to restore competitiveness by reducing production costs, trimming bulky

social-security programs and resolving the worsening structural unemployment. The alternative, he said, is to lose out in competition with Eastern Europe.

Western Europe must understand that countries like the Czech Republic, Poland, Hungary and Slovakia are serious about competition. ...European integration doesn't only mean economic and political reform in our countries, but also means the need for economic and political reforms in your countries as well. We are not just dumping our exports in the West. We are exporting there because we are more cost effective.⁶⁸

The most detrimental aspect of Europe's competitiveness problem evolves largely around the same challenges which are creating its high structural unemployment and hinders its economic growth. All of these challenges reflect the economic problems afflicting the member states of the EU. They are significant even when viewed in isolation of other economic/political events. When these issues are coupled with the preconditions for MU their resolution becomes even more critical. First, they directly impact on whether or not a state will proceed to the final stage of EMU. Second, these problems when connected with governments's attempts to implement austere budget plans in order to meet MU preconditions, could lead to massive public disapproval or unrest. Lastly, Europe's economic woes, if not reversed, may also threaten the ability to sustain EMU, should it ever be achieved.

⁶⁸Czech Urges Economic Reform in the EC: Dropping Trade Barriers Will Spur Competition, *The Wall Street Journal Europe*, 1-2 October 1993.

Chapter Three

The Road to EMU:

The Maastricht Treaty and Convergence Criteria

The main emphasis of the Maastricht Treaty is the creation of a single European currency and a European Central Bank (ECB)⁶⁹ and represents the final drive towards complete economic and monetary unification. In order to proceed to this final stage the drafters of the Maastricht Treaty established a number of preconditions for member states. While, these preconditions pose a serious challenge for several states in their endeavors to proceed to the final stage of EMU, they also represent opportunities to enhance their economic prowess and provide employment for their publics. The intent of the convergence criteria is to instill similar macroeconomic conditions in the respective member states's economies by coordinating national fiscal and monetary policies in order to ensure a stable transition to a single currency.

The advocates of this process suggest that the current system of floating exchange rates of national currencies creates a mixture of uncertainty and expense which puts a tax on trade and runs contrary to the principle of a unified European economy.⁷⁰ The economic benefits of a single currency are:

⁶⁹The United Kingdom and Denmark have opt out clauses for EMU.

⁷⁰'Europe's Monetary Future', *The Economist*, 23 October 1993, p. 30.

1. The elimination currency conversion costs.⁷¹
2. The elimination of exchange rate uncertainty.⁷²
3. The transparency of prices.⁷³
4. The possibility of the European currency becoming an international reserve currency and the advantages of coordinated monetary and economic policies.⁷⁴

Conversely, there are economic costs associated with the creation of a single currency, which are discussed in greater detail below. Primarily, national governments effectively surrender their monetary sovereignty to a centralized EU monetary authority and are thus prevented from using exchange rates, interest rates, and monetary supply as adjustment tools to cope with economic shocks. Member states's fiscal policies are also constrained by MU debt and deficit targets.

⁷¹However, Eichengreen cites Emerson (1990), who estimates that these transaction costs are relatively small, amounting to 0.4 percent of GDP for the EU as a whole. Barry Eichengreen, 'European Monetary Unification', *Journal of Economic Literature*, Vol. XXXI, September 1993, p. 1327.

⁷²The argument that it discourages trade is also tenuous. Ibid. and Michele Fratianni, 'What Went Wrong with the EMS and European Monetary Union', Working Paper 1.16, University of California, Berkeley, February 1994, p. 7. In addition, the availability of financial tools allow traders to hedge against currency fluctuations at a very low cost. Eichengreen states that there is some evidence that it may depress direct foreign investment, but he adds that the argument can work both ways.

⁷³Goods and services would be priced with the same single currency. Price transparency would allow consumers a better comparison of products and thus increase competition. From a lecture given by Professor Jürgen Von Hagen, Candidate for the International Institute of Graduate Studies, Geneva, 1 December 1993. While this is a logical conclusion, it is difficult to measure.

⁷⁴This would allow imports to exceed exports should the rest of the world prove willing to hold the European currency. Dennis Swann, *The Economics of the Common Market*, 1992, p. 185. Member states would also be able to pool their international reserves, thus allowing trade imbalances to be postponed for a longer period. Swann also suggests that MU would provide more effective administration of aggregate demand management. As economies become increasingly dependent, states are less likely to pursue policies in isolation. (p. 186.) An additional advantage is the possibility of developing a union budget which reduces instability among states or regions afflicted with asymmetrical shocks. This is discussed in the next chapter.

The most fundamental question that needs to be raised concerning the implementation of MU in Europe is whether or not the member states of the EU represent an optimum currency area.⁷⁵ Do the governments of the EU states believe Europe is an optimum currency area as reflected by their continued support for monetary integration in the various treaties and other intergovernmental agreements since the Treaties of Rome? Or, does their support for MU expose deeper political integration as the primary motivator?⁷⁶

There is no consensus among economists on whether or not Europe represents an optimum currency area,⁷⁷ although the general view seems to be evolving towards Europe as meeting the economic criteria for an optimum currency area.⁷⁸ There are six generally agreed upon criteria for this assessment: factor mobility, openness, trade integration,

⁷⁵An optimal currency area is defined as a group of economic entities (individuals, regions, or countries) among which welfare is maximized through fixed internal exchange rates or a common currency.

⁷⁶See chapter one, p. 13. Additionally, Eichengreen clearly illustrates that the economic factors of optimum currency areas are merely a guide for choosing between floating and monetary union. Political constraints will be as equally important in the implementation of a MU regime. *International Monetary Arrangements for the 21st Century*, 1994, p. 94.

⁷⁷Kenneth Dyson provides a good overview of the debate. "Though the debate was ultimately inconclusive, in the sense that it did not yield any final agreement, the debate about monetary union was undoubtedly enriched by this body of theory." *Elusive Union*, 1994, p. 241.

⁷⁸Peter Bofinger, "Is Europe an Optimum Currency Area?", *Thirty Years of European Monetary Integration*, ed. Alfred Steinherr, 1994, provides convincing evidence to support that Europe is an optimum currency area. He departs from the Mundell model (used by many others since its development in 1961) by arguing that Europe does not reflect Mundell's 'one country-one sector model'. And adds that it is difficult to imagine 'a major asymmetrical real demand shock' in the EU, this being the major draw back of Europe as an optimum currency area under the Mundell model. Conversely, Jørgen Drud Hansen, Hans Heinrich and Jørgen Ulf-Møller Nielsen suggest that *today* Europe does not constitute an optimum currency area because it still does not provide the features necessary to deal with these asymmetrical shocks. They use Mundell's traditional theory of optimum currency areas. Labor mobility is still too low, there are differences in price and wage inflation, and about half of foreign trade is with third-party states. *An Economic Analysis of the EC*, 1992, pp. 198-9. Gail Fosler also argues that "the economic divergences will take more time to resolve than the drafters of the Maastricht Treaty surmised." *The Wall Street Journal Europe*, 1-2 October 1993.

international financial integration, wage and price flexibility and fiscal policy.

Eichengreen, for example, asserts that, "the European Union more closely approximates than most other regional groupings the criteria for an optimum currency area".⁷⁹ While Europe may find itself confronted by asymmetrical shocks, he suggests that they will not be an insurmountable problem.⁸⁰ Additionally, shocks are more likely to be symmetrical than asymmetrical in the future with the progressive implementation of the single market and the convergence of monetary policies demanded by MU.⁸¹

Regardless of the theoretical underpinnings of MU, as of January 1994, the EU has entered the second of three stages for the implementation of a single currency with the creation of the European Monetary Institute (EMI) in Frankfurt and with states coordinating economic, monetary, and fiscal policies to meet the convergence criteria. (See annex four for a summary of the three stages for MU.) Yet, the road to EMU is

⁷⁹Barry Eichengreen, *International Monetary Arrangements for the 21st Century*, 1994, pp. 101-9. "EU members are open and trade heavily with one another. More than 20 percent of EU GNP is exported; the comparable figure for the United States, Canada, and Mexico is less than 10 percent. Of the trade of EU countries 60 percent is with other member states; the comparable figure for the United States, Canada, and Mexico is only about one third. More than half of all foreign investment received by EU members come from other member states; the analogous figure for the United States, Canada, and Mexico is about 25 percent."

⁸⁰However, Eichengreen still recommends caution because of Europe's relative inflexible labor market of inelastic wages and unresponsive migration and because of the current absence of arrangements to transfer funds to other regions to cope with asymmetrical shocks. Barry Eichengreen, *International Monetary Arrangements for the 21st Century*, 1994, pp. 101-9.

⁸¹The SEA not only creates deeper economic integration, the removal of capital controls is a key criterion for MU in that the flow of transactions help to offset shifts in the balance of payments between the member states and thus provides an alternative adjustment mechanism. Paradoxically, the freedom of capital movements can also destabilize exchange rates. Kenneth Dyson, *Elusive Union*, 1994, p. 244. Asymmetrical shocks caused by inflation-producing monetary policies are less likely given the Maastricht Treaty's emphasis on price stability. Peter Bofinger further adds that with MU an independent ECB will provide states traditionally viewed as pursuing unstable monetary policies an enormous improvement of monetary credibility. "Is Europe an Optimum Currency Area?", *Thirty Years of European Monetary Integration*, ed. Alfred Steinherr, 1994, pp. 55-6.

paved with several obstacles which may prove to be insurmountable and could prevent EU member states from entering the final stage of MU.

In the preceding chapter, economic challenges to the MU process were addressed. This chapter addresses the challenges imposed by the convergence criteria. First, the convergence criteria and the member states' progress towards achieving the criteria are assessed. More specifically, this chapter examines whether MU can be implemented within the existing EMS, given the increasing fragility of pegged international monetary systems as exemplified by the European currency crises of 1992-3. It also assess the challenges imposed by the inflation and interest rate criteria and by the debt and deficit criteria. Lastly, this chapter surveys the political dimension of MU through the attitudes assumed by national leaders in their interpretations of the Maastricht Treaty and their desires for MU.

Convergence Criteria for a European Monetary Union

The Maastricht Treaty stipulates a series of preconditions which member states must meet before they can enter the final stage of MU. The theoretical idea behind the requirement for convergence criteria is to instill similar economic conditions among states prior to MU. These conditions would permit states to easily shed their national currencies for a common one without experiencing monetary or fiscal shocks, nor would such shocks, if they did occur, be transferred to other members already in MU. In theory, the rigid preconditions are designed to enhance price stability and instill confidence in the new currency. However, in practice, the convergence criteria jeopardize the possibility that

many states may ever enter the MU. The intent here is to describe and assess the preconditions established by the treaty and examine the member states's position in relation to the criteria. The convergence criteria are:

- Converging rates of inflation
- Converging long term interest rates
- Stable exchange rates
- Deficit to Gross Domestic Product (GDP) ratio of three percent or less
- Debt to GDP ratio of 60 percent or less

I. Stable exchange rates

National currencies must stay in the narrow band (2.25%) of the ERM and not be devalued over the latest two year period. This precondition depicts a national government's commitment to maintaining the value of their currency and precludes it from attempting a last minute devaluation for competitive purposes.

The European exchange rate crisis of 1992-3 delineates the problems and lack of credibility for pegged rate exchange schemes functioning under conditions of questionable political will and governmental resources to support the system. Indeed, the nature of this issue alone has led skeptics of MU to proclaim its death.⁸² First, this section assess the

⁸²This skepticism was generated by the perception that the first of three stages to EMU was permanently disrupted by the ERM crisis of 1992. During the first stage of EMU (begun July 1990) all EU currencies were to join the ERM, which they did, with the exception of Greece. David Cobham accurately points out however, that these views were primarily "anglo-saxon". The currencies that had left the ERM or had been devalued in 1992 were either peripheral or less committed to both the ERM and EMU. "Diversion or Dead End?", *European Monetary Upheavals*, 1994, p. 9. Even with the German-Franco axis battered in 1993, the EMS is still functioning and EMU is far from dead. On the opposite end of the spectrum however, (continued...)

difficulties of pegged exchange rates in today's global monetary environment, given the lack of capital controls and the instantaneous movements of enormous sums of capital. This is followed by an evaluation the European exchange rate crises of 1992-3. Lastly, with this background, the current condition of EU member states is appraised and projected into those likely of meeting the exchange rate precondition for proceeding to the final stage of EMU.

The Global Monetary Environment

As discussed in chapter one, the global monetary environment is radically changing, which in turn threatens the continuation of exchange rate schemes designed to function within certain limits over extended periods of time, such as the EMS⁸³. These changes are represented by a series of trends in currency markets, technology, and politics.

First, changes in international financial market structure offer numerous new monetary instruments with which to influence currency markets 24 hours a day. Second, technological changes increase international capital mobility in both time and space, overwhelming the capacity for governments to effectively manage rates during periods of market havoc. This trend, when coupled with global economic liberalization trends, one of which being the gradual removal of capital controls, causes exchange-rate systems based on pegged rates or target zones to be even more difficult to maintain. Lastly, the

⁸²(...continued)

one finds some of the most federalistic supporters proclaiming EMU's death as well, and then use this proclamation as evidence to support a more centrally-controlled plan for EMU. See, for example, Mario Albertini, "The Crisis in the EMS", *The Federalist*, 1993, number 2, pp. 119-22.

⁸³These changes in international monetary systems are best described by Barry Eichengreen, *International Monetary Arrangements for the 21st Century*, 1994.

politicalization of domestic money will increasingly erode a government's credibility for its monetary commitments to a pegged exchange rate system.

These market forces can inundate pegged exchange rates systems by their sheer size and rapidity, thus making the cost of governmental intervention too dear. Also these forces are growing briskly, making it doubtful that any relief for pegged exchange rates systems is in sight.⁸⁴ The EMS has recently been visited by these market forces, resulting in a severe pummeling. These trends in global monetary systems are of critical importance to the EMS and European economic integration, not only because the EMS provides the foundation for future MU, but also because its stability is a precondition for MU. Thus the 1992-3 crisis exemplifies how these trends increasingly threaten Europe's current system of pegged exchange rates and consequently the entire EMU project.

The 1992-3 EMS Crisis

The origins of the breakdown of the ERM during the crisis are attributed to a number of factors. Waning support for the Maastricht Treaty by Danish voters is often cited as the triggering mechanism of the crisis. However, throughout Europe there was general public apprehension about EMU and thus its ratification in all of the member states was increasingly questionable.⁸⁵ As currency traders allegedly perceived a possible rejection of EMU, they anticipated an easing of monetary policies in states whose commitment to keeping their currencies within the narrow exchange rate band was

⁸⁴Countries will still be able to adjust monetary supplies in response to exchange rate fluctuations, but will likely be unable to keep them pegged for significant periods of time. Barry Eichengreen, *International Monetary Arrangements for the 21st Century*, 1994, p. 6.

⁸⁵French opinion polls, for example, indicated the electorate to be split on the upcoming referendum on the Maastricht Treaty.

aggravating their ability to cope with the most severe recession in nearly five decades. With the rejection of Maastricht, many states would no longer have the incentive to remain within the ERM in face of domestic economic concerns.

The impact of German reunification is often cited at the very least as influencing the ERM crisis to various degrees. While some authors of the ERM crisis list German reunification as a fundamental reason for the crisis, others mention it rather in passing.⁸⁶ More important is the influence reunification carried with currency traders by influencing their overall estimation of fundamental economic conditions in Europe.

German reunification drastically changed Europe's economic environment. The influence of the German economy on the rest of Europe should not be underestimated. Germany is Europe's economic and monetary hegemon. Germany's GDP makes up over a quarter of the EU's GDP. (See figure 8.) It has led Europe out of every post W.W.II recession.⁸⁷ Several

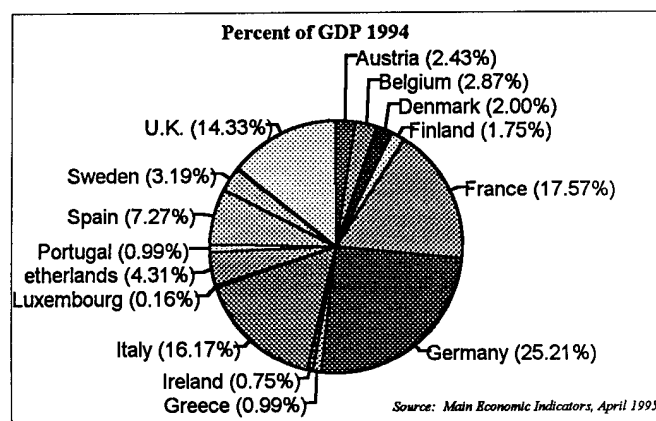


Figure 8

neighboring states peg their currencies to Germany's, and its currency represents the core of the ERM. Thus, any dramatic change in its domestic economic environment is certain

⁸⁶Barry Eichengreen, *International Monetary Arrangements for the 21st Century*, 1994, for example does not even mention German reunification in his discussion of the crisis.

⁸⁷Charles D. McVean, 'Hard Times Lie Ahead in Europe', *McVean Trading and Investments: Explorer Series #4*, 27 September 1993.

to have European wide repercussions. The costs of reunification were substantial and resulted in a ballooning German deficit.⁸⁸ In addition, the political decision to exchange East German Marks for deutschemarks at favorable rates for the eastern currency led to an explosion in Germany's

monetary supply, a sure indicator for potential inflationary pressures. (See figure 9.) Given Germany's historical fear of inflation and its central bank's traditional policy

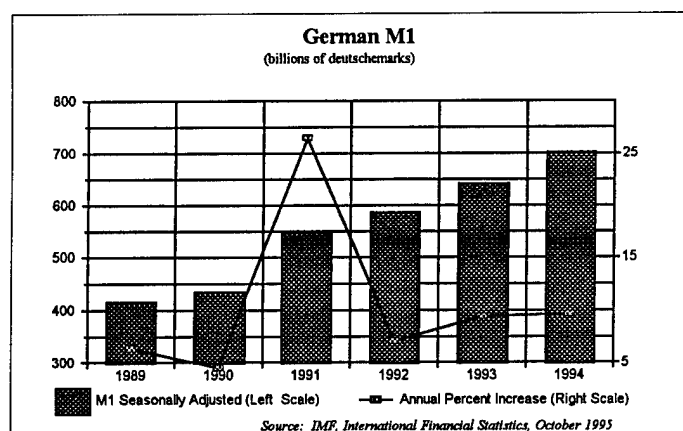


Figure 9

of price stability, it was not

surprising to witness a dramatic increase in German interest rates (See figure 10.) From 1989 to 1992 the deutschemark appreciated by 16.4 percent in real terms, intimating a currency realignment of the deutschemark vis-à-vis its other EMS partners.⁸⁹

Unfortunately, the timing of reunification was at an inopportune moment as

⁸⁸Intra-German Capital Transfers (billions of deutschemarks)

	1991	1992	1993	1994
Total Flow of Funds from West to East Germany	207	254	287	311
Percent of West German GDP	7.9	9.2	10.1	10.8

Charles D. McVean, 'Hard Times Lie Ahead in Europe', *McVean Trading and Investments: Explorer Series* #4, 27 September 1993, p.17.

⁸⁹IMF, *International Financial Statistics*, 1993. William Branson suggests that the deutschemark had appreciated by 12 to 20 percent in real effective terms since 1989 when the Berlin Wall came down and the reunification process began. "German Reunification and EMS Breakdown", *European Monetary Upheavals*, ed. David Cobham, 1994, p. 27.

Europe was entering a recessionary cycle. Thus Germany was raising interest rates while other EU member states sought lower rates to stimulate growth. Since the German mark is the anchor currency of the ERM, member states had little option but to maintain equivalent or higher rates of interest to remain within the ERM's narrow band or depreciate their currencies. Herein were the origins of crisis.

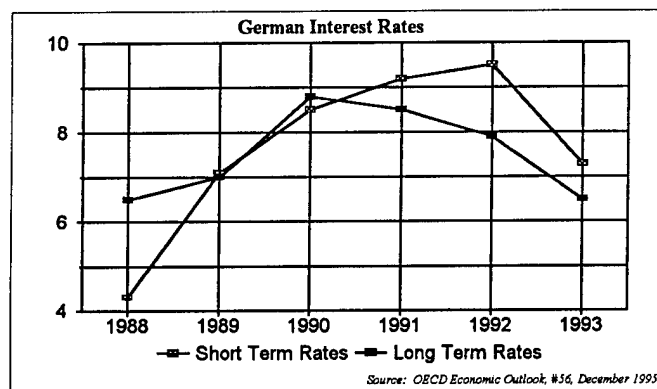


Figure 10

The EMS had a proven track record of five years of stability prior to September 1992.⁹⁰ This earlier success however radically changed, starting with the Danish rejection of Maastricht in June 1992. (See table 8) Already in July tension was mounting on the lira and sterling, coinciding with an increase in the Bundesbank's discount rate by 75 basis points. By the end of August a number of currencies were being supported by central bank interventions. Even though the lira was devalued by seven percent on 13 September 1992, it and the sterling were suspended from the ERM due to intense speculative pressures on 16 September 1992, despite increases in their interest rates and record levels of intervention by central banks.⁹¹

⁹⁰Only the Italian lire was devalued by 3.11 percent on 5 January 1990.

⁹¹A triggering factor for that day was reports that the Bundesbank President would have preferred a wider realignment of currencies at the time of the lira devaluation. David Cobham, "Diversion or Dead End?", *European Monetary Upheavals*, 1994, p. 4.

Key Dates of ERM Crisis of 1992-3

2 June 1992	First Danish Referendum on Maastricht: Majority no
19 June 1992	Pro Maastricht vote in Irish referendum
16 July 1992	Bundesbank raises discount rate sharply
8 September 1992	Finish markka abandons ECU peg
9 September 1992	Swedish Riksbank raises marginal lending rate to 75 percent
13 September 1992	Italian lire devalued by 7 percent
14 September 1992	Bundesbank reduces interest rates, but less than markets expected
16 September 1992	Riksbank marginal lending rate reaches 500 percent
16 September 1992	Sterling and lira leave ERM, Spanish peseta devalued by 5 percent
20 September 1992	French Referendum on Maastricht: narrow majority in favor
23 September 1992	Bank of France repo rate raised by 2.5 percent
24 September 1992	Ireland, Portugal, and Spain tighten capital controls
19 November 1992	Swedish krona abandons ECU peg
22 November 1992	Peseta and Portuguese escudo devalued by 6 percent
30 November 1992	Irish official overnight lending rate reaches 100 percent
10 December 1992	Norwegian krone abandons ECU peg
30 January 1993	Irish punt devalued by 10 percent
18 March 1993	German interest rate cuts disappointing to markets
18 May 1993	Peseta and escudo devalued by 8 percent
18 May 1993	Second Danish referendum on Maastricht: majority yes
18 June 1993	French money market intervention rate falls below German equivalent
1 July 1993	German interest rate cuts in line with expectations
23 July 1993	Bank of France forced to raise overnight borrowing rate
29 July 1993	Bundesbank fails to lower discount rate as expected
2 August 1993	ERM bands widen to 15 percent (except deutschemark-guilder band, kept at 2.25 percent)

Table 8 Source: David Cobham, *European Monetary Upheavals, 1994*

After this fracture of the ERM occurred, speculative currency attacks moved from country to country, sparing only the Dutch guilder and Belgian franc. There were several

devaluations and Spain, Portugal, and Ireland tightened capital controls. During this period France was maintaining its *franc fort* policy at a great cost in terms of domestic unemployment. France also wanted lower interest rates and openly challenged the German economic authorities.⁹² In July of 1993, speculative pressures again increased. France was once again obliged to increase its interest rates sharply to stay within the ERM band. On 29 July, Germany lowered its Lombard rate by half a percentage point, but failed to lower the more important discount rate. Consequently, a speculative frenzy struck not only the French currency, but the Belgian, Danish, Spanish, and Portuguese currencies as well. On 2 August 1993, after a weekend-long meeting, EU monetary officials widened the ERM bands from 2.25 percent to 15 percent, without changing central parities.

While nearly all economists would agree that the speculative attacks were founded on fundamental economic conditions for the lira, many suggest that absent prevailing attacks the U.K. and France could have maintained their exchange rates indefinitely.⁹³

⁹²On 18 June 1993, the French money market intervention rate was lowered to below the German rate. On 24 June 1993, The French Finance Minister, Edmond Alphandéry, invited his German counterpart, Theo Waigel, to come to Paris on short notice to discuss coordinated interest rate reductions, which Waigel declined. David Cobham, "Diversion or Dead End?", *European Monetary Upheavals*, 1994, p. 5.

⁹³Eichengreen, Rose, and Wyplosz are the strongest advocates of this view. They argue that several ERM countries displayed little evidence of excessive inflation accommodating policies, or of mounting competitive difficulties prior to the crisis. "In this view, the speculative attacks which forced them to raise interest rates created incipient macroeconomic imbalances rather than the other way around." Barry Eichengreen, Andrew Rose, and Charles Wyplosz, *Speculative Attacks on Pegged Exchange Rates: An Empirical Exploration with Special Reference to the European Monetary System*, 1994, p. 4. Oddly enough even George Soros, who is largely regarded in some circles as having single-handedly caused the crises in the first place, supports this assessment. He suggests that during certain periods market momentum can take on a life of its own. At this point, market prices no longer reflect rational economic conditions, but rather speculative momentum. *The Alchemy of Finance*, 1994, pp. 69-80. On the other hand, others such as William Branson, "German Reunification and EMS Breakdown", *European Monetary Upheavals*, ed. David Cobham, 1994, and Kenneth Dyson, *Elusive Union*, 1994, would argue that the macroeconomic imbalances could not

(continued...)

However, even though political events were the triggering mechanism for currency chaos, the foundations for these "attacks" resided in overall economic fundamentals.⁹⁴

In France's case, for example, currency traders increasingly realized that France could not maintain its exchange rate with the deutschemark while simultaneously lowering interest rates to battle growing unemployment - at that time over twelve percent. "The crisis was in essentials one of interest rates, based on the perception of foreign exchange market operators that the domestic policy needs and interests of the two key ERM countries, France and Germany, were diverging rather than converging."⁹⁵ Thus, one could strongly argue that the speculative attack on France's currency was based on a rational analysis of the current economic environment, which includes much more than merely rates of inflation and a nation's competitive position. A rational analysis would include an overall assessment of market and economic fundamentals as well.⁹⁶ Currency

⁹³(...continued)

justify current parities and thus high interest rates needed to be maintained.

⁹⁴This assertion is given new weight by the most recent Nobel prize winner, Robert Lucas, for his theory on rational expectations revealing how the average individual would anticipate - and thus could easily undermine - the impact of a government's economic policy. In recent years he has argued against attempts by central banks to intervene in foreign exchange rates, stating that such actions are "a mistake" and adds that central bankers and treasury officials "haven't learned anything in 200 years." *The Wall Street Journal*, 11 October 1995. Maurice Obstfeld adds that finance ministers past and present have preferred to blame crises on Gnomes of Zurich or *agioteurs* rather than face the reality of fundamental factors, including policy errors. *The Logic of Currency Crisis*, 1994, p. 1.

⁹⁵Kenneth Dyson, *Elusive Union*, 1994, p. 214.

⁹⁶See, for example, Charlie McVean, *An Economic Analysis of Western Europe with Special Emphasis on French Fixed Income Investment Opportunities*, 26 February 1993. Despite its publication date, McVean Trading and Investments had already taken up currency positions reflecting a weakening of the French Franc and a lowering of its interest rates in 1992. Their position was not based on speculative trends, but rather on economic fundamentals. They were long the Pibor (France's 90 day rate). Eichengreen, on the other hand, suggests a type of conspiracy in which traders simultaneously attack a currency with the knowledge that a state cannot indefinitely fend off such attacks. More specifically, in France's case, he argues that because

(continued...)

traders should perhaps be given credit for their insights and understanding of the fundamental economic dilemmas which strike national economies.

The discussion behind the root causes of the ERM crisis are important. Should one estimate the impact of German reunification as the most significant then, barring any near-term future cataclysmic economic event similar in nature to German reunification, the ERM can expect to return to a period of stability similar to the one it enjoyed prior to 1992 and rely on orderly currency realignments as economic fundamentals may dictate.⁹⁷ Conversely, should one see the breakdown of the EMS as a speculative conspiracy more than a speculative stampede of currency traders pursuing "herd mentality" instincts, albeit established on economic fundamentals, then the road to MU will continually be obstructed

⁹⁶(...continued)

traders perceived that they would attack the French franc in unison, they did so. Thus, according to Eichengreen, the attack occurred in the absence of any fundamental economic reason; traders were armed only with the perception that they would all attack at once. Given market complexities, such a coordinated attack seems highly improbable. Warwick Lightfoot, treasury economist at the Royal Bank of Scotland, and former advisor to the Chancellors of the Exchequer Nigel Lawson, John Major, and Norman Lamont, dismisses this notion: "This judgment displays a profound misunderstanding of the nature of markets. Financial markets are capable of many things: a bovine herd instinct, overshooting and creating short-lived speculative bubbles. What they are not capable of is acting deliberately and willfully in concert. There are too many separate players with different fiduciary interests involved for speculators to be able to move markets alone." *The Wall Street Journal Europe*, 30 September 1993. Furthermore, were this truly the case market trend setters, such as Soros and his Quantum Fund, should have obtained fantastic results in the most recent turmoil of the currency markets; yet precisely the inverse occurred. These hedge funds have had dismal returns with most of their losses emanating from currency speculation. *The Economist*, 12 August 1995. (This in turn may relieve Midwestern academia. In a 28 September 1995 *The Financial Times* editorial on Soros, Samuel Brittain asks "... is there any reason why anyone should listen to the views of wealthy gurus with any more respect than to a professor from a Midwestern US campus?" - apparently, no.)

⁹⁷However, half of the five year period of stability functioned with the use of capital controls. During the 1980s, France and Italy used them to insulate its currencies from the full force of speculative attacks. Maurice Obstfeld, *Competitiveness, Realignment, and Speculation: The Role of Financial Markets*, 1988. Obstfeld states that changes in parity are perhaps the most critical aspect currency markets: Empirically, the fear of devaluation is a leading -"perhaps the leading"- factor behind currency flight, as the prospect of revaluation is to currency in-flows. Peter Kenen asserts however that there is no way to know by how much capital controls restricted the volume of capital flows or held down reserve losses in turbulent periods. "Capital Controls, the EMS, and EMU", *The Economic Journal*, Number 105, January 1995, p. 182.

by volatile currency upheavals within the EMS - requiring either capital controls or wider bands in order to maintain the system.

Capital Controls and the EMS

Regardless of the reasons for speculative attacks, one thing is certain - they do occur, leaving a path of destruction in their wake. In this light a new debate emerged after the ERM crisis over the use of capital controls. And again there is no consensus for or against their use. The main argument for their reincorporation within the EMS is to soften the blow of speculative attacks by permitting central banks and governments time to properly intervene and/or realign their currencies. Their use would be only temporary and upon achievement of MU capital controls could again be lifted.⁹⁸ Advocates for their use suggest that without these controls the likelihood of achieving MU is substantially reduced given the market volatility associated with pegged exchange rate schemes.

Those who argue against capital controls suggest that its reintroduction would be a step backwards without necessarily guaranteeing smooth sailing in the currency markets to MU. The re-implementation of the type of pre-1990 capital controls would violate the

⁹⁸Barry Eichengreen, James Tobin, and Charles Wyplosz, "Two Cases For Sand in the Wheels of International Finance", *The Economic Journal*, Number 105, January, 1995, pp. 162-72, and Barry Eichengreen, A.K. Rose, and Charles Wyplosz, *Is There a Safe Passage to EMU? Evidence on Capital Controls and a Proposal*, 1994, pp. 1-25. These authors propose the use of non-interest bearing domestic currency deposits with central banks for non-residents to borrow money. Patrick Artus and Henri Bourguinat, also suggest some type of controls to stem speculative capital flows which do not specifically violate the Maastricht Treaty, such as limiting loans to foreign investors or speculators. "The Stability of the EMS", *Thirty Years of European Monetary Integration*, ed. Alfred Steinherr, 1994, pp. 162-3. Peter Garber and Mark Taylor rebuke the proposal by arguing that such requirements could be evaded. Furthermore, they suggest that even if they could be enforced, these measures would not necessarily contain speculative pressures. "Sands in the Wheels of Foreign Exchange Markets: A Sceptical Note", *The Economic Journal*, Number 105, January, 1995, pp. 173-80.

SEA and Maastricht Treaty.⁹⁹ Since EU currencies are traded around the world 24 hours a day, implementing capital controls would require participation of all states and financial institutions.¹⁰⁰ Lastly, aside from disrupting optimal capital allocation, the use of capital controls would divert foreign capital away from Europe at a time in which Europe's economy is in desperate need of it.

Regardless of the ensuing debates it is, in all probability, a moot point. Not only would restoring capital controls transgress the global trend of capital liberalization, "the political (and economic) objections to the reimposition of controls over capital flows or the foreign exchange market more generally appear forbidding; in the circumstances, it seems more profitable to consider alternative types of transitional arrangements."¹⁰¹

The Mexican Peso Crisis of 1994-5

The strength and speed with which speculative attacks marred the ERM beg comparison with the fall of the Mexican peso in December 1994. There are similarities between the two crises: the peso is also a pegged currency, expectations of adverse financial conditions became self-fulfilling in the financial markets, and most importantly interest rate policies which threaten employment or other domestic financial institutions

⁹⁹Eichengreen's, Tobin's, and Wyplosz's proposal would not violate the Maastricht Treaty or the SEA.

¹⁰⁰Alfred Steinherr, "The Case for EMU", *European Monetary Upheavals*, ed. David Cobham, 1994, p. 157. Peter Kenen also makes the same assertion in "Capital Controls, the EMS, and EMU", *The Economic Journal*, Number 105, January 1995, pp. 188-9. Not only would transaction taxes be difficult to enforce, it would be difficult to determine the rate required to discourage speculation without affecting trade and long-term capital transactions, if such a rate even exists.

¹⁰¹Michael Artis, "Feasible Transitions", *European Monetary Upheavals*, ed. David Cobham, 1994, p. 197.

(i.e. banks) were unsustainable with pegged exchange rates. Other than that, the events leading to the crises and the crises itself were generally unrelated. Most notably there was not a speculative attack, but rather a rapid departure of fearful foreign investors.¹⁰² Additionally, the Mexican crisis was primarily country specific, whereas in Europe the impact spread across time and space.¹⁰³

Foreign investors were becoming increasingly concerned about Mexico's dwindling reserves. When Mexico's finance minister announced a 13 percent devaluation before reimposing former limits on the peso's daily movements, investors ran for the door, leaving the peso to float and dive further. The dramatic increases in interest rates failed to attract foreign capital, while they rekindled concern about the possibility of Mexico's

¹⁰²The most glaring difference is that Mexico is regarded as an emerging economy as opposed to Europe's advanced industrialized economies. Additionally, it has been tormented by Indian revolts and political assassination, all of which do little to instill investor confidence. More specifically, Mexico's foreign currency reserves were steadily dwindling throughout 1994 as its current account deficit was steadily rising. In response, the central bank expanded credit which eventually reduced reserves even more. With such a policy, Mexico soon depleted its reserves by year's end. Jeffrey Sachs, Aaron Tornell, and Andrés Velasco suggest that Mexican central bank authorities should have expanded credit *moderately* and allowed the exchange rate to depreciate. "We might note that several countries in Europe in 1992-93 also found the costs of tight credit and pegged exchange rates to be unbearable, leading to a serious weakening of domestic banking systems. These countries, including U.K., Sweden, Finland, and Norway, ended up allowing their exchange rates to depreciate vis-a-vis the deutschmark, rather than depleting reserves or sticking with a costly credit squeeze at great risk to the banking sector." *The Collapse of the Mexican Peso: What Have We Learned*, 1995, p. 14.

¹⁰³Initially, other Latin American countries felt exchange rate pressures as well from panicked investors. However, the extent was limited and exchange rates are basically the same as they were a year ago.

Currency Units per \$

	Latest	Year Ago	% change
Mexico	6.54	3.41	-48%
Brazil	0.96	0.85	-11%
Chile	406	402	>-1%
Argentina	1.00	0.99	-1%
Venezuela	170	170	0

Source: *The Economist*, 7 October 1995

defaulting on its short term debt, causing the peso to fall even further. Certainly capital controls could have reduced the rapid departure of foreign capital, but such controls would then have in all probability dissuaded foreign investment in the first place¹⁰⁴. For this study, Mexico's peso crisis serves our purposes by reemphasizing the difficulties inherent in adjustment under fixed exchange rates.¹⁰⁵

Assessing the Precondition for a Stable Currency

Europe's dilemma with pegged exchange rates may have been resolved, since the EMS has basically moved to a flexible exchange rate. In July 1993, after the last "attack" on several EU currencies, the exchange rate band was widened to 15%. Yet this widening of the ERM does not necessarily solve the precondition for MU. First, the Maastricht Treaty does not mention a specific range in which currencies are allowed to fluctuate. Article Three of the Protocol on the Convergence Criteria referred to in article 109j of the Treaty states:

The criterion on participation in the Exchange Rate mechanism of the European Monetary System referred to in the third indent of Article 109j(1) of this Treaty shall mean that a Member State has respected *the normal fluctuation margins* provided for by the Exchange Rate Mechanism of the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period. (Italics added)

This presents a technical problem now for interpreting the exchange rate precondition as stated in the treaty. Which band applies, the 2.25 percent band or the 15 percent band?

Alexandre Lamfalussy, president of the newly created European Monetary Institute

¹⁰⁴A large portion of capital inflows had been speculative investments in equities or short-term deposits, rather than foreign direct investment. *The Economist*, 7 January 1995, p. 14.

¹⁰⁵Jeffrey Sachs, Aaron Tornell, and Andrés Velasco, *The Collapse of the Mexican Peso: What Have We Learned*, 1995, p. 29.

(EMI), said the wider bands should be maintained in order to defend currencies against speculative pressures. Von Hagen suggests that those who demand a literal interpretation are intentionally attempting to ruin MU because a narrow 2.25 percent band will not allow the adjustment needed for countries with high debt-to-GDP ratio to meet the debt criteria.¹⁰⁶

Germany's leaders however are insisting on strict interpretation of the treaty. They argue that when the treaty was signed the narrow 2.25 percent bands were in effect. The significance of how the treaty is interpreted is discussed later. It suffices to state here that the widening of the bands does not necessarily suggest that it will be applicable for meeting this MU precondition. A wider margin of fluctuation may make sense on economic grounds, but political realities are likely to preclude this from transpiring.

Secondly, even should the wider bands of currency fluctuations apply as the "normal margin of fluctuation", it does not guarantee that all EU currencies will remain within it. Nevertheless, should this relaxation of the ERM apply, it would undoubtedly facilitate the entrance of weak currency states should they meet the remaining criteria and dramatically lower the possibility of another currency crisis.

In either case, since the latter part of 1993 and despite the recent currency market turmoil as a result of the Deutsche Bundesbank President Hans Tietmeyer's and German Finance Minister Theo Waigel's statements that Italy and Belgium may not meet the

¹⁰⁶During interview on 2 November 1994. In addition, Lionel Barber suggests that, "It is quite conceivable, too, that finance ministers could elect to call the wider ERM bands 'normal' later this year." 'Sceptics Forced to Think Again', *The Financial Times*, 30 September 1994.

convergence criteria, several currencies have moved back towards the narrower 2.25 percent band. (See figure 11.) The exchange rate spreads above represent exchange rates for the first week of September

1995.¹⁰⁷ Thus well over half of the states meet the criteria. Even Italy which is no longer in the EMS is currently within the narrow band.

According to the Maastricht Treaty, if by the end of 1997 the date for the beginning of the third stage has not been set, the third stage shall start on 1

January 1999. Before 1 July 1998, the political decision must be made to determine which states qualify for the final stage. Both the heads of state and finance ministers have stated that they will meet these dates. The decision will be based on actual 1996-7 data rather than forecasts or quarterly results.¹⁰⁸ Subsequently, the prior failure of the ERM is only relevant in that European leaders learn from the experience so that it is not so easily replicated in the future when the official clock to MU running.

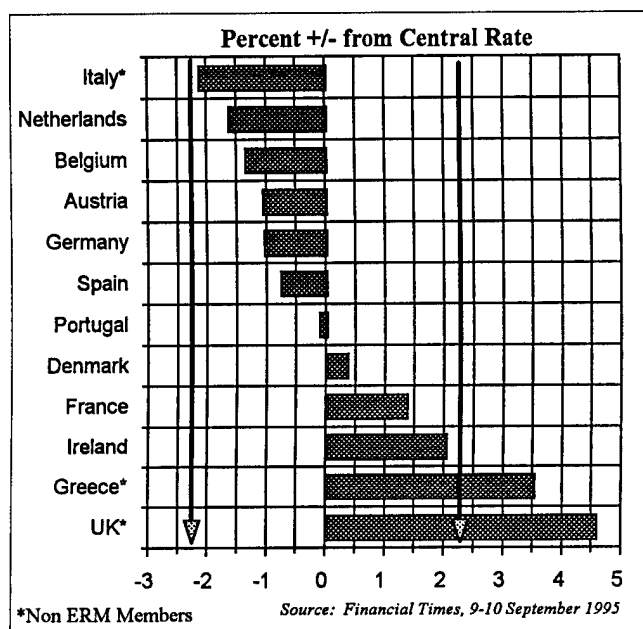


Figure 11

¹⁰⁷Figure 11 is only a "snapshot" and shows the 2.25 percent band. To meet the treaty requirement currencies must remain within the margin of fluctuation for two years. Additionally the graph represents fluctuations from the central parity of the ECU; while this is a good indicator of where currencies stand, they must maintain a margin of fluctuation between all currencies, not the ECU.

¹⁰⁸The Financial Times, 2 October 1995.

With this said one can thus observe that MU is far from dead, especially considering that the timing for the decision to enter the final stage should occur during a period of slowly sustained economic growth. It is difficult to imagine another political or economic event as powerful as German reunification, but even should that transpire there would still be a number of hard currency states which should be able to ride out another ERM storm.¹⁰⁹ Given a stable economic environment, currencies bordering the limit could possibly be maintained within the limit for the two year period prior to the final stage. Even after the crisis in 1993, financial market's behavior suggested that the EMS will succeed. Mr. Bishop at Salomon Brothers stated, "The market, in its wisdom, is not expecting a trend of divergence between the French franc and the deutschemark. The market is indicating that it expects a monetary union."¹¹⁰ Still, history demonstrates that this is by no means guaranteed and as they close on the final stage speculative pressure could build against weaker currencies, assuming the narrower ERM criteria is applied.

To restrict this possibility, those currencies whose parities are unsustainable, such as the British pound sterling, should be realigned to reflect economic reality prior to the year's end. And in the case of the pound and lira, these currencies would need to rejoin

¹⁰⁹Jürgen von Hagen and Manfred J.M. Neumann submit that the conditions for EMU have improved for certain states. By measuring exchange rate variances, they conclude that Austria, Belgium, France, Luxembourg, and the Netherlands have a low real exchange rate variance with Germany. They add that real exchange rate variance between Germany and Denmark, Italy, and the U.K. are much higher, (Denmark to a lesser extent) but not as a result of imperfect monetary coordination. These variances are from other sources, such as asymmetric real supply and demand shocks. Thus they assert that a premature monetary union including Germany and these states could strain these economies given the treaty's demand for fiscal restraint. "Real Exchange Rates Within and Between Currency Area: How Far Away is EMU?", *The Review of Economics and Statistics*, 1994.

¹¹⁰'EC Prepares for Next Steps Toward Union', *The Wall Street Journal Europe*, 31 December 1993-1 January 1994. In a more recent Wall Street Journal article, October 1995, Salomon Brothers reemphasized their confidence in MU.

the ERM.¹¹¹ To resort to capital controls is questionable and ignores the primary cause of the last crisis: fundamental shifts in Europe's economic structure. The period represented an aberration in history of great significance which was, and continues to be, too often overlooked.

In the current discussion only little attention has been paid to the fact that the next few years are extremely unsuitable for the transition towards a single European currency. The economic restructuring of Eastern Europe, German reunification, and the completion of the EC internal market will generate a fundamental structural change which will require considerable changes in relative prices between the basket of commodities in the different countries, in other words - real exchange rate changes.¹¹²

These currency realignments would better reflect the enormous changes in Europe's economic environment.

II. Converging rates of inflation and long term interest rates

In the year prior to possible entry the applicant country can have a rate of inflation no higher than 1.5 percentage points above the average of the three EU states with the

¹¹¹Both Dyson and Steinherr state the pound/deutschemark rate is misaligned and was the primary reason behind the U.K.'s speedy departure from the ERM. They argue that the pound should be devalued against the deutschemark. Currency realignments are one of the normal mechanisms for periodic adjustment of the EMS. As recently, as 6 March 1995, both Spain and Portugal devalued their currencies by 7 and 3½ percent respectively.

¹¹²Cited by Peter Bofinger, "Is Europe an Optimum Currency Area?", *Thirty Years of European Monetary Integration*, ed. Alfred Steinherr, 1994, p. 40. William Branson also suggests that the crisis resulted in unilateral realignment of the deutschemark as would be required by reunification, but in a "particularly unfortunate manner. Instead of an orderly realignment that could be seen as a German event, it is now viewed as a speculative rout of all the other Central Banks, which now have lost the credibility they thought to maintain by remaining pegged to the deutschemark." "German Reunification and EMS Breakdown", *European Monetary Upheavals*, ed. David Cobham, 1994, p. 26. Alfred Steinherr has a different interpretation of events but makes the same conclusion. "I conclude then that it was not German unification that destroyed the system, rather it was the fact that incomplete inflation convergence was not accompanied by exchange rate adjustments." He goes on to suggest that German reunification did more to strengthen the EMS as Germany fiscal situation and balances of payments came closer to the EU average, thus making convergence easier for the rest of Europe. "The Case for EMU", *European Monetary Upheavals*, ed. David Cobham, 1994, pp. 149-50.

lowest rates of inflation. Member states must demonstrate sustainable price stability. This precondition is largely regarded as justifiable since a state entering the final stage of convergence with high inflation would create competitiveness problems for states with lower inflation rates, assuming the ECB would maintain the stated goal of price stability by enforcing a restrictive monetary policy.¹¹³

However, De Grauwe suggest that this explanation is not applicable once a state with inflationary bias sheds its national currency.¹¹⁴ He equates

monetary union to

monetary reform. Consequently, since the old currency “disappears” with the establishment of a common currency so does its inflationary expectations.

Currently, the precondition for inflation poses no obstacle for a majority of the states for MU. (See figure 12.) However, as Europe comes out of recession, it risks

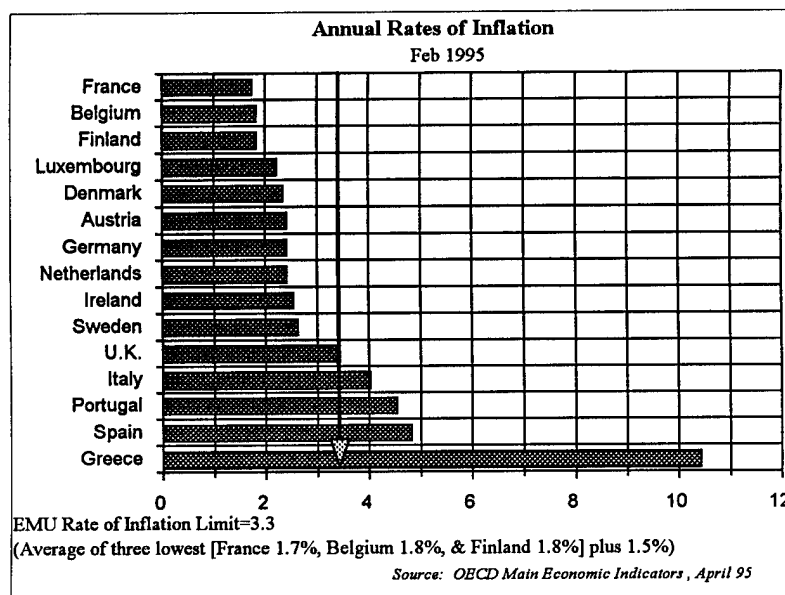


Figure 12

¹¹³Barry Eichengreen, 'European Monetary Unification', *Journal of Economic Literature*, Vol. XXXI, September 1993, p. 1346. One would expect just the opposite, but Bini-Smaghi and Paolo Del Giovane show that if the ECB adopts a restrictive monetary policy to promote price stability to counter the inflationary shock, output will fall most sharply in low inflation countries.

¹¹⁴Paul De Grauwe, "Inflation Convergence During the Transition to EMU", *Economies et Sociétés*, Number 9, September-October 1992, pp. 21-24.

possible asymmetrical rapid growth in certain states which could cause them to experience inflationary pressures. Still, even should this occur, the cyclical effect would be a relatively short term.

The relative low variance of inflation rates in figure 12 seems to suggest that the EMS has, to a large degree, been successful in its attempts to converge macroeconomic conditions. Given the ease in which the lira and pound were knocked out of the ERM and the series of devaluations of the peseta and escudo, one should not be surprised to find precisely the states possessing these currencies at the top of the inflation scale. Yet De Grauwe warns that the low variance between rates of inflation may be as misleading as it was during the 1960s.¹¹⁵ States which require currency rate devaluations are more likely to see renewed divergence of inflation.

While the elementariness of his statement is rather self-evident, it tends to coincide with von Hagen's and Neumann's assessment of low exchange rate variances amongst certain states. (footnote 102) It is precisely the same weak currency countries identified by von Hagen and Neumann that require the inflationary-biased devaluations stated by De Grauwe. Not surprisingly these trends have already manifested themselves in exchange rate operations since 1992, the results of which can be readily observed by the relatively

¹¹⁵De Grauwe argues that from an historical perspective the degree of inflation convergence is at an historically high level, and that the hopes of a further narrowing of the differences in national inflation rates are unrealistic. He states that given the increasing divergencies in price levels, a renewed divergence in rates of inflation is more likely to the contrary. Paul De Grauwe, "Inflation Convergence During the Transition to EMU", *Economies et Sociétés*, Number 9, September-October 1992, pp. 21-24.

higher inflationary bias in those states.¹¹⁶ These happenings do not necessarily dictate that the inflation rate criteria is too strict, as De Grauwe argues; rather, it is increasingly more apparent that the final stage of MU will be achieved at different times by different states as their economies converge with Germany's.

Another closely related MU precondition concerns the convergence of interest rates.¹¹⁷ In the year prior to possible entry, the applicant country must have a long term rate of interest within two percentage points of the average of the three EU states with the best record in terms of inflation. This precondition tends to have an inverse relationship with the inflation precondition. States trying to maintain price stability and low inflation during recoveries routinely resort to raising interest rates, restricting monetary supply, or a combination of the two,¹¹⁸ thus the challenge is to adjust interest rates in unison. This is difficult when states' economic interests diverge, such as during asymmetrical shocks.

The dichotomy between interest and inflation rates justifiably suggests that the utility of the interest rate criteria is questionable. Gerd Haller, Secretary of State in

¹¹⁶This higher inflation rate does not necessarily reflect a problem. Higher rates in Italy and Spain, for example, are partially due to their higher rates of productivity. Paul De Grauwe, "Inflation Convergence During the Transition to EMU", *Economies et Sociétés*, Number 9, September-October 1992, p. 18.

¹¹⁷In general, long term interest rates in a particular currency can be considered to consist of two components: the global real interest rate and a country specific premium or discount reflecting several factors of which inflation variances are the most important. These inflation variances tend to get reflected in the expected long run appreciation or depreciation of the currency. Andrew Crockett, "The Role of Convergence in the Process of EMU", *Thirty Years of European Monetary Integration*, ed. Alfred Steinherr, 1994, p. 180.

¹¹⁸In theory, states could also increase or decrease their monetary supply to offset the effects of high or low inflation without substantially changing their interest rates. Ultimately however, there are several other factors which will influence interest rates over the long term; market forces are increasingly playing a crucial role as witnessed in the EMS discussion above. How bond markets interpret state debt or exchange rates (both are MU preconditions) will also affect rates.

Germany's Ministry of Finance and an influential member of the monetary committee, arguably submits the 'Economist's view' (as opposed to the 'Monetarist's view') that the interest rate criteria is not needed. "They need to switch the emphasis away from monetary policy as an instrument and concentrate more on creating sound economic policies and reducing budget deficits." He added that guidelines should avoid any reference to interest rate cuts at all. "We all want low interest rates, but as a result of good economic policies not as a instrument themselves."¹¹⁹ Indeed one of the advantages of MU is the economic environment it should theoretically inspire for low and stable interest rates brought about by stable currencies and low inflation and not through the manipulation of interest rates themselves.

Low inflation combined with the elimination of currency risks within Europe could significantly lower interest rate levels all over the Continent, since interest rates are at least in part risk premiums demanded by the investors as a hedge against the vagaries of exchange and inflation rates. Thus a large number of potential fixed investments all over Europe would turn from unprofitable propositions into viable, feasible projects, meaning that levels of (industrial, public, housing) investment could be realized in Europe that would otherwise be clearly unattainable. And this does not pertain only to future investment, *all* investments made in the past would be freed from a measure of risk and uncertainty arising out of the volatility of exchange rates between the currencies of neighboring countries!¹²⁰

The role of interest rates on an economy's performance and on a currency's rate of exchange are well established. On one hand, interest rates which are maintained at artificially high levels to meet the stable currency precondition at the expense of higher unemployment are ultimately unsustainable; the ERM crisis of 1992-3 illustrated the

¹¹⁹*The Wall Street Journal Europe*, 1 December 1993.

¹²⁰Peter G. Rogge, "Monetary Union in Europe", *Europe After Maastricht*, ed. Paul Michael Lutzeler, 1994, p. 118. Not only does this passage serve to illustrate the close link between inflation rates, interest rates, and ERM stability, it also provides a clear and concise summary of how EMU could dramatically assist EU member states with the economic challenges discussed in the previous chapter.

conflict which develops between credibility and sustainability when this occurs. On the other hand, interest rates are set by independent central banks (primarily the Bundesbank) whose primary objective is price stability rather than growth or employment. Thus, for example, during

Europe's last recession
the European
Communities Committee
of the U.K. House of
Lords submitted that the
scale and pace of the
European recovery was
questionable because the
lowering of interest rates

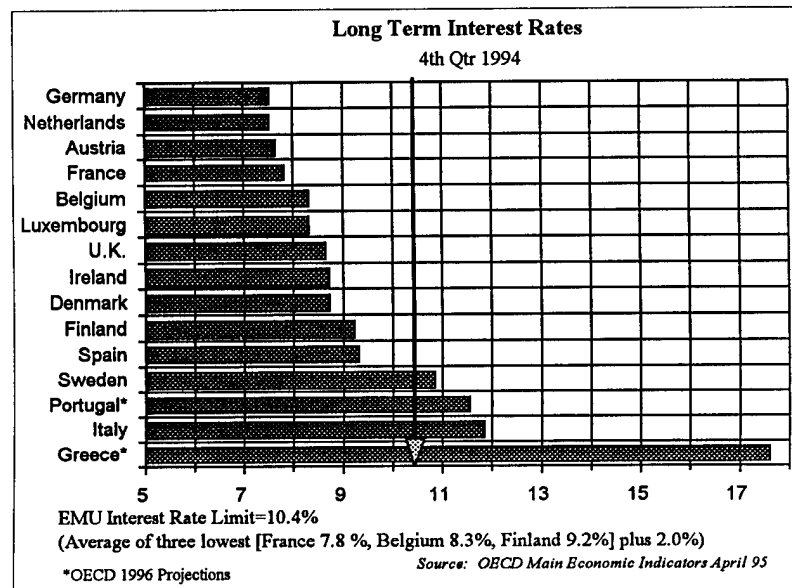


Figure 13

required for recovery and to alleviate cyclical unemployment were perhaps insufficient.¹²¹

Nevertheless, most member states meet the interest rate criteria for MU. (See figure 13.) Since it is based on the three countries with the lowest inflation rate, future cyclical growth should have little impact for most member states. Those states with the lowest rate of inflation do not necessarily have the lowest interest rates; couple this with a generous two percentage point window, most states should then meet this particular precondition. Again, those states with relative higher interest rates are generally the same

¹²¹House of Lords, Select Committee on the European Communities, *Growth, Competitiveness and Employment in the European Community*, April 1994, p. 32.

states with higher rates of inflation and not surprisingly have devalued their currencies within the last few years. These monetary trends would thus imply that these states have not yet achieved the level of convergence required for EMU. While the manipulation of interest rates is a key tool for meeting the previously mentioned MU preconditions, Haller's argument for concentrating on sound economic policies and reducing federal deficits is given additional weight when measuring these state's economic performance to date.

III. Deficit to GDP ratio of three percent or less and debt to GDP ratio of 60 percent or less

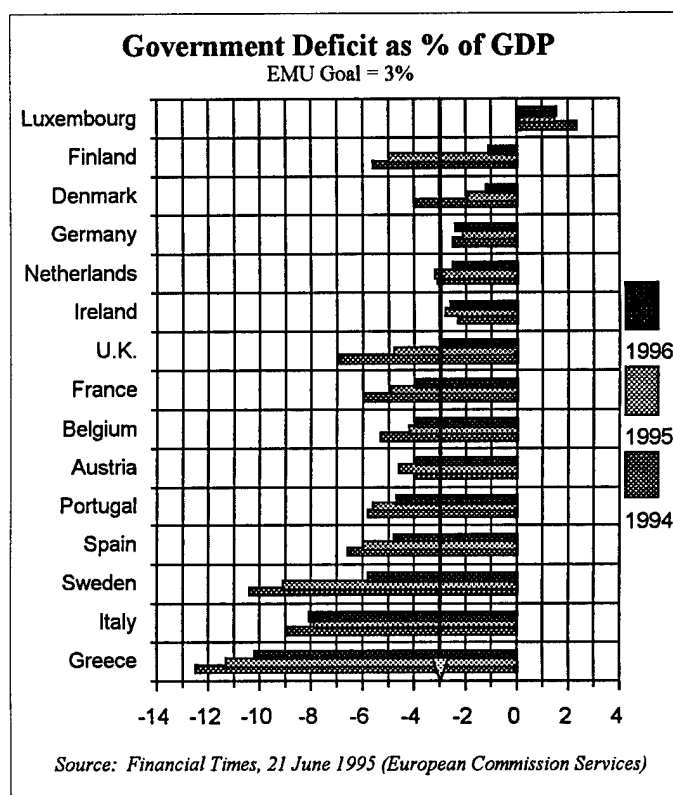


Figure 14

The national budget deficit must be less than three percent of GDP and the public debt to GDP ratio must be 60 percent or less. These preconditions possibly represent the largest challenge to MU. MU needs the deficit and debt criteria to quell inflationary pressures that would otherwise be transferred to the Union by states with excessive debts and

deficits.¹²²

The fact that EU states are experiencing economic growth decreases the debt and deficit ratios, thus facilitating the achievement of these preconditions, especially for those states bordering the limits. (See figures 14 and 15.) Also assisting several states in their efforts to lower debt and deficit balances is the privatization trend. In addition, the treaty offers a certain degree of interpretation. Should states not meet the above mentioned limits, they can, in theory, still qualify if they are making continued and substantial progress towards the stated goal. And indeed most states have developed fiscal targets to assist them in this effort. (See annex five.) Article 104c states:

1. Member States shall avoid excessive governmental deficits.
2. The Commission shall monitor the development of the budgetary situation and of the stock of government debt in the Member States with a view to identifying gross errors. In particular it shall examine compliance with budgetary discipline on the basis of the following two criteria:
 - (a) whether the ratio of the planned or actual government deficit to gross domestic product exceeds a reference value, unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;
 - (b) whether the ratio of government debt to gross domestic product exceeds a reference value, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace.

Subsequently, given a loose interpretation of the treaty and the positive correlation between the criteria and recent growth in GDP many member states could, in theory, meet the debt

¹²²De Grauwe questions the debt requirement as well. He points out that it would be much easier for states with high levels of debt to reduce them inside EMU. Once a state such as Italy or Belgium is inside EMU it automatically would get lower inflation without the need to pay the credibility penalty on real interest rates, thus permitting a savings on servicing its debt. He adds that the preconditions for MU may serve only to entrench existing divisions within Europe. Insisting on these preconditions will make it harder for the states that need to reduce their debt and/or rates of inflation to do so. However, unlike the inflation precondition, De Grauwe does recognize the rationale behind the debt precondition. *The Economist*, 5 August 1995, p. 72.

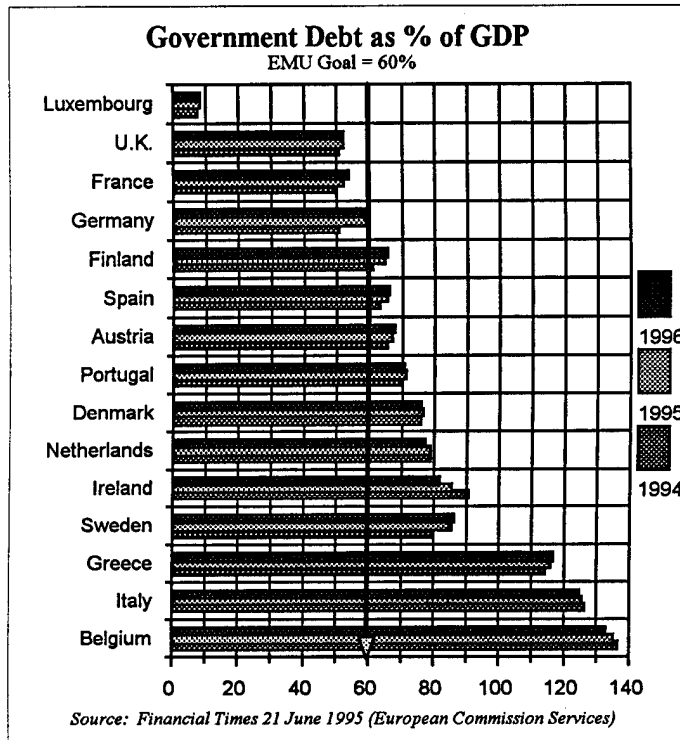


Figure 15

growth nonetheless. And yet despite this growth, several states's deficit ratios are still perilously close to the stipulated maximum level, begging the question of sustainability during the next cyclical downturn.

In the short term, the costs of implementing austerity programs can be high, both socially and politically. Most governments have already implemented budgetary programs to meet the Maastricht deficit and debt criteria, but with a certain degree of caution.

"Many governments are anxious to outflank opponents eager to pin the blame for job losses on austerity programs aimed at qualifying for membership of an end-century monetary union."¹²³ There is indeed a legitimate concern of the impact of such spartan

¹²³Alain Juppé, France's Prime Minister warned that if his twin attack on unemployment and the budget deficit failed, he would be replaced by a nationalist. *The Reuter European Community Report*, 27 June (continued...)

budget policies.¹²⁴

Consequently, another paradoxical situation arises over budget deficits and debt which are quite similar to the ones discussed in the previous chapter. On one hand, the failure to reign in deficits in a vast majority of states threatens both economic growth and stability and could prevent states from entering the final stage of MU; while MU is desired at least theoretically to enhance economic growth. On the other hand, austere measures threatens political and social stability, and in certain cases, may even hinder economic growth, without necessarily guaranteeing that states would meet the other convergence criteria. Thus the challenge to European leaders is to find the appropriate mix of measures which ensures political and social stability and economic growth and stability; for certain states this may be an impossibility.

Interpreting the Maastricht Treaty

The Maastricht Treaty is chocked full of compromises, as are most international agreements, which is fully understandable given that the various outcomes desired by each participant are not necessarily the same.¹²⁵ As such, the treaty leaves itself open to

¹²³(...continued)
1995.

¹²⁴A Rand report suggests that in the United States, balancing the federal budget deficit should not be the central objective of long-run economic strategy. They suggest that some times deficit reduction detracts from economic growth. Robert A. Levine and Peter J.E. Stan, *Macroeconomic Strategy for the 1990s*, 1993, p. 33.

¹²⁵Kenneth Dyson, *Elusive Union*, 1994 and Geoffrey Garrett, "The Politics of Maastricht", *Economics and Politics*, July 1993, pp. 105-123 offer excellent accounts of behind-the-scenes compromises that occurred during the treaty negotiations.

interpretation on a number of articles dealing with MU. Whereas the inflation and interest rate criteria are quite specific, the requirements for a stable currency and debt and deficit limits are vague.

What are "normal fluctuation margins" for a stable EMS currency? 2.25 percent or 15 percent? How does one determine if the ratio of government deficit to GDP has "declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value?" These questions of the economic realm can only be answered by political leaders.¹²⁶ While the decision-making outcome will definitively influence Europe's economic climate, the decision-making process itself will be wholly political. Subsequently, an examination of EMU necessitates linking the economic aspects of the debt, deficit, and stable currency preconditions for MU, and the treaty's generous latitude in its interpretation with the current European political environment.

Political comments from Germany indicate that its leaders will demand a much stricter interpretation of the convergence criteria. In a pre-election interview with *Le Monde*, Chancellor Kohl stated that, "Germany will never approve a modification of the criteria, what ever it may be," and his position has not wavered since.¹²⁷ Kohl's statement

¹²⁶The best recent example of this aspect was Kohl's political decision to support the plan for economic and monetary union with East Germany, despite the strongest objections from the Bundesbank.

¹²⁷"Helmut Kohl se prononce contre une 'Europe à la carte'", *Le Monde*, 1 October 1994. *The Financial Times* also reported that Germany signaled its unhappiness about the Commissions decision to exclude Ireland from the "excessive deficits" rules. "Germany does not want to create a precedent that will make it easier for countries with bigger debt problems, such as Italy, to become full EMU members.", *The Financial Times*, 2 September 1994.

is significant for several reasons. First, not only does it reflect the Bundesbank's stance on MU preconditions, it is also fairly indicative of most of Germany's political and economic elite. Second, several journalists accredited Kohl's statement to pre-electoral rhetoric to extinguish the general public's fears and criticisms of MU. Should this have truly been the case, what does it say about the necessary public support for a single currency? Third, Germany is Europe's economic cornerstone. Any EU economic decision without Germany's leaders consent will have much less significance or none at all. Most importantly, as its currency represents the core of the EMS, there can be no meaningful MU without Germany's participation.¹²⁸

Germany's political leaders and monetary officials have a justifiable concern and responsibility in maintaining a strong currency, be it the deutschemark or a future single European currency.¹²⁹ Even though Germany's leaders and its central bank can expect to continue to play key roles in MU, they will be sharing these responsibilities with others. When it comes to MU, the German state is certainly conceding more than any other state. Therefore, Chancellor Kohl's, Finance Minister Waigel's, and Bundesbank President

¹²⁸An additional aspect worthy of mentioning is Germany's experience during its own monetary unification exercise with its eastern sister state. With reunification Germany has gained first hand knowledge of the costs of a monetary union with an economically weak state. Furthermore, Germany's Constitutional Court ruled on the treaty in October 1993. In their interpretation they stated that Germany would not automatically be forced into the EMU because of strict convergence criteria that cannot legally be weakened without a decision by the German government with the advice of the Bundestag. *The Economist*, 16 October 1993, p.28.

¹²⁹To illustrate the point Mr. Tietmeyer declared that the Bundesbank will deliver a public judgement on the EU members that qualify for MU. "This is expected of us because of our monetary political supervisory role. This is also what the German public expects of us." He stated that strict standards are more important than meeting the target date. "A misconstrued currency union would not only endanger economic stability and prosperity. It would also be a setback to the process of European Integration." *The Financial Times*, 26 September 1995.

By clearly depicting the requirements for states to enter the final stage of MU, this reaffirmation at such an early date precludes any potential unpleasant political surprises in 1998 when the actual decision is finally made as to which states will be in the first group of single currency participants. Additionally since the decision on which states proceed to the final stage is based on a qualified majority it was important for German leaders to shore up support for its position among other member states.¹³⁴

To this end the German position has solidified and may even be appropriate on

¹³³(...continued)

first group of single currency countries, and expressed doubts about Belgium and the Netherlands as well. This led to stupefaction and anger among leading Italians, as well as a fall in the lira and Italian equity markets. *Agence France Presse*, 21 September 1995. Additionally, Germany reportedly came away from the Valencia meeting with even stricter deficit criteria. "All participants seem destined to subscribe to a new 'gentleman's agreement' to enforce curbs on budget deficits binding on future governments...Mr Trichet, governor of the Bank of France agreed with the Bundesbank's suggestion that it should include a commitment to reduce deficits to 'well below' 3 percent of GDP in recovery, so allowing a 'ceiling' of 3 percent in a recession." *The Financial Times*, 2 October 1995.

¹³⁴Because the decision will be made by a qualified majority one may conclude that Germany could not have single-handedly prevented any country from entering the final stage of MU. In theory this conclusion is correct. One might then assert that Germany's demand for a strict interpretation is less relevant should a qualified majority see otherwise; this however is misleading. While Germany certainly cannot prevent a state or states from entering, its Constitutional Court has effectively given Germany an opt out clause (see footnote # 128) thus, Germany has a de facto veto over the entire process. There can be no MU without Germany's participation. This fact may have influenced others in their support of Germany's position.

Another aspect is the derogation process for those states who do not meet the criteria. Article 109k of the Maastricht Treaty, paragraph 2 states:

At least once every two years, or at the request of a Member State with a derogation, the Commission and the ECB shall report to the Council in accordance with the procedure laid down in Article 109j(1). After consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or of Government, the Council shall, acting by a qualified majority on a proposal from the Commission, decide which Member States with a derogation fulfil the necessary conditions on the basis of the criteria set out in Article 109j(1), and abrogate the derogations of the Member States concerned.

Thus, in theory, once Germany would be a single currency participant its past influence gained from the threat of opting out would be substantially reduced and weak currency states, while unable to vote themselves, could influence a qualified majority to support their entrance. Even though it would not make sense on economic grounds for existing participants to support weak currency states, other non-economic factors may influence their decision. Consequently, while Germany could, under international treaty law, unilaterally revoke its treaty commitments, its leaders would be unlikely to do so because of both political and economic costs. While clarifying MU membership requirements now does not preclude this scenario from transpiring, it would make it more improbable.

both political and economic grounds. First, even though the utility of some of the convergence criteria is debatable or certain aspects of other preconditions are questionable, there is an undeniable economic logic to them all. Second, several of the preconditions may prove to be indispensable if Europe is to properly address some of its most serious economic deficiencies. Lastly, by relying on unbiased economic criteria, they lower the level of potential political conflict amongst EU members.

Public Opinion

One also needs to note a non-economic factor that presents a formidable challenge to realizing monetary unification: citizen's attachment to their own national currencies. As late as May 1990 France's finance minister said:

Let us stop dreaming. Can anybody imagine for a moment that Germany will give up the deutschmark or Britain the pound sterling? It would be better to stop messing about with such illusions and deal with realistic, practical matters instead.¹³⁵

Even though Mr. Balladur has adjusted his stance since then, his comment accurately depicts a big hurdle for European democracies to overcome, one that is often overlooked by economists. While a majority of European citizens (51%) are in favor of the introduction of a single currency, there is substantial opposition against its introduction in some of the "hard currency" states, most notably Germany. (See figure 16.) Thus, political leaders in certain states must not only overcome the challenges imposed by the convergence criteria, they must also convince their electorate on the advantages of MU and its single currency.

¹³⁵*The Wall Street Journal Europe*, 29 June 1993.

Nonetheless, positive trends can be distinguished even among those states that are not wholly enthusiastic about MU, particularly in Germany and Austria (+9 and +8 between April and June). Another positive aspect is that there is still a majority of European citizens who think that the single currency will be used regularly in the year 2000 (53%).¹³⁶ Still, despite these positive factors, domestic political positioning demonstrates that political leaders are aware of the public's apprehensiveness.¹³⁷

MU, as with economic union, can clash with nationalistic inclinations and strain domestic political support for deeper integration. This apprehensiveness towards deeper integration may transpire in several fashions. In the MU

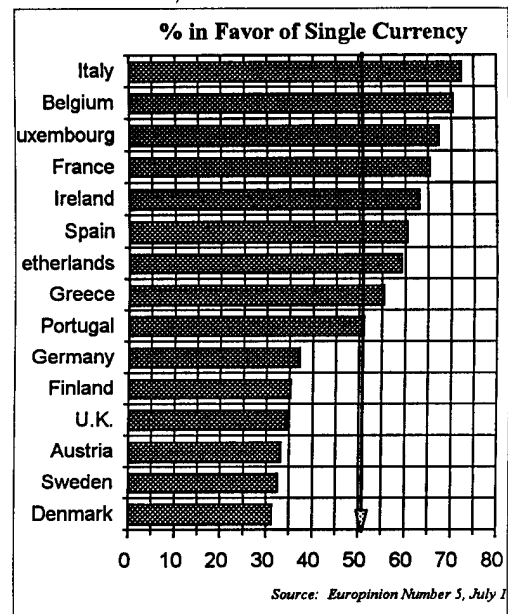


Figure 16

¹³⁶EUROPINION N° 5, <http://www.cec.lu/en/comm/dg10/incom/epo/eo/5/5.html>, July 1995. In a June 1995 survey of those who think that the single currency will be used regularly in the year 2000 German citizens surpassed the 50% mark for the first time: 52% - a 10-point rise - believe that the regular usage of a single currency will have become a reality in the year 2000. The proportion of Irish citizens holding this view, in turn, dropped below the 50% mark: only 45% - a 10-point drop - are still convinced of the common usage of a single currency in the year 2000. The decline is most notable in Portugal (38%, -10). The French and the Belgians are the most convinced (respectively 76% and 68%). The Swedish remain the most skeptical (27%).

¹³⁷Kohl's pre-electoral remarks and then French presidential candidate Chirac's pre-electoral statement calling for another referendum on MU (*Le Monde*, 25 October 1994), are glaring examples of political leaders's awareness of the lack of public support. National governments failure to pass EU directives into national laws may also be indicative. The British and the Danes have uncharacteristically been the most active legislators, while the French, Greeks, and Spanish have been rather slower to implement directives. By the end of 1993 only 59% of required public procurement directives were passed into national law. (60% for company law, 61% for intellectual and industrial property, and 73% for insurance). 'The European Union Survey', *The Economist*, 22 October 1994.

arena, the incompatibility of high rates of interest and unemployment or the need to implement austere budgets can sap public support. In the area of economic unification dwindling support can be caused by short term shocks in certain industries as a result of increased competition. In such an environment, myths and half-truths proliferate creating even a larger gap of support.

The interpretation of events, accurately or not, ultimately persuades perceptions which are more influential than reality. Thus, should the voting public perceive that the source of their economic woes is the result of closer integration, then resentment and dissatisfaction towards the EU will grow.¹³⁸ To a certain degree their perceptions may not be that far from reality. Nevertheless, a portion of the apprehensiveness around deeper integration involves inaccurate perceptions, due, in part, by the inability of pro-European political leaders to educate and convince their electorate, and in part, by an effective misinformation campaign by those forces opposed to deeper integration.¹³⁹

Still, other complaints are quite legitimate. In an effort to eliminate non-tariff-barriers (NTBs) and more fully enjoy the advantages of a single market, certain steps were

¹³⁸As far as benefits obtained through membership are concerned, they have been perceived as positive by one in two European citizens (50%) since the end of 1994. This opinion has been declining in Spain since January 1995 and reached its lowest level in April (only 24% recognized certain benefits accruing to their country from Union membership). Concerning this issue, the three new Member States' citizens have also been strongly and increasingly disenchanted. Between January and June 1995, the Austrians' positive perception of membership benefits fell from 49% to 32% (-17). That of the Finns declined by 26, from 62% in March to 36% in June, whilst 33% less Swedes were positive in June (20%) - the lowest European figure - than in January (53%). EUROPINION N° 5, <http://www.cec.lu/en/comm/dg10/incom/epo/eo/eo5/eo5.html>, July 1995. Not surprisingly Spain has the highest level of unemployment in the EU. And while 50% thought EU membership produced positive benefits the other half did not think so.

¹³⁹So called "Euromyths" are the primary culprit behind this scheme. Most of these are blatant lies of which the EU blames 80% on the British press. *The Wall Street Journal*, 22 June 1995. The EU President of the Commission, Jacques Santer, also addressed these myths during a recent speech given to a group of British industrialists. *The Reuter European Community Report*, 17 May 1995.

taken which either aggravated public support or served to distort trade even more; such as the misuse of standards and subsidies.¹⁴⁰

Many of these issues do not directly relate to MU. Yet they are significant because they influence the public's opinion on the overall EU enterprise of deeper integration, of which MU is the most significant. While practically none of these issues can single-handedly be considered as a threat towards deeper integration, a culmination of these issues, coupled with the problems associated with MU and Europe's economic structural deficiencies, could inflict substantial damage to the integration process. Consequently, as in all democracies, leaders must be aware of public perceptions. But rather than allowing perceptions to influence events, leaders should aggressively attempt to influence perceptions.

Summary

MU is far from dead. Granted, the convergence criteria for MU represents significant challenges for several states, but not for all of them. In fact, there is a noticeable similarity of the names of states which tend to continually find themselves on the short end of the criteria. Conversely, there is also a noticeable similarity of the names of states on the long end of the criteria. These tendencies will be evaluated in the conclusion along with two elements of MU which one can address with a degree of certainty: advancement to the third stage will be under strict rules of interpretation of the

¹⁴⁰ Gregory F. Treverton, 'The Year of European (Dis) Unification', *Current History*, November 1992, p.354.

Maastricht Treaty and 1996 and 1997 will be the evaluated period for the first group of single currency participants.

Europe, more than any other region, meets the criteria for an optimum currency area. Thus, at least theoretically, they should be able to implement one. The ERM crisis served to illustrate the need for periodic currency realignments based on changes in Europe's economies, but not the need for the use of capital controls. Hopefully, European leaders and monetary official learned that should they fail to make these adjustments to their national currencies, the markets will make the adjustments for them but in an unmerciful fashion.

The other monetary preconditions for MU serve to reemphasize the point that if states do not meet these preconditions, then it is most likely because their economies have not yet converged with the others, and are thus simply not yet ready for MU. The debt and deficit criteria will continue to be the biggest challenge for most states. But prudence should be applied so that social and political costs are balanced with economic benefits.

Along these lines EU leaders must be just that: leaders. Should they truly desire MU, then there is an additional requirement as equally as important as the MU preconditions - the requirement to educate and persuade their electorates.

The Maastricht criteria have identified the key areas of economic convergence. There should not be any watering down of these criteria in an attempt to hasten the process of MU. "However, it is important to ensure that the criteria are not simply

achieved at a moment in time, but are sustainable through time.”¹⁴¹ The issue of sustainability is addressed in the next chapter.

¹⁴¹Andrew Crockett, “The role of Convergence in the Process of EMU”, *30 Years of European Monetary Integration From the Werner Plan to EMU*, ed. Alfred Steinherr, 1994, p. 173.

Chapter Four

Sustaining EMU

Whether states meet the preconditions and enter the final stage of MU or are in the process of attempting to meet the preconditions, the challenges imposed by the preconditions remain in effect. In other words, getting to stage three is only half of the battle and sustainability becomes the next critical factor. Once a state reaches stage three, monetary and political authorities must still maintain the same fiscal and monetary policies used to achieve MU preconditions. Therefore, harsher domestic fiscal and monetary policy restraints implemented to reach the third stage will not necessarily ease upon entering the final stage of MU.¹⁴²

First, monetary decisions will be effected by the ECB whose primary objective according to the Maastricht Treaty is price stability. This will result in a loss of control of national monetary policy by states to influence national economic conditions. The ECB's monetary policy will not necessarily coincide with the desires of national authorities. Second, national governments will still be fiscally restrained by the amount of annual deficit spending and the amount of debt they may accumulate.

While these restraints will enhance price stability and thus a more efficient operation of the single market, they may also elicit domestic opposition and economic hardship. This chapter will analyze the challenges of sustaining MU. First, it addresses the

¹⁴²At least theoretically, certain states may see a reduction in interest rates from the formation of a single stronger currency, thus reducing the financial burden of servicing the national debt.

issue from an historical perspective. Second, the chapter looks at the challenges national governments face in coping with asymmetrical economic shocks without the use of their traditional tools of monetary policy and restrained fiscal policy.

The Historical Record of Monetary Unions

Benjamin Cohen, in an historical study of monetary unions, argues that without a strong political union, monetary unions have proved to be temporary and fragile arrangements.¹⁴³ Using sustainability, defined as longevity, as his dependent variable, and economic, organizational, and political factors as his independent variables, Cohen evaluates six formal currency unions among sovereign national governments

His evaluation shows little evidence that economic factors of an optimum currency area are substantially influential in sustaining these unions or leading to their dissolution. His findings are nearly the same for organizational factors, other than that the degree of centralization influences the cost of exiting the union; greater centralization appears to raise the costs of defection, but this does not preclude states from dropping out of highly centralized systems.¹⁴⁴ He concludes that political factors are the most persuasive in sustaining currency unions.

Cohen depicts two critical political elements which stand out in his survey: the

¹⁴³Benjamin Cohen, 'Beyond EMU: The Problem of Sustainability', *Economic and Politics*, July 1993. He evaluates the Belgium-Luxembourg Economic Union, the CFA Franc Zone, the East Caribbean Currency Area, the East African Community, the Latin Monetary Union, and Scandinavian Monetary Union.

¹⁴⁴A highly centralized monetary union would have a single currency and a central monetary authority. Benjamin Cohen, 'Beyond EMU: The Problem of Sustainability', *Economic and Politics*, July 1993, p. 195.

“realist” approach and the “institutional” approach. The realist approach deals with the role of the local hegemon in enforcing and maintaining the system.¹⁴⁵ The institutional approach focuses on a well developed set of institutional linkages and reflects a genuine sense of solidarity and community. He suggests that one or both of these two elements are necessary for a sustainable arrangement.

In this context, one could contend that the EU political environment promotes both of these approaches. Foremost, Germany is Europe’s hegemonic power.¹⁴⁶ As seen in the previous chapter, at least in the context of economic and monetary integration, Germany has dominated the direction of MU. This trend is witnessed through a series of events, from the location of the EMI and future ECB in Frankfurt to the most recent turmoil in the MU debate, with *The Financial Times*’s headline proclaiming the outcome: “Bonn sets agenda for monetary union”. Another indication that Germany is fulfilling the role of the hegemon is the German Central Bank’s announcement that it will publish which states meet the Maastricht preconditions for MU. Could any other European central bank make the same announcement and carry the same significance? The ERM crisis of 1992-3 was an extension of its capacity to finance its reunification through borrowing rather than

¹⁴⁵The role of the hegemon in international monetary arrangements is clearly described in Robert Gilpin’s *The Political Economy of International Relations*, 1987. In this work, Gilpin states that the argument for cooperative or pluralistic management in the absence of an hegemonic power is not supported by historical experience. p. 365.

¹⁴⁶This assertion perhaps violates the traditional realist concept of hegemony, as Germany’s role in Europe’s economic domain is not necessarily overshadowed by the primacy of security and political interests. On the other hand Germany’s role is applicable to Keohane’s theory of hegemonic stability, at least in the European context, as Europe’s dominate liberal power.

increasing taxes again indicating its strength as an economic power.¹⁴⁷ Up to this point Germany has to a large extent dictated the terms of MU.

However, while the earlier stages of MU are dominated by Germany, this will not necessarily be the case in the final stage. Monetary policies will be determined by the ECB, of which Germany monetary officials will represent only one of several states, albeit one with a considerable say. This indicates that the institutional approach will more accurately reflect the EU, especially upon the commencement of stage III and the establishment of the ECB. Should only those states whose economies have converged sufficiently participate, then one might anticipate a relatively cooperative and mutually supporting environment for formulating and implementing monetary policy.¹⁴⁸ There are and will in the future be elements of both approaches in EMU. Consequently, the EU, at least theoretically, possesses the political elements to sustain MU.¹⁴⁹ Even assuming EU states have the political structure to sustain MU, self-inflicted economic requirements may limit MU's duration, despite Cohen's findings.

¹⁴⁷The concept that a hegemon pursues its own interest is a fundamental aspect of the theory. It does not necessarily imply that the pursuit of its own interests is unstable for maintaining the system. However, Germany's role during the ERM crisis was arguably destabilizing. The 'Emminger Letter' also provides further proof that the German central bank regards the domestic stability of its currency as its chief priority before satisfying community commitments of unlimited intervention. Kenneth Dyson, *Elusive Union*, 1994, p. 109.

¹⁴⁸Von Hagen and Fratianni argue that in order to have the most efficient implementation of EMU (a centralized system with a single currency) then the membership of the single currency participants must be restricted to the core group. Jürgen von Hagen and Michele Fratianni, "The Transition to European Monetary Union and the European Monetary Institute", *Economics and Politics*, July 1993, p. 181.

¹⁴⁹Tietmeyer forewarns that the "independence" of the ECB cannot be a substitute for political power. He believes that if the basic budgetary, fiscal, and wage policy is not in place, then there is little the monetary authorities can do to maintain price stability. *The Wall Street Journal Europe*, 29 June 1993.

European Fiscal Federalism?

There are additional challenges to deeper monetary integration than those which may occur from a state's inability to meet the convergence criteria or alleviate economic structural problems. Sustaining MU debt and deficit conditions and the loss of national monetary policy may also create economic-political difficulties for EU member states.

The domestic challenges of MU will be virtually the same for states that meet the preconditions and enter the final stage of MU as when they were attempting to meet the preconditions. As the British have demonstrated with more rapid rates of growth and reduced unemployment when they dropped out of the EMS in 1992, it may be better to be out of the system than in it, at least during the short term. The loss of exchange rates as an adjustment tool to accommodate state-specific economic conditions and budgetary constraints with increasingly demanding economic structural difficulties to overcome could result in waning political support of MU and thus threaten its sustainability unless the single currency members are limited to states whose economies have converged or unless there is a means for the transfer of union funds to regions: a form of fiscal federalism.

I. Coping with the Loss of Exchange Rates as an Adjustment Tool

Under a system of flexible exchange rates, currencies can fluctuate in response to changing economic conditions. During a recession, for example, a currency will typically demonstrate a downward bias in response to reduced demand, permitting the state to recapture a more competitive position through a reduction in prices of its exports vis-à-vis

its competitors assuming their economies are not experiencing a similar downturn.

In a fixed exchange rate scheme, such as the one envisioned by the Maastricht Treaty, states would lose this adjustment tool. Should all the participating member states in the ERM also experience the same degree of recession or growth, the effects from the loss of this adjustment tool are minimal. However, during periods of asymmetrical economic shock, the inability for changes in exchange rates to ease adjustment could aggravate the economic situation. Still, one of the positive benefits of MU is that speculation ends once a state adopts a single currency because, the temptation to withdraw from the system is greatly reduced by the fact of no longer having a national currency to withdraw to.

Another monetary tool member states concede is their control over the supply of money and interest rates. The ECB will control both of these and most likely with a great deal of restraint in its attempt to maintain price stability.

Wage flexibility and labor mobility can serve to offset the loss of national monetary policies to contend with asymmetrical economic shocks. In an area that operates under a single currency, such as the United States, one can witness a reduction in wages and/or a movement of labor on a regional basis during periods of recession. However, in Europe, wages are relatively inflexible and labor is comparatively less mobile.

Many European states are well known for their strong, and at times, militant labor unions. Powerful unions and strict labor laws which are politically untouchable are the two most critical factors that reduce Europe's labor flexibility. Through the use of collective bargaining and by their retention of political strength, the European unions have

established an inflexible labor force.¹⁵⁰ Labor mobility is low due primarily to language and cultural barriers, but also due to different social schemes among the states, making the transfer of benefits difficult.¹⁵¹ Consequently, within Europe the ability to adjust to economic shocks through a flexible labor force and/or a national monetary policy is considerably reduced.¹⁵²

II. National Fiscal Constraints

While participants of the single currency are struggling with the loss of monetary policy to cope with economic shocks, they are simultaneously restricted in their use of fiscal tools. Certainly, the goals of reducing the national debt and governmental deficit are quite worthy and will serve to improve the long term economic growth of Europe.

However, should these preconditions be applied as a type of "shock therapy", in an

¹⁵⁰Wage differentials between low and high skilled workers in most European states are very narrow, especially in the Scandinavian countries. The trend in most European states is to increase wages for low skill workers through the use of collective bargaining, thus often serving as a disincentive for employers to hire new workers. Additionally, national legislation designed to discourage dismissals or to establish working-time arrangements also serves as a disincentive to hire. And while the EU Commission applauds Volkswagen for its time sharing scheme to keep people employed, others, such as the OECD, suggest that it is merely a short term fix and does not address the long term fundamental requirements for increased employment. "Legislated, across-the-board, work-sharing address the unemployment problem not by increasing the number of jobs through more economic activity, but through rationing gainful work. Enforced work-sharing has never succeeded in cutting unemployment significantly, not least because of worker resistance to reduced income. This "cure" must be distinguished from voluntary negotiations between workers and firms over flexible working-time arrangements, which can lower costs and lead to higher employment." OECD, *OECD Jobs Study*, 1994, p.29.

¹⁵¹However, according to the Maastricht Treaty's agreement on social policy concluded between the member states of the European community with the exception of the United Kingdom, social agreements can be concluded at *Community level* and are implemented either in accordance with the procedures and practices specific to management and labour and the member states or, in matters covered by Article 2, at the joint request of the signatory parties, by a Council decision on a proposal from the Commission. Thus there is a possibility in the treaty for reconciling benefit differences in the future.

¹⁵²Barry Eichengreen and Jeffrey Frieden, "The Political Economy of European Monetary Unification", *Economics and Politics*, July 1993, p. 93. European economic shocks are more asymmetrically distributed than shocks within the U.S., while both labor mobility and wage flexibility are much lower.

attempt to hastily rush towards MU, the reaction of the public may be similar to that in certain Eastern Europe states.¹⁵³

Upon entering the final stage of MU, fines or deposits at the ECB could be imposed upon states that surpass debt or deficit limits. Furthermore, the treaty on MU prohibits the ECB from providing credit to national, state, and local governments, as well as buying up the debt of states experiencing fiscal crises.¹⁵⁴ The deficit criteria obliges governments to either decrease spending and/or increase revenues through tax increases. France and Germany, for example, the two largest European economies, have resorted to raising taxes to reduce their deficits; this in turn generates additional problems elsewhere such as an outflow of investment capital.¹⁵⁵ In addition, the three percent limit on the ratio

¹⁵³Last year's disrupting protests in France serve as a constant reminder of the public's resistance to any type of austerity program. In every case, the Balladur government had to back down in its attempts to reduce government spending or reform France's economic structure: The employees of Air France, -while being ineffective in generating profits and thus costing the French taxpayer nearly four billion dollars last year alone,- effectively shut down Paris for several days because of plans to reduce its payroll. Balladur caved in. The fishermen demonstrations, which culminated in the burning of Nantes's city hall, were rewarded with increased benefits. Students ran rampant smashing store-front windows and setting vehicles ablaze in several French cities against plans to lower the minimum wage and again the government backed down. The current administration has also not been able to substantially reduce the deficit either, despite tax increases. It found itself obliged to relieve the finance minister in light of his realistically harsh approach to meaningful deficit reduction.

¹⁵⁴Berry Eichengreen, "European Monetary Unification", *Journal of Economic Literature*, Vol. XXXI, September 1993, p. 1341.

¹⁵⁵To a certain degree this has already happened *within* the EU. An example being the flight of capital from Germany to Luxembourg in order to escape the new capital gains tax. This serves to illustrate another potential challenge in which EU states could find themselves in a tax competition to attract industry. Under the Maastricht treaty there are no penalties for this practice, states are merely required to "regard their economic policies as a matter of common concern and [to]...coordinate them with the council. Barry Eichengreen, "European Monetary Unification", *Journal of Economic Literature*, Vol. XXXI, September 1993, pp. 1339-40. There are no enforcement powers similar to those of the deficit. This presents the classical prisoner's dilemma where obviously the participants are better off should they elect to coordinate tax policies as the treaty recommends. This type of competition would affect deficit levels as well.

of deficit to GDP may be too low during an economic downswing.¹⁵⁶ (Conversely, it is also most likely to be too high during periods of economic growth.)

Another aspect which deserves consideration is the dynamics of debt buildup.¹⁵⁷ Should a strict interpretation of the convergence criteria prevail, several states may never be in the MU and more importantly, for sustainment purposes, even states which become single currency participants may find it impossible to escape the debt trap and eventually surpass the debt limits. The terminal condition of excessive debt creates a situation in which states could find themselves caught in an unending quandary.

Debt and deficit limitations and the dynamics of debt buildup present a daunting dilemma. If the GDP growth rate does not exceed the deficit to GDP ratio, a state that already exceeds a debt to GDP ratio of 60 percent will hardly be able to meet the convergence criteria, and states which are precariously close risk exceeding the limit. For example, assuming an annual three percent growth rate and the accepted requirement of a three percent deficit to GDP ratio, France would exceed the debt to GDP ratio by 1998. Belgium's condition, with the same assumptions, would be terminal.¹⁵⁸

¹⁵⁶Andrew Crockett, "The Role of Convergence in the Process of EMU", *30 Years of European Monetary Integration From the Werner Plan to EMU*, ed. Alfred Steinherr, 1994, p. 179. Also see footnote 126 in the previous chapter.

¹⁵⁷From a lecture on the "Economics of Europe" presented by Professor Roy Gardner, Indiana University, 20 September 1994.

¹⁵⁸In a related article Winfred Horstman and Friedrich Schnieder suggest that the Maastricht Treaty will entice states to assume larger debts and deficits after stage III since the negative affects of excessive debts and deficits will be spread out over the entire EMU. They further suggest that this will be possible because the ECB will extend credit due to political pressure. "Deficits, Bailouts, and Free Riders: Fiscal Elements of a European Constitution", *Kyklos*, Volume 47, 1994, p. 362. However, the Maastricht Treaty specifically precludes states from exceeding the debt and deficit limits; states are penalized should they exceed them. States with excessive debts and deficits will most probably be excluded from participating in the single

(continued...)

III. Elements of Fiscal Federalism

In order to surmount some of the economic difficulties discussed above a vehicle of fiscal coinsurance at the union level would be required to shift resources to states experiencing an asymmetrical economic downturn. Currently, the EU has a number of structural and development funds which may provide the illusion of fiscal coinsurance, but in their present condition would not meet coinsurance requirements.

First, the current system of EU structural and regional funds are primarily intended as equalization funds.¹⁵⁹ The EU's structural and regional policies are primarily meant to narrow the productivity and wealth differentials within the community, and not to contend with negative regional economic fluctuations.¹⁶⁰ Yet this does not preclude the EU from developing a fund to handle these needs after the implementation of a single currency.

Second, it is questionable whether the EU will have the budget resources for this type of scheme. In 1994, the union's budget was only 1.24 percent of member states's

¹⁵⁸(...continued)

currency system. Furthermore, the ECB is not allowed to finance governmental deficits or debts and is largely regarded as independent of political persuasions.

¹⁵⁹This issue is debatable. On the one hand, some economists argue that the end result is transfers to areas which most require them; for whatever reasons these funds are targeted is relatively unimportant. On the other hand, other economist argue that equalization effects are different than insurance effects. Barry Eichengreen, "European Monetary Unification", *Journal of Economic Literature*, Vol. XXXI, September 1993, pp. 1337-8.

¹⁶⁰Conversely, certain funds are specifically targeted at reducing unemployment at the regional level. The European Commission, *Helping Europe's Regions*, 1992. These regions tend to be within states (even the most industrialized) and at times cross traditional national borders, perhaps suggesting that a EU centralized system can more precisely target pooled resources.

GDP and represented only 2.4 percent of public-sector expenditures in member states. Nearly half of the EU's budget is non-discretionary spending to subsidize EU farmers.¹⁶¹ (See figure 17.) Yet again, this does not necessarily indicate that additional funding cannot be increased or even that a substantial amount would be required for fiscal coinsurance. Proposed systems of transfers from the EU to member states do not have to represent a significant increase in the union's budget.¹⁶²

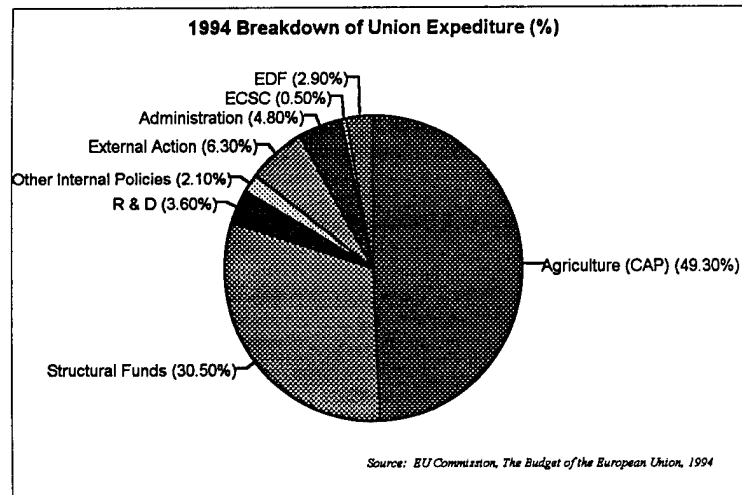


Figure 17

Reforming the Common Agriculture Policy (CAP, required for eastward EU expansion) could also assist in finding additional funding for coinsurance.

Federal systems, such as Germany and the United States, have a high proportion of public spending at the federal level, 20-25 percent of GDP,¹⁶³ while the EU's is at less than one and a half percent. This might suggest that at present the EU does not have the

¹⁶¹European Commission, *The Budget of the European Union, 1994*.

¹⁶²Alexander Italianer and Jean Pisani-Ferry propose a system of transfers from the EU to member states as a function of GDP and relative unemployment rates. As a state's unemployment rate rises relative to the union's average, so would the level of funds it receives from the EU. Such a program could provide transfers on a scale comparable to Canada's where about 20 percent of a decline in a region's relative income is offset by transfers. By capping transfers when unemployment exceeds two percent of the union's average, the budget would increase by no more than 0.25 percent of the EU's GDP. Barry Eichengreen, "European Monetary Unification", *Journal of Economic Literature*, Vol. XXXI, September 1993, pp. 1339.

¹⁶³Dennis Swann, *The Economics of the Common Market*, 1992, p. 87.

required financial resources to implement a system of fiscal coinsurance. Conversely, Eichengreen suggests that the current national systems of fiscal federalism "may go some way toward substituting for explicit coinsurance at the EC level."¹⁶⁴ Furthermore, assuming that a strict interpretation of the Maastricht Treaty is enforced, then only states whose economies have converged will participate in the single currency stage of MU. Subsequently, the likelihood of any of them experiencing asymmetrical shocks is reduced, and should such shocks occur, the degree of severity relative to other single currency members would conceivably be lower as well. Thus the need and extent of an EU coinsurance policy is also substantially lowered. This scenario for fiscal federalism at the EU level however would be drastically different should states whose economies have not sufficiently converged be allowed to participate in the final stage of MU.

Summary

Much of the pressure from MU may be alleviated as Europe comes out of recession. Exchange rate bands have widened reducing speculative strain on the EMS and debt and deficit ratios to GDP are generally declining. Subsequently, today, one could confidently conclude that the system is stable and will allow states's economies to converge. Nevertheless, the next asymmetrical cyclical downturn or the following one, before which a state may have already shed its national currency, may be catastrophic for MU. With the exchange rate adjustment option unavailable and given the rather inflexible

¹⁶⁴Barry Eichengreen, "European Monetary Unification", *Journal of Economic Literature*, Vol. XXXI, September 1993, pp. 1339.

wages and low labor mobility, coupled with the fact that the ECB's main priority will be price stability, the next country specific recession could compel the national government to start back up its printing presses to expand the money supply in response to nationalistic domestic unrest. This would indeed be an irreparable calamity for the EU, as the public may likely perceive the EU, and more specifically MU, to be the source of their economic plight.

This need not be the case, as these shocks could be cushioned with significant structural or regional funds. But, given the paucity of the EU's structural and regional funds today, and its richer member's growing reluctance to fund them, this type of scenario cannot be dismissed. The most certain means to establish sustainability of MU is to ensure that membership to the final stage be restricted to those states that meet the convergence criteria, in its strict interpretation.

Chapter Five

Conclusion

The previous chapters served to illustrate the challenges and opportunities facing the EU in its pursuit of MU. For all member states there are a number of daunting macroeconomic deficiencies. For several of them these deficiencies will continue to be the chief barrier to the convergence of their economies with the core of Europe and consequently impede their entry to the final stage of MU.

At this point, one can generate a reasonable estimate as to the likely outcome of MU process over the short term. Provided with the political and economic backdrops of the preceding two chapters and the states's current and projected position in relation to the treaty's convergence criteria, one can attempt to deduce which states will be initial single currency participants and when this may occur.

According to the Maastricht Treaty, if by the end of 1997, the date for the beginning of the third stage has not been set, the third stage shall start on 1 January 1999. Before 1 July 1998, the political decision must be made to determine which states qualify for the final stage. Both the heads of state and finance ministers have stated that they will meet these dates. The decision will be based on actual 1996-7 data rather than forecasts or quarterly results.¹⁵⁸ The results of the decision should be similar to the following:

¹⁵⁸*The Financial Times*, 2 October 1995. Both Major and Dini have cast doubts on 1999. Major warned on moving ahead with limited number-could tear Europe apart. *The Financial Times*, 25 September 1995.

Potential Initial Stage Three Participants					
	<i>Debt</i> ¹	<i>Deficit</i> ²	<i>Currency</i> ³	<i>Interest Rates</i> ⁴	<i>Inflation</i> ⁵
Luxembourg	below	below	ok	ok	ok
Germany	below	below	ok	ok	ok
France	below	3.9%; decreasing	ok	ok	ok
United Kingdom	below	below	over	ok	slightly over
Finland	65%; increasing	below	?	ok	ok
Austria	67%; increasing	3.9%; decreasing	ok	ok	ok
Denmark	75%; decreasing	below	ok	ok	ok
The Netherlands	77%; decreasing	below	ok	ok	ok
Ireland	81%; decreasing	below	ok	ok	ok
Spain	65%; increasing	over	ok	ok	over
Portugal	70%; increasing	over	ok	over	over
Sweden	86%; increasing	over	?	over	ok
Belgium	132%; decreasing	3.9%; decreasing	ok	ok	ok
Italy	124%; decreasing	over	ok ⁶	over	over
Greece	116%; increasing	over	over	over	over

Table 9

	No Problems
	Problems Surmountable
	Increased Problems
	No Chance

¹EU Commission 1996 Projections.

²EU Commission 1996 Projections.

³*Financial Times*, 9-10 September 1995. Italy, UK, Greece, Finland, and Sweden need to join the ERM.

⁴OECD, 4th Quarter, 1994.

⁵OECD, February 1995 figures.

⁶Even though Italy is within the 2.25% narrow band, as the time nears for the decision of which states proceed to stage, speculative pressure may force it out of the band because it will not qualify due to other preconditions. Italy is also currently not in the ERM.

passage of the Maastricht Treaty, the treaty will not be amended and strict interpretation of the convergence criteria will be honored.¹⁵⁹ In addition, the information provided above serves only as an indicator. The EU Commission will determine where each state stands; their figures may fluctuate from those provided by others.

Despite appearances, the results are not overly discouraging. According to the Maastricht Treaty even two states can constitute a currency union. Theoretically, there is nothing to prevent Germany and Luxembourg from doing so. From the German perspective however, France must also be a participant. Mr. Waigel, the German Finance Minister stressed that France must be in the third phase from the start: "Otherwise the currency union would lead to the division of the European Union."¹⁶⁰ Indeed, France and the United Kingdom are also in a strong position to be among the initial participants.

Even though such a union would only have four of the 15 member states, these states make up the bulk of Europe's economy. A monetary union consisting of Germany, France, the U.K., and Luxembourg would encompass the first, second and fourth largest European economies, (as well as the smallest) representing over 57 percent of the EU's GDP. Furthermore, these states also represent over half of Europe's imports and exports (52.4 and 52.6 percent respectively, see annex six). Lastly, their currencies are widely held as foreign reserve currencies throughout the developing and industrialized world,

¹⁵⁹These assumptions are supported by findings in chapters one and three.

¹⁶⁰*Deutsche Presse-Agentur*, 20 September 1995. *The Economist*, 30 September 1995, intimates possible problems should France be allowed to participate for non-economic reasons. They argue that EMU should focus on the economic aspects, "an EMU founded on foreign-policy lacks credibility. If France can maintain budget discipline only because it regards joining EMU as a political imperative, how will it cope with strict monetary discipline once a single currency has been achieved?"

indicating a certain level of confidence in their economies.¹⁶¹ Such a unified MU pillar in itself represents a high degree of monetary strength and stability.

France's 1996 budget projection is nearly one percent over the treaty's limit. In order to proceed to stage three it would need to further reduce its deficit for 1997. While this is a surmountable challenge, it is by no means a *fait accompli* should one observe its most recent efforts of deficit reduction.

The UK's is also well placed as a possible initial stage three entrant, yet it would need to make certain alterations in its monetary policies. First, it must rejoin the ERM by 1 January 1996 so that it can demonstrate two years of currency stability prior to the 1998 decision. Its reentry central rate would need to be lower than its previous one. Second, monetary officials need to keep inflation in check. Lastly, the government needs to decide to opt-in at 1996 IGC.¹⁶²

Finland, Austria, Denmark, the Netherlands and Ireland are also possible contenders as initial single currency participants; however, each has debt problems to overcome. Finland's and Austria's debt levels are just above the precondition limit of 60 percent debt to GDP, but their levels are increasing and thus violate the Maastricht requirement. Both states would need to reverse these trends, itself a significant challenge. In addition, Finland would also need to join the ERM by 1 January 1996 and Austria would need to lower its 1997 and subsequent deficits to under three percent of GDP.

¹⁶¹*The Economist*, 21 October 1995, p. 111.

¹⁶² Due to its reputation of resisting closer European integration, one is tempted to conclude that for all intents and purposes the U.K. has already opted out of MU. Kenneth Clarke, Chancellor of the Exchequer insists that the U.K. government is keeping an open mind on whether to exercise its right to an opt-out. He also predicted that the U.K. would meet the preconditions. *The Financial Times*, 2 October, 1995.

Even though Finland's and Austria's debt levels are lower than Denmark's, the Netherlands's and Ireland's, the latter states's levels are decreasing and thus may meet the debt criteria of "sufficiently diminishing and approaching the reference value at a satisfactory pace."¹⁶³ Furthermore, Denmark, the Netherlands, and Ireland show no indication of not being able to meet the other criteria.¹⁶⁴ Yet it would appear odd to allow Ireland to participate in the final stage of MU and not Austria, even though Austria's debt to GDP ratio would conceivably be lower than Ireland's. Should these states also be initial single currency participants, one would notice a distinct similarity to those states which are often referred to as the core states.

Belgium is usually referred to also as being in this core; its currency has been successfully pegged to the deutschemark for an extended period of time. Yet its level of debt precludes it as a possible initial stage III entrant. The remaining peripheral states also demonstrate little possibility of meeting the 1998 decision date. Italy's Prime Minister Dini has already conceded the point.¹⁶⁵

By adhering to the principal of strict criteria, Germany and France obtain basically the same results as earlier plans for deepening, but without the political upheavals.¹⁶⁶

¹⁶³The EU Commission has already announces that Ireland meets the debt precondition. However, their 1996 projections are over the limit. Since the decision will ultimately be made by the heads of state or government, it is not certain that Ireland will meet this requirement merely because the Commission says so.

¹⁶⁴Denmark would also have to opt-in at the 1996 IGC.

¹⁶⁵*The Financial Times*, 27 September 1995.

¹⁶⁶The German/French proposal basically envisioned three tiers, or groups of states which move towards closer integration at varying speeds. The proposals were made by the French Prime Minister Balladur and by the German Christian Democrat's parliamentary leader, Schäuble (same party as Chancellor Kohl's) within a week of each other in September 1994. The "hard core", or tier one states would include France,

(continued...)

Yet there is an inherent danger of dividing Europe instead of uniting it by proceeding along these lines. Hans Tietmeyer, Bundesbank president, offers an excellent summary of the paradox created by this proposal when he suggested that the question had to be addressed of whether this might divide Europe rather than bring it together.¹⁶⁷ The same question is applicable should the final stage of MU be initiated as suggested above.

Tietmeyer's and others's statements hint at potential political fallout. Economists such as De Grauwe argue that such a scheme may be economically devastating for non-participant EU member states. The strain from higher interest rates, inflationary pressures, currency devaluations, and the subsequent fiscal difficulties could cause the non-participating states's economies to diverge rather than converge.

The widening gap in turn could lead to additional political discord between the two groups. Consequently, the issue of fiscal federalism discussed in chapter four may become vital not for single currency states but for non-participating states. Thus, while strict interpretation of the treaty makes MU sustainable for its participants, it could erode the support of non-participating leaders and electorates. Even though today 58 percent of EU citizens believe that its state's membership in the EU is a "good thing", MU risks driving

¹⁶⁶(...continued)

Germany, Belgium, Luxembourg, and the Netherlands, tier two states would be Italy, a founding member, Spain, the U.K., and the remaining states, and Eastern European states would be in tier three. Understandably, those states that are not in the "hard core" generally opposed this multi-speed approach. The Italian Minister for European Affairs stated, "If you're going to talk about a Europe of two speeds, then you might as well talk about a Europe of 16 (actually 15, Norway declined to join the Union for a second time in a national referendum) speeds." *The Financial Times*, 4 September 1994.

¹⁶⁷"Tietmeyer Warns Over EU Integration", *The Financial Times*, 8 September 1994.

this public support lower.¹⁶⁸

The fact that a considerable part of public opinion in the member states and political leaders in favor of EMU are out of step with each other is not necessarily to be counted against those leaders. Without being able to rejoice, let us acknowledge that it was very predictable that enthusiasm would cool in a period of economic recession which strengthens national egoism and favors immobilism. But a construction of the historical scope of European Union should not be in thrall to the fluctuations of collective cyclothymia. It is the responsibility of the political parties, intellectuals and all citizens capable of gauging what is at stake to continue the advance - learning from past errors and respecting the pace imposed by realism...¹⁶⁹

This commendable advise is also applicable not only for MU but for European leaders to correct the structural problems plaguing their economies. Even though there is a resurgence of economic growth, the specter of unemployment will remain to haunt these leaders during the next cyclical downturn should they fail to exorcize it today. To ignore unemployment problems jeopardizes proceeding to the final stage of MU and threatens the sustainment of the currency union.

The gargantuan undertaking of such an enterprise as European unification could never be free of obstacles. Such an endeavor inevitably causes inter and intra-state friction and conflict, as various groups debate the type of Europe they desire. Subsequently, the

¹⁶⁸A fairly large majority of European citizens (58%) stated in June that their country's membership of the European Union is a good thing. Almost no change has occurred since May. Nonetheless, when taking into account the individual national opinions, it is clear that, between the first and the second term of 1995, support has been eroded in the three new Member States, particularly strongly in Sweden and less so in Austria and Finland. Sweden's positive evaluation of membership has decreased from 40% in January to 20% in June - the lowest figure in the whole of the Union. 48% of Swedish citizens state that membership of the Union is a "bad thing" (June), whilst the average across the entire population of the Union is 13%. EUROPINION N° 5, <http://www.cec.lu/en/comm/dg10/infcom/epo/eo/eo5/eo5.html>, July 1995.

¹⁶⁹Miguel Boyer, 'Application of the Maastricht Treaty and the experience of a year of crises in the European Monetary System', *30 Years of European Monetary Integration from the Werner Plan to EMU*, ed. Alfred Steinherr, 1994, p. 87.

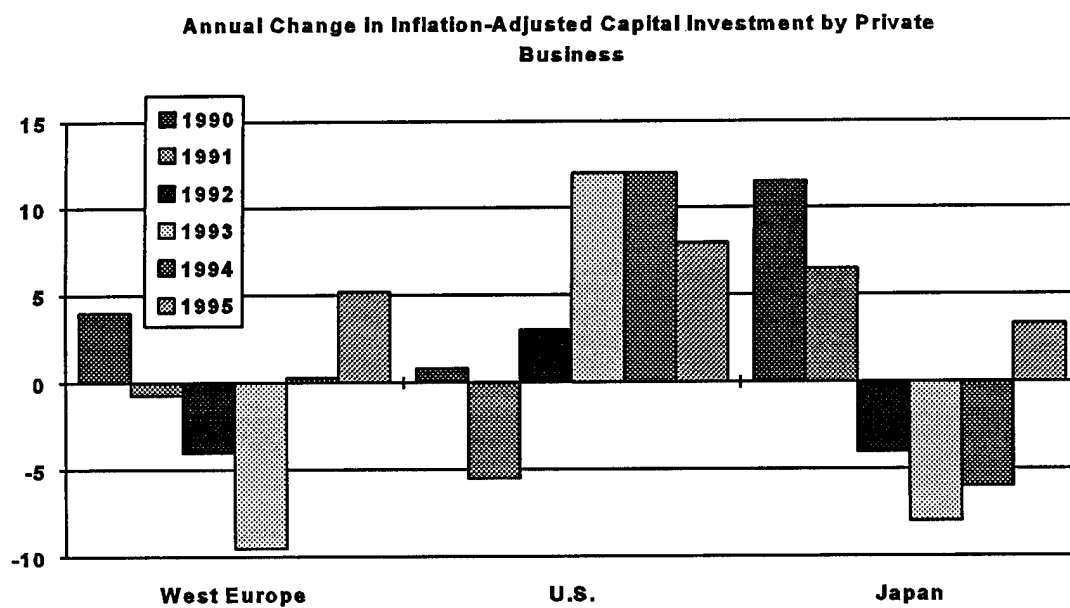
challenges presented here are understandably significant, but certainly not insurmountable. Even as consensus for unification becomes increasingly difficult, as the subject areas become more complex and controversial, and demand greater centralization at the expense of national sovereignty, one must keep in mind the evolutionary (as opposed to revolutionary) nature of the process.

A successful EMU therefore is dependent on a gradual convergence of European economies and strict interpretation of the Maastricht Treaty, unrestrained by unrealistic timetables. As Kohl says, "Stability has priority and the calendar is secondary". Political leaders must also implement measures to improve their national economic positions and promote the EMU amongst their constituencies if EMU is to succeed both in the initial stages and over the long term. Lastly, national leaders need to emphasize the long-term gains to be achieved by MU and to de-emphasize the costs imposed by it during short-term cyclical economic crises in order to obtain the necessary level of domestic support.

Annex 1

Stages of EMU	
1969	The Community Summit in The Hague commissions a report on the possibilities of developing the Community into an economic and monetary union.
1971	The Community concludes a phased plan for the creation of an economic and monetary union within ten years. The project fails mainly because of the collapse of the dollar-based world monetary system, which results in several member states allowing the exchange rates of their currencies to float.
1972	The setting-up of the 'currency snake'; a first attempt to make the exchange rates of participating countries stable in relation to one another and flexible in relation to the dollar. The number of member states that participate and then withdraw varies over time.
March 1979	The European Monetary System (EMS), on which agreement was reached in late 1978, comes into force; the participating member states, eight at first, are required to maintain their exchange rates within certain fluctuation margins. Creation of the ECU.
July 1987	The Single European Act (SEA), which reforms the EEC Treaty, comes into force. Its objective is the completion of the frontier-free market by the end of 1992.
June 1988	The Hanover European Council appoints a committee of experts (chaired by Jacques Delors) to examine ways and means of completing economic and monetary union.
June 1989	The Madrid European Council approves the Delors Report. The Heads of State or Government decide to begin the first stage of EMU on 1 July 1990 and to prepare for an intergovernmental conference on economic and monetary union.
July 1990	First stage of EMU involving the removal of most of the remaining restrictions on capital movements, increased coordination of individual economic policies, and more intensive coordination between central banks.
December 1991	The European Council agrees to the Treaty on European Union in Maastricht: completion of EMU and introduction of a single European currency by 1999 at the latest.

Annex 2



Source: The Wall Street Journal, 30 September 1994

Annex 3

State Aids by Sector and Purpose; industry/services Percentage figures, average 1981-1986

	B	DK	D	GR	F	IRL	I	LUX	NL	UK
Horizontal Goals	14	19	13	55	20	13	16	3	26	17
R&D	3	8	7	6	1	1	1		5	6
Environment		1							1	
SME	3		2	3		2	3	1	13	1
Trade/Export	2	6	1	46	12	10	4		2	8
Energy Saving		3	1				1		2	
Investment, general	3		1		6		1	2	3	1
Other	3		1				6			
Individual Sectors	15	15	5	14	20	18	18	27	16	18
Steel	11	1	2		9	3	9	27	2	7
Ship Building	2	14	1		3	1	1		3	5
Other Crises Sectors	2				4	5			7	5
Other Growth Sectors			1		2		10		1	0
Other Sectors			1	14	2	9			3	
Regional Aid	5	1	18	17	3	21	20	5	8	15
State Aids under EC Directives	67	64	64	13	56	48	44	65	52	51
Agriculture	4	29	7		17	23	10	9	21	10
Fishing		1				2				1
Transportation	35	34	31	13	26	12	34	56	30	14
Coal	28		26		13					19

Source: Hugh Mosley and Günter Schmid, 'Public Services and Competitiveness', *European Competitiveness*, 1993, p. 216.

Annex 4

Stages of Monetary Union

- July 90 **First stage of economic and monetary union** involving the removal of most of the remaining restrictions on capital movements, increased coordination of individual economic policies and more intensive cooperation between central banks.
- 1 Jan 94 **Second stage of economic and monetary union** begins with the creation of the European Monetary Institute in Frankfurt, home of Germany's influential Bundesbank. States coordinate economic, monetary, and fiscal policies to meet convergence criteria.
- 31 Dec 96 Deadline for EU leaders to decide if majority of countries meet **criteria for monetary union**. This deadline has already been conceded. (Intergovernmental conference to decide further institutional reforms for the community during 1996.) At the latest by 31 December 1996, the EMI shall specify the regulatory, organizational and logistical framework necessary for the ESCB to perform its tasks in the third stage. This framework shall be submitted for decision to the ECB at the date of its establishment.
- 1 Jan 97 Single currency if the necessary majority of members meet criteria. EU leaders already have conceded this deadline. Inauguration of European Central Bank and European System of Central Banks (ESCB), comprises ECB and national central banks.
- Otherwise, set by end of 1997 a date for ECB, ESCB and single currency to start. If this deadline is also missed, decide by 1 July 1998, which countries qualify for single currency and appoint the president, vice president and other members of the executive board of the ECB.
- 1 Jan 99 ECB, ESCB automatically come to life and single currency begins with any countries that qualify.

Annex 5

Fiscal Targets

Germany	The medium-term consolidation strategy aims at cutting the federal deficit from DM 67 billion in 1993 to DM 46 billion in 1997, and limiting the annual rise of expenditure of the territorial authorities to 3 percent per annum.
France	The government intends to reduce the central government deficit to 2½ percent of GDP in 1997 and to increase spending by the state (including debt servicing) by no more than the rate of inflation, assuming an average annual rate of growth of real GDP of 2.8 percent and revenues rising in line with GDP.
Italy	The new "Convergence Programme" drawn up in July 1993 targets a reduction in the state deficit (excluding proceeds from privatization) from 9.7 percent of GDP in 1993 to 5.8 percent in 1996.
United Kingdom	The government intends to bring the public sector borrowing requirement back to balance by the end of the century. This target assumes that real growth will be around 3 percent per annum.
Austria	The government intends to reduce the federal deficit to 2½ percent of GDP by 1996.
Belgium	The "Plan de Convergence" aims at putting fiscal consolidation on course, and targets the general government budget deficit at 3 percent of GDP in 1996, while setting the debt to GDP ratio on a declining trend.
Denmark	The government intends to achieve fiscal balance on a cyclically-adjusted basis by 1999.
Finland	The government intends to stabilize central government debt at 70 percent of GDP by 1997 and freeze real government expenditure at 1991 levels.
Ireland	The government intends to keep the exchequer borrowing requirement within 3 percent of GNP by 1997 and continue to reduce the debt to GDP ratio.
Netherlands	The government intends to achieve a central government deficit of 3 3/4 percent of Net National Income for 1994 and a maximum of 3 3/4 percent for 1995 and 1996.
Portugal	The government intends to reduce the deficit to 3.3 percent of GDP, and reverse the upward trend in the public debt ratio, reducing it to 67 percent by 1997.
Spain	The government intends to achieve Maastricht deficit and debt targets for convergence by 1996.
Sweden	The government intends to achieve a gradual return to structural budget balance by 1998.

Source: Economic Outlook, Number 55, June 1994

Annex 6

Foreign Trade 1993 in billion U.S. \$

	Imports	% of Total	Exports	% of Total	Surplus/Deficit
Austria	4.05	3.4	3.35	2.8	-0.70
Belgium	9.71	8.2	10.12	8.3	0.41
Denmark	2.54	2.2	3.1	2.5	0.56
Finland	1.5	1.3	1.95	1.6	0.45
France	16.23	13.8	17.53	14.4	1.30
Germany	28.55	24.2	31.67	26.0	3.12
Greece	1.84	1.6	0.7	0.6	-1.14
Ireland	1.81	1.5	2.4	2.0	0.59
Italy	12.32	10.4	14.04	11.5	1.72
Netherlands	10.37	8.8	11.59	9.5	1.22
Portugal	1.96	1.7	1.24	1.0	-0.72
Spain	6.55	5.6	4.96	4.1	-1.59
Sweden	3.57	3.0	4.16	3.4	0.59
U.K.	16.98	14.4	14.85	12.2	-2.13
Total	117.98		121.66		3.68

Source: OECD, Main Economic Indicators, April 1995

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