

EMU: The Road Ahead

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Florus Wijsenbeek, a Dutch Liberal Member of the European Parliament, has taken to riding his bicycle in the corridors of the Parliament building. This has provoked a rebuke from the College of Quaestors, the five senior parliamentarians responsible for maintaining discipline among their colleagues. "Cycling inside the European Parliament will not be permitted," they have declared, "in the interests of the dignity of the institution." The Dutch MEP responds that he has no intention of complying. Without taking sides in this dispute, academic observers will nonetheless feel a debt of gratitude to Mr. Wijsenbeek for providing the first concrete evidence of the "bicycle theory," the notion that European integration must keep rolling forward if it is not to collapse.

There is every indication that monetary unification, as the latest step in the integration process, will go ahead in 1999. If so, it will take place over the protests of a variety of critics. Four German opponents object that it violates the Federal Republic's Basic Law and have brought a case to stop it before the German Constitutional Court. One hundred and fifty five German economists have signed a declaration urging that Emu be postponed on the grounds that the prospective members have not succeeded in bringing down their debts to the reference value of 60 per cent of GDP specified in the Maastricht Treaty as a precondition for qualifying for participation and that their efforts to meet another of these preconditions, the 3 per cent ceiling on deficits, have taken the form of creative accounting and one-off measures rather than a new resolve to live within their means. American observers warn that Europe

possesses neither of the two characteristics crucial for the smooth operation of a monetary union: the free mobility of labor within the unified monetary zone and a federal tax and transfer system to shift resources from booming to slumping regions.

The common conclusion of these critics is that Europeans should apply the brakes and dismount the bicycle. The Single European Market, they concede, is a valuable achievement which has allowed manufacturers to produce for a continental market and reap the cost savings from long production runs enjoyed by their American competitors. By freeing cross-border sales, it has stimulated deregulation and injected the chill winds of competition into the European economy. But it would be unwise and unnecessary, in their view, to append a single currency to the Single Market. Why not instead declare victory and withdraw the troops?

The Emuphiles' answer is that a Single Market with 14 distinct national currencies (Belgium and Luxembourg already sharing the Belgian franc) would be neither economically efficient nor politically viable. The exchange rates between separate national currencies would fluctuate against one another, as exchange rates are wont to do. Intra-European currency swings would confer capricious competitive advantages on some member states and penalize others. Strong-currency countries would accuse their weak-currency counterparts of competitive devaluation, currency manipulation, and exchange dumping, as they did when the pound sterling and the lira depreciated in 1992. These "arbitrary" changes in competitiveness might provoke French, farmers, for example, to block lorries bringing in cheap goods or set them on fire. Governments, in response, would be tempted to subsidize domestic producers and erect hidden barriers to imports. The Single Market would be destroyed de facto if not de jure.

But separate currencies need not fluctuate violently, the Emuphobes rebut. The instability of sterling and the lira in 1992 was the exception, not the rule. Both the UK and Italy had followed unstable policies in the period leading up to their currency crises, with predictable consequences. Since the summer of 1993, in contrast, policies have been better. The currencies of the countries participating in the Exchange Rate Mechanism of the European Monetary System have displayed admirable stability. Their limited fluctuation has done nothing to undermine political support for the Single Market. Why not leave well enough alone?

The reason not to leave well enough alone is that this admirable stability may itself reflect the approach of monetary union. The Maastricht Treaty makes not just fiscal rectitude but exchange rate stability and economic convergence more generally preconditions for Emu. Aspiring participants must not just bring down their debts and deficits but also reduce their inflation and interest rates toward those of the lowest inflation countries and hold their currencies within their ERM bands. European governments generally, and those of inflation-prone countries like Italy in particular, have staked their political reputations on success. Remove the prize of Emu, and you remove the incentive to adopt the painful policies of convergence needed for exchange rate stability. And once the markets lose faith in the readiness of governments to subordinate other economic policy goals to the overriding imperative of qualifying for Emu, all hell could break loose. The whole process of European integration could run off the tracks.

This argument is all the more compelling in the wake of the Asian crisis. From the start, one motivation of European monetary integration from the start has been to create a

zone of monetary stability in Europe. The creation of the Snake and then the European Monetary System in the 1970s was a response to the collapse of the Bretton Woods System and the volatility of the dollar and the yen. The solidification of the EMS and now the drive for Emu are similarly designed to shield Europe from the instability of international financial markets, much as Arizona or New Hampshire have been shielded from the Asian financial crisis and felt only the mildest repercussions of the collapse of the Asian currencies by virtue of their participation in an integrated and stable monetary zone, namely, the United States of America.

That a single currency is the logical way of shielding regional trading partners from exchange-rate instability is, not incidentally, is the conclusion drawn by some Asian policymakers. Thus, Malaysian Prime Minister Mahathir Mohamad suggested earlier this year that the ASEAN countries should consider using the Singapore dollar as their common trading currency with an eye toward introducing a single regional money similar to the euro, a view recently echoed by Japan's Executive Director to the IMF.

Good things do not come for free. In the European context, the fear is that by giving up the exchange rate and an independent national monetary policy, governments will give up the only effective instrument for adjustment to business-cycle disturbances. This assumes, of course, that exchange-rate depreciation and monetary expansion are still effective for stimulating recovery from recessions. If, however, they simply generate additional inflation and not additional output and employment, their sacrifice is costless. That European policymakers have displayed so little inclination to make active use of the exchange rate in recent years can be taken to indicate that they doubt its power. On the other hand, anecdotal

evidence from the early 1990s, when Italy and the United Kingdom withdrew from the ERM and Spain and Portugal realigned their currencies downward, is frequently invoked to suggest that exchange rate changes retain their power. In fact, however, the evidence on this is not clear cut. To be sure, those European countries that depreciated their currencies in 1992 grew their exports more quickly than those which succeeded in maintaining their ERM pegs. But the first group's superior export performance did not in fact translate into faster overall GNP growth.

This is something of a paradox. The depreciation of the British, Italy, Spanish, Portuguese and -- outside the EU -- Swedish and Finnish currencies did alter relative prices. It raised the prices of imports and exports compared to the prices of goods and services produced exclusively for the home market, which accounts for these countries' relatively rapid export growth. It is not as if the change in the exchange rate was simply neutralized by inflation. Why then did it not show up in faster economic growth?

The solution to this paradox is as follows. While currency depreciation boosted exports and could have stimulated growth, governments took advantage of the incipient acceleration to cut their deficits, further curtailing domestic demand. With little perceptible acceleration in inflation relative to countries with unchanged ERM parities, there was a shift in relative prices toward traded goods in countries which depreciated their currencies, and a surge in exports, but no acceleration in growth due to the compensatory compression of the budget deficit. (The one country that does not fit into this schema is the United Kingdom, where no dramatic Italian-style budgetary retrenchment was required, but there the business cycle was out of phase with that of Continental Europe: recovery had begun earlier and

decelerated when the other countries depreciating their currencies felt the effects of the induced export surge.)

The implications of this analysis are three. First, intra-European exchange rates retain the capacity to stabilize the economies of the member states if governments only allow their exchange markets to operate. Emu, by forcing them to forsake the exchange rate instrument, will have real economic costs.

But second, intra-European exchange rate changes also have the capacity to destabilize the Single Market. The 1992 depreciation of sterling and the lira boosted British and Italian exports without boosting British and Italian growth. This may or may not have been good for the UK and Italian economies, but it was clearly painful for France and Germany, who felt the effects mainly as more intense British and Italian competition.

Third, fiscal policy is every bit as powerful as monetary policy from the stabilization point of view. That European governments will have given up their independent national monetary policies is all the more worrisome insofar as their fiscal freedom is also hamstrung by the Excessive Deficit Procedure of the Maastricht Treaty and the subsequently-negotiated Stability Pact designed to prevent budget deficits from exceeding 3 per cent of national income under all but exceptional circumstances.

The Stability Pact will bite at the beginning, since most member states will enter the monetary union with budget deficits right up against the three per cent limit. But if they succeed, as intended, in reducing their deficits further over time and moving their budgets into balance, they will then have more fiscal room for maneuver. Free to expand their deficits from zero to three per cent of GDP without the consent of their monetary union partners, they

will have the capacity to cope with all but the most exceptionally severe recessions. (And the Stability Pact makes explicit exceptions for exceptionally severe recessions.) Moreover, there is reason to think that labor mobility will rise slowly but steadily over time, as it has already begun to do, as workers accustom themselves to the Single Market. Wage flexibility may even increase once unions realize that national governments no longer possess monetary instruments with which to bail them out of their mistakes. All these are reasons to think that the first years of Emu will be the hardest but that the going will grow easier over time.

What will not result from monetary union is early political union. While a single currency for a group of several sovereign states may be an all but unprecedented step, real political unification would far, far more momentous. However widespread support may be in Europe for economic integration, political integration is viewed with greater skepticism, but just in the U.K. and Denmark but in Germany itself.

Here, however, Germany confronts a dilemma, and not merely because the political elite is more committed to integration than the man on the street. Germany, more than any other European state, fears inflation and worries that the euro might not be stable. This leads it to attach special weight to the Stability Pact on the grounds that the profligate tendencies of other Emu participants must be forcibly restrained. But the more tightly the Stability Pact is applied, the less capacity EU member states will retain to operate their own automatic fiscal stabilizers. Lacking both an independent national monetary policy and an independent national fiscal policy, they will be tempted to ask the European Union to do the fiscal stabilization for them. Depressed regions will demand subsidies from the European Union, and providing

them will require the power to tax. Strict enforcement of the Stability Pact could thus lead to the transfer of budgetary authority to the level of the European Union.

And it is hard to think of a more meaningful step toward political union than the transfer to Brussels of the power of the purse, the right to tax (and spend) being perhaps the defining characteristic of a sovereign state. The average German may be strongly opposed to political union, but his insistence on restraining the fiscal autonomy of his neighbors may nevertheless present him with that possibility.

The logical outcome is that Germany accepts the less distasteful of two distasteful alternatives. Rather than pressing on toward political union which, Chancellor Kohl's vision notwithstanding, is something the vast majority of his constituents do not desire, Germany steps back and accepts a more permissible application of the Stability Pact. There is time for this to occur, since any movement in the direction of political union will necessarily proceed with glacial speed. In particular, there is time for the European Central Bank to first reassure Germany's Nervous Nellies by demonstrating the depth of its commitment to price stability.

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