



EMU: the Rising Challenge to the Dollar — A European Perspective on American Scepticism about Monetary Union

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I. Introduction

America's reactions to the European Union's "grand design" to introduce a European monetary union by 1999 provide a wealth of insights into the manner in which the United States perceives the complex and historically unprecedented phenomenon which is European integration.

The purpose of this essay is thus twofold: (i) to present and assess American views on EMU and the arguments on which the latter are based (bearing in mind that there is a variety of such views, not a single consensus), and (ii) to attempt an assessment of the reasons which lie behind the particular views held.

US policy has been supportive of European integration since its early stages. A more united and stronger Europe was deemed to be both politically and economically advantageous to the United States. For most of the post-war period, the international difficulties confronting the United States and Western Europe related mainly to their common interests in the reconstruction of the world economy and in keeping communism at bay. The means for doing so — including European integration — were widely seen as providing benefits to both sides. This premise has been, by and large, borne out by the facts, in light of both the success of security and defence cooperation, as far as the political domain is concerned, and the strength of the transatlantic trade and investment relationship, as far as the economic domain is concerned. ¹ But the underlying reality until now was that the greatest accomplishments of European economic integration, *viz.* the Common Market, and its more recent, and improved, version, the Single Market, were of a nature to offer, on balance, significant economic benefits to the United States itself, in particular US companies doing business in or with Europe. ²

In contrast, the next step in European integration, *viz.* monetary unification, appears to be considerably more ambiguous in its economic implications for the United States.

On the one hand, if the single currency proves a success, the attractiveness of the European economy from a US business perspective will be enhanced, and the euro will add the advantages of monetary stability to the static and dynamic benefits already provided by the Single Market through the removal of internal barriers and the concomitant tendency to market integration, in the form of new trading and investment opportunities. This explains the strong support already voiced for the euro by many executives of multinational corporations.

On the other hand, if the euro eventually succeeds in becoming an international currency on a par with the dollar, this will certainly prove to be a development of no minor economic or political consequence, and will influence EU–US relations in ways yet to be determined. For a start, by reducing the international demand for US dollars and the US government's scope to reap seigniorage ³ (estimated currently to be worth as much as 0.5 per cent of GDP *per annum*, from the use of dollar bills in other countries ⁴), it will affect the United States' ability to run substantial federal budget deficits (as it has done in the past) and to run large current account deficits (which it continues to do ⁵). Once all fifteen of the member states of the European Union join the monetary union, the euro area as a group will account for over 30 per cent of world output and 20 per cent of world trade (excluding intra-EU transactions), as compared with 27 per cent and 18 per cent for the United States, respectively. ⁶ Furthermore, whereas the European Union has run modest surpluses in its international accounts in recent years, ⁷ the United States — which has the ability to borrow from abroad in its own currency practically without limits — has run current account deficits for the last sixteen years and accumulated a net foreign debt exceeding \$1 trillion; for the United States, possessing the world's currency in practice has meant (perhaps not irrationally) becoming the world's largest debtor. ⁸ In this context, it is easy to understand the link between the emergence of the euro and the question of the future stability, value, and hence role, of the dollar. Already, the debate is not about whether or not the euro will become an international currency, but rather how long this will take (with views ranging from very long ⁹ to relatively short periods ¹⁰). In the end, EMU will have important implications for the way in which the international monetary system is managed and for the dollar-centered American preponderance in the area. Europe's influence as a trading power, which thanks to its common trade policy has been on a par with that of the United States for many years, will in future be complemented by a similar influence on the monetary side. The bipolarity of the system will be consolidated, with Japan playing the part of a junior partner.

To be sure, there is no single reaction in the United States to the prospect of the euro. An initial observation is that (as perhaps one would expect), in general, political leaders have been relatively supportive (albeit, while keeping a low diplomatic profile), scholars more questioning and outspoken. A common trait in the United States, overall, is a fairly clear lack of enthusiasm. Largely as a result of the fact that EMU will have such important consequences, both in Europe and internationally, perhaps for the first time in the history of European integration pronouncements by US officials and economists have begun to exhibit a palpable sense of unease, reflecting the ambiguous uncertainty surrounding the possible implications of both failure *and* success of the project. If EMU fails, this will have serious economic and strategic implications for the United States. If EMU succeeds, it will pose a greater challenge to US economic and diplomatic might than any previous stage of European integration. In the first instance, public statements of concern in the United States tend to be related to the risks facing monetary unification in view of the alleged weaknesses of Europe's institutional arrangements in relation to the demands of the task ahead, and the apparent rigidities characterising her economy, including

today's very high structural unemployment rates (the implicit message being that the United States may be called upon to "bail out" Europe in case the EMU exercise goes terribly wrong — clearly an unpalatable prospect); at a deeper level, public statements arguably reflect uncertainty over the implications for the U.S. economy should EMU prove successful. This study will try to identify these different views, examine the arguments underpinning them and attempt an appreciation of their merits and weaknesses.

In attempting to identify the more serious arguments put forward in the United States regarding the prospects of the euro, this paper will try to distinguish those arguments which have interest from a "conventional" analytical point of view from those which, though broadly economic in character (and usually approached in customary scholarly fashion), are ultimately too uncertain and speculative to be capable of conclusions of the requisite (wide) degree of acceptance; the latter arguments — and especially the conclusions drawn from them — are often introduced into the debate by way of supporting or supplementary evidence, but are actually too fraught with uncertainties, and too often used in a partisan way, to be capable of swaying the argument in any particular direction.

II. European Integration and the American Stance over Time

A.- The Cold War Period: The Primacy of Geostrategic Concerns

US foreign policy has shown remarkable consistency in its support for European unity ever since this objective was formulated in the Marshall Plan. ¹¹ This positive stance, coming so soon after the end of the Second World War, was probably one of the first expressions of post-war American "super-power" geostrategic thinking: as one author put it recently, among the motives prevalent in Washington for supporting an integrated Europe, "none were more important than the 'double' containment of Germany and the Soviet Union." ¹²

However, this approach was not without its ambiguities: on the one hand, European independence was considered in Washington a desirable goal, helping to lighten the heavy burden placed upon the United States after the Second World War; on the other, the closer cooperation aspired to between the United States and Europe would have to take place — despite the apparent contradictions inherent in such a goal — within an (American-dominated) "Atlantic framework." ¹³ As Lundestad puts it, "Somehow Europe was to be both independent of and dependent on the United States at the same time." ¹⁴

With the Marshall Plan speech in 1947, the United States came out firmly in support of Western European integration, and integration on as comprehensive a scale as possible, including the creation of a customs union under the OEEC. Ironically, it was the Europeans who disappointed the Americans at the time — for not going far enough. ¹⁵ Ten years later, in 1957, as the six founding members of the European Economic Community were preparing to establish the Common Market, Washington's main concern was not economic competition from a resurgent Europe, but that British (counter)proposals for a looser, wider free-trade area might dilute Europe's efforts toward supranationalism and some form of federalism. ¹⁶

Thus, even when it would have been possible — or, indeed, logical — for the United States to entertain

reasonable doubts about the implications of European integration for its own economy, based on considerations of economic rivalry (or discord over such issues as agriculture), the official position time and again was that, ultimately, the political gains to the United States outweighed the possible economic costs. ¹⁷ Supporters of this view might anyway have been pushing against an open door: the dismantling of trade barriers and a marked inflow of US foreign direct investment generated mutual economic gains as well, as indicated earlier.

The ending of the Cold War with the collapse of communism in Eastern Europe in 1989 and the unification of Germany in 1990 actually reinforced Washington's sympathy for European integration; the European Community had a valuable role to play insofar as its member states declared themselves prepared to assume the bulk of the costs of stabilising Eastern Europe and of re-integrating it into the world economy.

In this new, more peaceful but perhaps more complex, world, however, one could argue that security-motivated geopolitical strategic objectives will increasingly come into direct competition with narrower economic ones; in such an environment, the element of rivalry, always lurking underneath the surface in international economic relations, may begin to assume a more prominent role.

B.- External and Internal Causes of EMU

It has become an article of faith among the vast majority of commentators that EMU is not to be understood or explained by economics alone. Among the various attempts to analyse the deeper rationale of EMU, rarely does one not find wider references to the role of politics and national interests. The latter are invariably presented as the real forces lying behind monetary integration.

In one sense, this is little more than a truism: ever since the Treaty of Rome, which proclaimed in its preamble that its goal was "to lay the foundations of an ever closer union among the peoples of Europe", European integration has been undergirded by an overarching, if ill-defined, political vision. But in another sense, the "political-motivation" thesis, by force of repetition, has ended crowding out possible explanations which could justify EMU in terms of hard-nosed economic calculations.

In contrast to this view, the present section places the emphasis on the economic rationale on which the pursuit of monetary integration has been based. Without pretending to ignore the role of political factors — political and economic explanations should not be seen as being in competition ¹⁸ — this section concentrates on the concrete factors which led to increasing monetary coordination in the European Community, and presents the most important American reactions to these events. The history of monetary union is thus presented as a quest for currency stability designed to enhance economic efficiency in an ever integrating European single market, not only through the further facilitation of trade, but *also* through the more rational organisation of capital and labour markets. ¹⁹ Clearly, in this narrative the fundamental objective of EMU must be seen to be the enhancement of both welfare levels and the (collective) competitive position of those countries taking part. ²⁰ However, it can be argued ²¹ that the potential "dynamic" benefits associated with a single currency (as opposed to a pegged-but-adjustable régime), including an (induced) increase in the flexibility, mobility and efficiency of factor markets, will be an even more important element than the "static", product-market efficiency benefits of the euro. Unfortunately, such benefits are much more difficult to predict, to evaluate and to calculate. The upshot is that there is ample scope for disagreement as to the final economic consequences of EMU.

The results of the Hague Summit of 1969, ²² the publication of the Werner Report in early 1971 aiming at EMU by 1980, and the first plans to narrow exchange-rate margins were all indicative of a search for a new driving force for the process of European integration. But they also reflected a frustration with the newly-observed ineffectiveness of national economic policy, born of growing trade interpenetration and international monetary instability.

These developments, including their monetary component, did not, of course, pass unnoticed in the United States. But, mirroring European thinking, any debate on EMU in the United States could not (the record suggests) be conducted without regard to the more immediate and serious problems caused by the international monetary crises characterising the end of the 1960s and the early 1970s, and culminating, in 1973, in the final breakdown of the Bretton Woods system: the more serious discussions in the United States about the effects of EMU on the United States itself tended to be limited, by and large, to speculation about the effects the EEC's step-by-step EMU policy objectives — and the Europeans' travails in attempting to achieve them in very adverse circumstances — would have on their ability to formulate a coherent and, indeed, constructive negotiating stance in the talks on monetary reform. ²³ The fact that the central country of the Bretton Woods system, *viz.* the United States, proved no longer willing or able to provide the public good of monetary stability (largely due to the problems generated by the financing of the Viet Nam war, problems arguably compounded by the Europeans' reluctance to bear a greater share of the expenses for the defence of Europe) was, among the economic factors usually tendered to explain the early drive to EMU, given relatively less prominence in the United States than domestic turbulence in Europe herself. As it happens, this drive *was* partly a result of intra-European factors (the 1966–67 recession in West Germany and the political upheaval in France in May and June 1968), but also partly a consequence of the aforementioned external factors, *viz.* monetary instability.

By the mid-1970s interest in EMU in the United States subsided as the process of integration lost momentum — and free-floating became more prevalent — under the pressure of divergent policy responses to the economic shocks of the period, *viz.* the oil-price rises of 1973 and 1974.

The process of monetary integration was relaunched in 1979 with the creation of the European Monetary System and the European Currency Unit. The initiative for the creation of the EMS was not unrelated to the perception that a substantial reform of the international monetary system was not about to happen. The negative experience of the 1970s, at least from a European perspective — in the shaping of which the US inflation of the Carter years played a determining role — eventually ended discrediting the new ideas about the alleged efficiency of freely fluctuating exchange-rates, ideas which had been imported mainly from the other side of the Atlantic. ²⁴ In their place re-emerged the belief — traditionally held by the majority of European policy-makers and businessmen, if not the academic community — that fixed (but not necessarily irrevocably fixed) exchange rates were more appropriate than a free-floating system for delivering the economic goods associated with the Common Market, *viz.* higher overall efficiency via economic integration and the full freedom of product and factor movements. ²⁵ In the circumstances, free-floating meant, in effect, recurrent pressures on the Deutsche Mark to appreciate *vis-à-vis* the majority of European currencies; this was held to disturb the orderly functioning of the common market (an arguably sound efficiency argument, to the extent that free-floating can generate protectionist pressures, while also entailing a host of “static” costs ²⁶) as well as to disrupt the Common Agricultural Policy (a more dubious efficiency argument). ²⁷ Thus, the EMS was supposed to enhance Europe's

effectiveness and role at a time when US leadership was perceived as wanting.

The post-1979 period can be broadly described as one of increasing exchange-rate stability in the European Community, paralleling a convergence of inflation rates. To be sure, there were realignments — in fact, twelve even before the 1992–93 crisis. But in retrospect the majority of these were relatively minor. In contrast, the 1992–93 upheaval was much more severe, and led to the abandonment of the narrow bands of fluctuation within the ERM. But this was mainly the result of a historically unique development, *viz.* German reunification, and the resulting macroeconomic policies in Germany — an event which, in the view of many policy-makers, proved the need for *more* common monetary decision-making, not less. ²⁸ It is not possible to know whether the other destabilising factors that have been identified, such as insufficient convergence of inflation rates, political uncertainty before and after the Danish and French referenda, the weakness of the dollar and others ²⁹ would have by themselves or, indeed, in combination been sufficiently powerful to induce the realignments that took place in that period.

The final decision to proceed with EMU ³⁰ was, arguably, less dictated by external considerations, such as US policies of “unbenign neglect” with respect to the external value of the dollar and, against the backdrop of a more favourable political climate in European capitals, more by the logic of the Single Market, under completion since the Single Act of 1986, including the watershed decision to liberalise capital movements taken in early 1988. ³¹ Padoa-Schioppa spoke of the “inconsistent quartet” of free trade, free capital movements, fixed exchange rates, and monetary autonomy. ³² The first three objectives having already become central to the European project, the fourth would have to give way in favour of a gradual and eventually complete centralisation of monetary policy. The ERM crisis in 1992–93 subsequently seemed to vindicate those who believed that fixed exchange rates were sustainable only if monetary sovereignty were pooled — and the purest form of pooling was to create a single money-issuing authority. ³³

In a similar vein, Paul Volcker more recently has remarked that, in his view, it is “impossible” to envisage a truly “single market” coexisting with wide exchange-rate fluctuations. Furthermore,

“... once the decision is made to fix exchange rates within a narrow margin, the argument shifts. Then the retention of national currencies may only add to the costs. The market is bound to interpret such retention as a kind of ‘safety valve’ to relieve pressure when strains arise. That possibility will both encourage speculative attacks at times of pressure and undermine the political will to encourage more competitive and flexible labor markets and business practices.” ³⁴

To put it differently, by their very nature quasi-fixed exchange-rate systems, such as Bretton Woods and the EMS, are, in this view, hopelessly vulnerable to speculative attack.

As pointed out above, the long period between the publication of the Werner Report and the signing of the Maastricht Treaty was not one of progress as far as the goal of monetary union, as opposed to exchange-rate stability, was concerned. Steps to create a zone of currency stability in Europe if anything created advantages not only for the European Community’s member states, but also for the United States and other international investors, as, indeed, did the Single Market project of 1987–1993, despite often

overanxious — and, it now appears, totally misplaced — criticism in the Anglo–American press concerning the possible dangers of a discriminatory and protectionist “Fortress Europe”.

U.S. interest in EMU revived in 1992 with the Treaty on European Union. ³⁵ After the Maastricht meeting (December 1991), President Bush welcomed “the historic steps toward economic and political union”, and proclaimed that

“The United States has long supported European unity because of our strong conviction that it was good for Europe, good for the Atlantic partnership, and good for the world. I have made clear from the very outset of this administration my view that a strong, united Europe is very much in America’s interest. A more united Europe offers the United States a more effective partner, prepared for larger responsibilities”. ³⁶

President Clinton, speaking in Brussels in January 1994, expressed even more pro-European sentiments than his predecessors, not only supporting EMU and Eastern enlargement, but also in principle favouring the European Union’s plans to develop a Common Foreign and Security Policy, including a higher-profile role for the Western European Union. ³⁷ This is especially worthy of note, considering that one of the (two) main motivating forces behind traditional US policy vis-à-vis European integration — *viz.* the containment of the Soviet Union — has been rendered obsolete by events. However, it is relatively obvious that, in US geostrategic calculations and assessments, the “Soviet factor” has been replaced by another, more recent, dual preoccupation, *viz.* the need (i) to stabilize the former Eastern Europe and (ii) to integrate it in the world economy. In this light, the European Union’s eastern enlargement plans provide, from the American point of view, a cost-free — if slow — strategy for fulfilling these goals, ³⁸ which at the same time buttress U.S. plans for NATO expansion. Indeed, some analysts even argue that a failed monetary union would be detrimental to U.S. interests insofar as the weakness and instability this would unleash in the EU would threaten European-wide regional stability ³⁹ and thereby compromise the realisation of the above strategic goals. Meanwhile, continuing moves on the part of the Europeans to deepen the process of European integration, despite some progress, are clearly not of a nature to challenge the primacy of NATO and/or the role of the United States ⁴⁰ — monetary union perhaps apart.

Thus, as the date of 1 January 1999 approaches, official statements have not only become more numerous, but also are taking a less detached tone.

Recent public pronouncements by leading members of the Administration continue to reflect the traditional view that “what is good for Europe is good for us”. But, in the event, they also reveal a mounting unease. The latter is evidenced by the various types of — no doubt, well-meaning, yet sometimes ambiguous — advice tendered. For example, US officials often urge Europeans not to neglect, in the course of implementing EMU, to seek solutions to their continent’s structural problems, such as unemployment, and to avoid “excessive” preoccupation with the working details of EMU (paradoxically, even as they voice concern about certain institutional problems, *e.g.* the somewhat ambiguous question as to how will Europe speak with one voice in international monetary talks when responsibility for the exchange-rate policy of the EU as a whole is shared in effect by national finance ministers and the European Central Bank). Of course, why the “technicalities” of monetary union are relatively unimportant, and why seeking to address them (presumably, in the main, by central bankers)

should interfere with finding solutions to the member states' structural problems (presumably a matter within the purview primarily of governments, the Commission and the Council) is not explained.

Thus, the US Treasury Secretary Robert Rubin recently remarked that “[t]he euro risks taking attention away from the requirement of structural reforms in Europe”. [41](#) The Deputy Treasury Secretary Larry Summers, earlier, had remarked that “[I]f Emu works for Europe, it will work for us”; he added, however, that

“[European] Policymakers cannot afford to allow Emu to distract them from pursuing fundamental reforms.” (...) “The aim must be to ensure that Europe emerges out of Emu with the capacity to play an active, constructive role on the world stage on political, monetary and other matters. The corollary is that European policymakers will have to avoid being overly preoccupied with building and refining the architecture of monetary union.” [42](#)

Looking beyond the public pronouncements on EMU, it seems fair to say that the Americans at first had not taken the prospects of a European monetary union very seriously, probably due to the great technical and political uncertainties attaching to the project, including, not least, the size of the original membership. For example, the smaller the original membership, the more the euro-zone would resemble the Mark-zone already in existence. In terms of substance, the economic case could be argued plausibly well on both sides of the issue. However, the seeming inevitability of the project, coupled with the potential benefits to US companies, led the US administration not only to play down the possible challenge to the role of the dollar, but also altogether to project a rather low profile in the matter — according to some commentators, even to appear, at least until recently, “marginally positive” toward EMU. [43](#) The most ardent supporters of EMU among Americans are US multinational corporations, which see in monetary union a chance for the European market finally to become a truly single market, given that the expectations associated with “1992” were not wholly met. [44](#) However, as the date approaches, official U.S. views are showing a tendency to diverge from the corresponding European ones. Thus, while apparently recognising a link between the objectives of a single currency and structural reform and change, Washington evidently seems to regard them, potentially, as conflicting, mutually exclusive propositions, rather than mutually reinforcing ones, a means to an end, as in Europe. [45](#)

C.- The US Academics' Critique

If one were to venture a single opinion on US views regarding what would happen after 1999, it would not be unduly unfair to say that in general these views tended to err on the side of scepticism. This scepticism assumes varying intensities, of course, ranging from constructive advice, to criticism, to outright warnings of impending doom.

Most members of the academic community, in particular, take a very questioning, probing, and overall critical, approach. Economists naturally concentrate, in the first instance, on analysing the economic case for EMU and exploring the extent to which EMU is likely to provide efficiency gains for the European countries concerned. Some emphasise the ramifications for the dollar's role and the management of the international monetary system. [46](#) The conclusion the majority have reached is that the costs of abolishing the national exchange rate and interest rate as policy instruments in a multi-country economy lacking countervailing mechanisms, such as the European one, are probably not outweighed by the

allegedly small benefits that can be expected from passing from a system of quasi-fixed exchange rates to a single currency (greater price transparency, elimination of exchange-rate volatility). Possible “dynamic” economic advantages, such as higher growth and investment (ascribable to lower and less volatile interest rates in an integrated pan-European single-currency capital market), are hardly ever discussed, presumably on the grounds that the latter are very difficult to predict, let alone quantify. [47](#)

Hence the often-heard argument that the real motivating force behind monetary union must be “political”. This (prevailing) view was probably put forward first (and most vociferously) by Martin Feldstein, [48](#) and is captured typically by the statement by Eichengreen and Frieden to the effect that “[t]he absence of a clear economic justification for EMU leads us to conclude that events in Europe are being driven mainly by political factors”. [49](#)

But once “political factors” are brought into play, henceforth it does not require much to shift the discussion about the euro in general, and its potential impact for the United States in particular, into the sphere of political discourse, within which economic theory proper has little to say. This has not prevented economists from offering various opinions.

Reflecting the above political-economic assessments, there are those, like Milton Friedman, who claim that EMU was a political idea “imposed under unfavorable circumstances” which, rather than leading to political unity, will prove a barrier to it. [50](#)

Others, like Rudiger Dornbusch believe that

“EMU has gone from being an improbable and bad idea, to a bad idea that is about to come true ... High unemployment, low growth, discomfort with the welfare state that is no longer affordable — all these issues have found new hope for resolution in a desperate bid for a common currency, as if that could address the real problems of Europe. On the contrary, the hard work of attaining a common currency ... is adding to the burden of an already mismanaged Europe. The struggle to achieve monetary union under the Maastricht formula may be remembered as one of the more useless battles in European history”. [51](#)

Lester Thurow argues, for his part, that the euro will become too strong, as it will begin to attract volatile dollars from across the Atlantic, thereby reducing the international competitiveness of the European manufacturing industry. [52](#), [53](#)

Martin Feldstein of late has renewed his attack on EMU, predicting even more dire consequences. He concludes not only that EMU is bound to bring about important macroeconomic distortions (*viz.* both greater cyclical unemployment *and* higher inflation); but it also “will change the political character of Europe in ways that could lead to conflicts in Europe and confrontations with the United States”. [54](#) In the beginning, as he explains, this could come about as a result of important disagreements among the EMU members about the goals and methods of monetary policy. Labour-market flexibility and EU-wide transfer payments being absent or unavailable in Europe, the euro will undermine the European Union’s competitiveness, causing the global trading system to suffer. Eventually, through political union in Europe induced by EMU, Europe could begin to pursue an independent military and foreign policy and drift apart from the United States, thereby weakening NATO and complicating international relationships more generally, to the point of creating risks of war within Europe, and serious conflicts with the United

States.

Perhaps the range of reactions is natural, given the inherent risks underlying a project which in Europe was seen as an enormous political undertaking ever since the days of the Werner Report, [55](#) and one which would require remarkable amounts of political will from European governments to come to fruition. But it is precisely because of the fundamentally political character of the project that reactions to it, in spite of the “positive” (in the conceptual sense) approach adhered to by most writers, will ultimately reflect a corresponding “political” appraisal as well, as the above quotes indicate. For an expert opinion cannot be formulated without also an appreciation — necessarily subjective — of a number of issues which, although in principle amenable to economic theorising or to quantitative analysis, at least in part, are nonetheless of a nature to provide sufficient scope for disagreement. As themes requiring an appraisal, one could include:

- a. whether or not “[t]he establishment of an economic and monetary union would give *the Community a greater say in international negotiations* and enhance its capacity to influence economic relations between industrial and developing countries”, a question answered in the affirmative by the 1989 Delors Report (an affirmation repeated by many European politicians), but doubted by others in the United States; [56](#)
- b. the extent to which monetary integration requires (or does not require) further political and economic integration, including a more coordinated, or even federal, fiscal policy (for example, steps to supplement national efforts at counteracting country-specific shocks); [57](#)
- c. the ability of the European central banking authorities to conduct an effective and credible monetary policy (including their ability to elicit democratic support through proper accountability [58](#)), especially in the light of conflicting social and political pressures;
- d. the ability/willingness of European politicians to abide by the strict convergence rules regarding fiscal policy (the seriousness of treaty commitments being allegedly open to questioning due to the temptations of “moral hazard” [59](#));
- e. more generally, the ability/willingness of European governments to adequately address the new political and economic problems that will be compounded by, or result from, monetary union (including such problems as potentially unfundable public pension liabilities; devising the proper institutional arrangements both ensuring effective policy coordination among the various tiers of public economic authority and enabling Europe to speak with a single voice in international fora); and,
- f. the very adaptiveness of the societies subjected to the monetary experiment, in particular the question of whether monetary integration will actually promote or induce the required changes in labour mobility and price and wage flexibility or whether, instead, monetary union will be held hostage to Europe’s perceived structural rigidities. This is an argument to be reckoned with given that most of the continental European countries suffer from very high structural unemployment rates; the latter may, according to the IMF, be of the order of 8 to 9 percent of the labour force in the three largest countries. International comparisons suggest that this is 3 to 3 1/2 percentage points more than might be attributed to normal frictions and mismatches in the labour market. [60](#)

Though analysts of EMU on both sides of the Atlantic will no doubt consider all of these themes, one can already detect — at the risk of some simplification — some geographically-biased differences in

emphasis, not only in terms of the tentative answers given to each question, but also in terms of the weight given to each of them: naturally, the European supporters of monetary union tend to give rather more optimistic answers to the above questions than the Eurosceptics on the other side of the Atlantic; but at the same time the debate in Europe seems to place greater stress on some issues rather than others, including the possibility of Europe exerting greater influence in world affairs thanks to the euro, as well as the question as to whether or not Europe should develop mechanisms allowing more efficient economic policy coordination, and whether or not this should lead to a more federal approach in matters of countercyclical policy, taxation, social, employment and regional policy. In contrast, the American approach tends to emphasise the alleged absence of certain features in the European economy which would allow a proper functioning of monetary union, while also expressing doubt as to the ability of the European institutions (points [c], [d], [e] and [f] above) to rise to the challenge. [61](#)

However, as suggested in the introduction, this debate has proven inconclusive as it is significantly biased by non-verifiable, subjective, and ultimately speculative assessments of possible future developments — hence, in what will follow later (section IV), the emphasis will lie with the economic arguments in the more narrow sense. An effort to explain the reasons for the U.S. sceptics' orientation will follow in section V.

III. The Political vs. Economic Case Debate

Before turning to the, *stricto sensu*, economic arguments, it may be useful to review the broader terms in which the “for-and-against” debate is usually conducted. As indicated earlier, many authors, especially in the United States, distinguish between the economic case (or non-case) for EMU and the political case. (The political case is usually held to rest on the benefits associated with [i] the consolidation of the process of integration, including the “Europeanisation” of Germany, a strategic goal aimed at not least by Germany’s leadership itself, and [ii] the creation of the preconditions for further, political, integration [62](#)).

This approach, though intuitively appealing, is actually based on questionable conceptual foundations. It presupposes that “economic” and “political” factors are clearly definable and distinguishable from each other. In fact, the “economic” and “political” motivational categories not only overlap conceptually, but, complicating matters further, are prone to intertemporal inconsistencies: the results of any appraisal regarding the relative value and role of the two categories based on the assumption of separateness will tend to vary according as the time-horizon considered shifts from the short term to the longer term. To the extent that these observations are true (as will be argued below), maintaining the above conceptual dichotomy without qualifications may well lead to misleading conclusions regarding the true motivating forces lying behind EMU.

In terms of what has become the traditional political- vs. economic-rationale debate, one could construct the following categories:

- a. European monetary integration involves both net economic benefits and net political benefits;
- b. monetary integration involves net economic costs but net political benefits;
- c. monetary integration involves net economic benefits but net political costs; and

d. monetary integration involves net economic costs and net political costs.

In terms of placing the actors involved in the debate in these categories, in category (a) one could include the EU governments without an opt-out (and respective Central Banks) and the official US government view (with the aforementioned qualifications on the economic side).

In category (b), one could include perhaps a majority of American commentators and, probably as a reluctant participant, the Bundesbank. A number of Dutch politicians belonging to the (pre-May 6 general election) coalition government were also reportedly dissatisfied with a “broad-based” EMU membership, though not with EMU as such. [63](#)

Category (c) is probably the most interesting, and telling, category. It includes the United Kingdom, assuming it eventually joins EMU (the UK government’s informal timetable providing for membership early in the next parliament, *i.e.* sometime after May 2002 [64](#)), and likewise Denmark and Sweden. This is a key category, for it could substantiate the opposite argument to the one often held, *viz.* that the economic benefits of joining are not only positive in themselves, but may be such as to outweigh perceived net political costs (however defined). [65](#)

In category (d) one could include the hard-line British, and other European, Eurosceptics, the three opting-out countries in the event they decide to never join, and some American economists and commentators. This latter group essentially believes that the economic costs in Europe of EMU (in terms of mismanaged economies) will probably end up fragmenting the solidarity among EU citizens required to pursue European monetary stability; in these circumstances, European monetary union may well have the perverse effect of forestalling political integration (which, actually, may be no bad thing, as far as some of these commentators are concerned) or causing it to unravel altogether — rather than acting as a vehicle for it, as its proponents would hope. [66](#)

As suggested above, the view that monetary integration currently is primarily motivated by “political” (and misplaced) considerations underestimates two important elements, one conceptual, the other factual:

(i) at the present stage of European integration, it is probably less and less useful to try to disentangle, in order to examine separately, “political” and “economic” considerations. The British case probably illustrates this point best, the UK being the member state which seems to have grappled most seriously with the implications of a perceived antithesis between economic and political consequences of EMU: if the UK decides to join the single currency, clearly it will not be because the British government has converted to the goals of political union; rather, it will be because economic and political evaluations have been revised. How can Britain’s supposedly fundamental “political” objections end up being overturned? The answer lies with the costs of following the alternative course: remaining outside EMU could lead not only to high *long-term* political costs (loss of influence within the decision-making process in general and marginalisation in the negotiations leading to the next steps of European integration in particular), outweighing the *short-term* political gains (retention of monetary sovereignty), but also to direct *economic* costs, *e.g.* loss of inward investment, or a forsaking of the potential benefits, in terms of greater competitiveness, attaching to a successful euro-zone. In short, attempts at calculating the “political” and “economic” costs and benefits in isolation may be a misguided and futile exercise;

(ii) in the light of some recent developments, the argument that EMU is perceived by European governments as a self-justifying vehicle for greater political union (independently of any possible

economic advantages) appears too weak to explain the commitment of European governments to the Maastricht convergence process, including the commitment of the opting-out countries during the second stage of EMU, especially given the high political costs potentially facing governments in terms of loss of voter support. ⁶⁷ This argument cannot be easily reconciled with the limited progress made by the Amsterdam intergovernmental conference (IGC) in the direction of political union: when confronted with the opportunity to accept, or make, proposals for reforms leading to greater political union, member states, while not entirely rejecting such reforms, ⁶⁸ overall exhibited a marked reluctance to make the additional sacrifices of national sovereignty which are necessary for greater political union, notwithstanding the expectations hinging on the 1996 IGC as a result of the widely perceived lack of progress made during discussion of the political chapter of the Maastricht negotiations in 1991. ⁶⁹ In the course of the 1996–97 IGC, this tendency was particularly evident in relation to institutional reform, which lies at the heart of the matter, particularly in view of the goal of enlargement: the failure of governments to make sufficient progress on the questions of the composition of the Commission, the weighting of the votes in the Council, and the extension of qualified majority voting, and the decision to hold a new intergovernmental conference at a later date to address specifically these issues, confirms the point. ⁷⁰ These developments should cast at least some doubt on the view which posits the primacy of “political” goals among governments’ “European” agenda ⁷¹ — at least in the current period.

IV. The Economic Case For and Against European Monetary Integration

A.- The Theory of “Optimal Currency Areas” and the Delors Report

The point of departure of any analysis of the desirability of EMU in Europe, of course, has to be Mundell’s classic paper on the “theory of optimal currency areas”. ⁷² As Mundell himself pointed out at the outset, existing arrangements around the world were not necessarily optimal, *i.e.* economic regions did not necessarily coincide with actual currency areas (for perfectly good political reasons). Therefore, it is worth recalling at this point that any comparison between European monetary union and its predecessor(s) anyway will have to be one between two sub-optimal situations. But this is sometimes overlooked, and economists usually tend, as will be seen below, to compare Europe (which will enter into monetary union) with the United States (which has done so at least since 1913, year the Federal Reserve System was founded, and to this extent has had ample time to develop some or most of the necessary features of a currency union). Though comparing the EU with the US may not in itself be an invalid approach, it does tend to underestimate — as evidenced by the type of “static” arguments and criticisms put forward by EMU’s critics — the degree to which EMU is seen by its architects as an *agent* for dynamic change, as opposed to a static model merely to be superimposed effortlessly on the European economy. ⁷³ In this sense, all agree: there are risks involved.

Two — interrelated — analytical features stand out in Mundell’s analysis: (i) his definition of an optimal currency area, or “economic region”, as fundamentally “a domain in which exchange rates are fixed” and (ii) his assumptions about labour mobility, based on the Ricardian trade model (perfect factor mobility within the trading country/region and perfect factor immobility across borders/regions). These two themes permeate all discussions of EMU, and will be encountered also below.

The 1989 Delors Report on Economic and Monetary Union implicitly accepted that the Community did not necessarily enjoy the characteristics of an optimum currency area. Though it claimed that “the creation of a single currency area would add to the potential benefits of an enlarged economic area because it would remove intra-Community exchange-rate uncertainties and reduce transactions costs, eliminate exchange-rate variability and reduce the susceptibility of the Community to external shocks”, at the same time it pointed out that “exchange-rate adjustments would no longer be available as an instrument to correct economic imbalances...”. Such imbalances were likely to arise as the process of adjustment and restructuring set in motion by the removal of barriers would probably have an uneven impact on different regions; they were also likely to emanate from labour and other cost developments, external shocks with differing repercussions on individual economies, or divergent economic policies pursued at national level. ⁷⁴

It was in recognition of these facts that the Report advocated “parallelism” ⁷⁵ on the road to monetary union, *i.e.* the parallel advancement of economic integration as indispensable to the success of monetary integration. By “economic integration” was meant the attempt to promote barrier-free, regionally-balanced economic development in the European Community, and a convergence of policies. This would be achieved not only via the Single Market, macroeconomic policy coordination and policies aimed at strengthening market mechanisms (competition policy etc.), but, since the Single Market objective itself contained the risk of greater regional disparities, also by means of common policies aimed at “structural change” and “regional development”. ⁷⁶ It might be interesting to point out that the relevant chapter of the Report devotes only two sentences to the need for greater labour mobility and price and wage flexibility as a means of remedying possible divergences in economic performance and competitiveness between different regions and countries of the Community; ⁷⁷ in contrast, it discusses, at length, how EMU might disadvantage the less developed regions of the Community and how this will require countervailing policies, in the form of structural policies/funds aiming above all at “equaliz[ing] production conditions through investment programmes in such areas as physical infrastructure, communications, transportation and education *so that large-scale movements of labour do not become the major adjustment factor.*” ⁷⁸ Therefore, just as the creation of a single currency area would add to the potential benefits of an enlarged economic area, so it could add to the potential costs.

Again, what are these “monetary” costs? Chronic regional imbalances — such as obtain in areas which are deprived of natural resources, generally lack the preconditions for self-sustaining growth, or are excessively reliant on industries which are in irreversible, long-term decline — can hardly be addressed via the exchange-rate instrument (even if it were available) — hence the emphasis, both in the Delors Report and in actual EU policy, of the necessity for remedial action of a *redistributive* nature when tendencies to regional imbalance set in. As for imbalances emanating from labour and other cost developments, these would probably be a result of divergent national economic policies, which in turn ought to be addressed by economic policy coordination. The literature, when discussing the problems that are likely to be associated with the surrender of the (national) exchange rate as a policy instrument, stresses the issue of “asymmetrical shocks”.

B.- The Role of the Exchange Rate in the Face of Economic Divergence

As suggested in the previous paragraph, the exchange rate is usually held to work best as a policy instrument — when it does work — when addressing regional shocks (provided the currency too is

“regional”) which are sizable, temporary and reversible in nature, rather than phenomena of chronic backwardness or permanent decline, which normally call for real adjustment by means of changes in relative prices between sectors, labour mobility and/or downward flexibility of both real and nominal wages, occupational mobility and, more often than not in modern economies, so-called “structural” reforms and policy improvements (*e.g.* measures aiming at reinforcing competition, removing labour- and product-market rigidities, privatisation, etc.). Thus, a long-term fall in demand usually will require, *inter alia*, a parallel reduction in real wages to allow the affected region or country to become more competitive; in most cases this will need to take the form of a moderation of *nominal* wage increases below the average increase in labour productivity in the economy. Whether this same result can be achieved via a devaluation is certainly a matter which is open to discussion: more often than not, a continuous depreciation of the currency designed to counter the slower productivity growth of a laggard region will act as a temporary palliative, delaying rather than triggering the required changes. By insulating producers from the disciplinary conditions imposed by fixed exchange rates, it may even prove detrimental to the economy ⁷⁹ — as well as open up the country in question to accusations that it is pursuing a “beggar thy neighbour” policy at the expense of its partners.

In the face of *temporary* shocks, in contrast, the argument is that an exchange-rate change can assist in the adjustment process, by making the products of the region more competitive almost immediately, partly by reducing prices in terms of foreign currencies, and partly by reducing real wages without a need for an actual fall in the nominal wage. Again, this is contingent upon the assumption that workers will not attempt to offset the fall in their real wages via demands for higher real (and nominal) wages compensating them for the higher prices of imports (or that the economy will enjoy a breathing space until they do). The argument in favour of retaining the exchange rate therefore also requires certain assumptions about the money illusion afflicting workers, *viz.* that they do not readily accept the prospect of a fall in real wages resulting from a fall in nominal wages, yet they do not react to a fall in real wages resulting from rising prices (initially of imported goods, and possibly of competing domestic goods as well). ⁸⁰ This is why most economists are agreed that, ultimately, the beneficial effects of a devaluation on competitiveness are only temporary, and are typically eroded by rising prices, exacerbated by new wage claims. Furthermore, devaluation can prove a crude instrument insofar as it will change the relative prices of a wide-ranging set of goods and assets, many of which may not be necessary to tackle the imbalance problem at hand, thereby possibly generating undesirable side-effects. Addressing the latter will involve additional, corrective relative-price adjustments and/or a reallocation of resources, including labour movements. The problem will be the greater, the more marked the differences in productivity and competitiveness as between sectors or activities within the region (and as between regions within the country — see the next section IV.c.1). At the other end of the spectrum, some authors have even argued that devaluation is relatively ineffective in the first place, in that prices (expressed in domestic currency) of foreign goods adjust only very sluggishly to an exchange-rate change because price-setters treat individual domestic markets differently. ⁸¹ Lastly, devaluation in one country creates tensions between member states within the Single Market ⁸² (a criticism the sceptics usually reserve for the third stage of EMU). Despite these limiting factors, exchange-rate adjustments have at times averted, at least temporarily, situations which otherwise would have produced significant dislocations in the economy.

It will be interesting to see how various writers have described the structural and institutional differences between the European economy and that of the United States and, on this basis, to examine the conclusions they have drawn regarding the susceptibility of the European economy to asymmetrical,

country-specific shocks, and hence its suitability — once the exchange rate has been eliminated as a policy instrument — for monetary union. The observation that the economies of the European Union and the United States are “different” is the basis which American commentators explicitly or implicitly use to argue that the European economy does not conform to the conditions required by economic theory to make a currency area work. The question can be broken down into two components. First, are the economies of the EU countries less or more homogeneous than those of the varying regions of the United States? And second, how relevant will the exchange rate be as a policy instrument in the EU, and how costly its elimination taking into account Europe’s structural characteristics (and the relative lack of countervailing mechanisms, as compared with the United States)?

C.- Comparisons of the Structures of the US and EU Economies

1. “Real” shocks

The empirical evidence regarding the structure of the EU and US economies is decidedly open to differing interpretations. For example, US authors often invoke the results of a 1992 study ⁸³ to claim that “both aggregate-supply and aggregate-demand shocks are more asymmetrically distributed across European nations than across the regions of existing monetary unions like the United States.” ⁸⁴

European authors, in contrast, provide evidence to the effect that, on average, the differences between regional production structures are much larger within the US than within the EU as a whole, and are therefore more likely to be subject to asymmetric disturbances. ⁸⁵ Indeed, it is even pointed out ⁸⁶ that the United States’ alleged greater regional specialisation may well be a *product* of national integration and monetary union in that country, reflecting a higher degree of spatial efficiency, as the theory of comparative advantage in fact would lead us to expect. ⁸⁷ In Europe, in contrast, less specialisation may be partly due to the relatively higher relocation costs facing factors of production contemplating crossing national borders, which inhibits the realisation of all potential agglomeration economies; it may even be the result of “the past use of autonomous responses in the member states, such as exchange rate modifications, to absorb the impact of differentiated shocks” ⁸⁸ dampening the need for equilibrating factor movements. The paradoxical conclusion, for these writers at least, is that the exchange rate is a less useful instrument in the European Community than it would be in the United States ⁸⁹ — not neglecting, of course, that, theoretically, the Single Market and EMU also may bring about the kind of comparative regional specialisation apparently characterising the American economy (however, see the following paragraph).

In fact, if there is any validity to the argument that economic integration over the past forty years has led to new patterns of specialisation at the EU level, *country*-specific shocks in Europe will have tended to become less important over time. Indeed, the evidence indicates that the largest part of Community trade is intra-industry and not inter-industry trade. ⁹⁰ This means that specialisation there is, but not along national lines. Some studies even suggest that, unlike the US economy, and contrary to what one would normally expect, the economies of the member states may actually be becoming more similar to each other, in spite of the Single Market. If this is true, future shocks will generally be more symmetric than asymmetric. ⁹¹ In fact, national economies continue to be characterised by fairly diverse industrial structures. ⁹² The upshot is that economic regions in Europe do not in general coincide with countries. ⁹³ Furthermore, the accession of three poorer countries in the 1980s (Greece, Spain, Portugal), while

injecting a measure of complementarity into the Community's combined industrial profile, was also accompanied, as far as these three countries are concerned, by a higher rate of increase of intra-industry trade than the corresponding rates in the more developed EU countries over the decade, suggesting a tendency to convergence of national levels of intra-industry trade as a proportion of national intra-EU trade. ⁹⁴ It is doubtful whether, in these circumstances, replacing the French franc or the Italian lira with the euro would worsen the mismatch between currencies and economic regions. It is therefore no surprise that actual examples of country-specific "real" shocks are difficult to adduce in convincing numbers. In the last two decades, Europe has seen two or three: the UK becoming a significant oil producer in the early 1980s, which necessitated a real appreciation of sterling; German reunification at the beginning of the 1990s, necessitating a real appreciation of the Deutsche Mark; and the collapse of Finland's export market following the break-up of the Soviet Union. It is difficult to imagine frequent repetitions of shocks such as these, or, indeed, to imagine governments rationally allowing for such scenarios in the designing of long-term policies. ⁹⁵ In short, in circumstances where asymmetric shocks are less likely to hit individual countries, and more likely to impact on industries or regions, the exchange rate will be the wrong adjustment tool.

2. "Monetary" shocks

Some writers stress the impact of eventual country-specific "monetary" shocks. Of course, most forms of national-specific monetary shocks, such as those which occur when central banks lose control of money supply, or when international speculators attack a national currency, causing a run on the national currency ⁹⁶ (an increasingly prominent feature of the international monetary system), will cease, by definition, to exist under EMU; as will those caused by an exogenous shift in the demand for money, which anyway are rare. Nonetheless, in this view, there remain risks: country-specific "monetary" shocks will potentially ensue as a result of the elimination of the autonomy of national monetary authorities. In a boom, a basic central-bank function is to act as a restraint on bank lending. In a depression, it is to serve as a lender of last resort.

Thus, an often-mentioned problem associated with the loss of domestic monetary policy and the elimination of domestic interest rates as tools of macroeconomic management ⁹⁷ is the question of how to address the country-specific effects of asynchronous business cycles, *e.g.* inflationary pressures in a member state experiencing higher-than-average rates of growth. ⁹⁸ This is the "endogenous" variant of country-specific shocks and the loss-of-the-exchange-rate-as-a-policy-instrument question. In principle, and in the absence of national interest rates, the same remedial mechanisms ought to apply, *viz.* factor movements and/or wage flexibility, and fiscal transfers, *i.e.* those ingredients that are presently said to be wanting in the European context. This problem will be more acute in the initial years of EMU as national growth rates now, despite the nominal convergence efforts of governments, still are characterized by considerable variance; ⁹⁹ the new monetary authorities' response to an inflationary boom in one part of the Union may well prove too severe, as the commitment to price stability, in conjunction with downward wage and price rigidity in regions of below-average inflation, lead overall to excessively contractionary results.

More generally, the new Europe-wide monetary policy, because it will be set on the basis of economic conditions in many countries, not just one, will result in interest rates oscillating less than before. But because greater attention will be paid by the European Central Bank to (probably some GDP-weighted

version of) the *average* rate of inflation, interest rates may well prove to be too low for the faster-growing euro-zone economies (presently, the “peripheral” countries of Ireland, Spain and Portugal) and too high for the slower-growing ones (the “core” countries), which is the opposite of what both sets of countries require.

However, there are equilibrating mechanisms, even in a currency union as imperfect as the European Union. Given the elimination of exchange-rate uncertainty, an additional equilibrating factor may be increased investment from the “core” to the “periphery”, this restraining marginal rates of return on capital and thereby easing pressures on the price level in the recipient areas. ¹⁰⁰ Another equilibrating factor — whose effectiveness will be strengthened in a currency union with greater price-transparency — will be rising relative costs in the “periphery”, rendering these economies less competitive. Also, as financial-market integration and banking sector-rationalisation advance, asymmetric shocks increasingly will tend to be absorbed, from the standpoint of individuals residing in a region suffering from a temporary downturn, thanks to the geographical diversification of financial assets (*e.g.* equities and pension funds) and to the cushioning effects afforded by income accruing from widely-dispersed, extra-regional investments. ¹⁰¹

In the medium term, in fact, the problem should tend to recede as the effects of EMU increasingly begin to permeate and take hold in the European economy; *other things being equal*, national performances should begin exhibiting a tendency to come closer into line, with differences in economic activity increasingly displaying a *sectoral*, rather than national, character (a concomitant of the observed tendency to intra-sectorally-based economic integration). Under these circumstances, the use of national monetary instruments (the interest rate, the exchange rate) will produce increasingly uneven effects across the (national) economy, and what would be advisable for one sector will not necessarily be so for another. ¹⁰² This will not, of course, preclude entirely the possible emergence of local phenomena analogous to localised booms or downswings in regions of the United States, given the existence of inter-sectoral, spatially-related spillover effects. Fiscal policy, which will essentially remain in the hands of national policy-makers, will be available in principle to address problems of this sort.

In the long run, as the tendency to “regional” specialisation proceeds ever further, national boundaries (and national statistics) will become progressively less important, and it will be less and less useful, and correct, to use them as a frame of reference. In such a context, national exchange rate and interest rate policies will become increasingly irrelevant as policy instruments.

The other problem mentioned above is country-specific banking/financial crises unrelated to foreign-exchange crises. However, as capital-market integration proceeds apace, as it is supposed to in a single market (further prodded on by monetary union itself), banking crises — when they occur — will tend to become decreasingly “national” and increasingly “European” in character, in terms of their economic impact as well as their geographical incidence on owners/shareholders, depositors and, eventually, even the taxpayers that may be called upon to bail out insolvent institutions. However, as long as banking regulation remains national and the lender-of-last resort issue remains unresolved, problems could conceivably emerge.

There are two basic causes of financial-sector unsoundness: ¹⁰³ (a) macroeconomic and (b) institutional. First, increasingly in the future, macroeconomic fundamentals will be shaped at the EU-wide level. Since the most common cause of institutions’ financial unsoundness is held to be poor macroeconomic policy

and/or unstable macroeconomic conditions, [104](#) national banks' fortunes will be more closely bound to developments in the European economy as a whole, rather than the national economy. Even where regional shocks do occur, banks operating on a EU-wide scale will be better placed to respond to such shocks. [105](#) Until the banking sector becomes more integrated Europe-wide, however, financial crises in one country may produce spillover effects on the common currency. Second, on the institutional side, only if there is a centralisation of institutional arrangements will it be possible to assert that *national*-specific monetary shocks caused by institutional weaknesses — which are usually ascribed to deficiencies in the legal, political, cultural and financial infrastructure in which banks operate — cannot occur. [106](#) Of course, the argument usually put forward is not the one just mentioned, but rather that, with the elimination of national central banks' autonomy and the Article 104 “no-bail-out clause”, the European Union will be faced with a lender-of-last-resort specification problem. [107](#) Framing the problem in these terms conceals the existence of a dilemma: how to balance the lender-of-last-resort function against the need to ensure private-sector responsibility for mistakes. The problem here, therefore, is essentially an administrative/institutional one; it cannot be considered an *inherent* problem of a European currency union — still, it remains as yet unresolved. The fact that the Maastricht Treaty has explicitly not accorded the ECB responsibility in these matters probably means that future arrangements will include an (*ad hoc*) role not only for the Commission, but also for the Ecofin Council. [108](#) Furthermore, the detailed plans being worked out by the European Monetary Institute (EMI) with an eye to efficient techniques of central monetary control and regulation suggest that the modern EMU venture places greater emphasis on preventing rather than curing; [109](#) to this extent, it is unlikely to encounter the same problems as those experienced in the past in the United States, Italy and other countries during the establishment of monetary union. Nonetheless, further negotiations within the EU bodies are required if a proper, effective regulatory framework at European level is to emerge.

D.- The Role of Remedial Mechanisms

The issue of the possible costs associated with the elimination of the exchange-rate as a policy instrument lies at the heart of the whole debate. The fact that no-one has ever suggested — except for reasons of theoretical exposition [110](#) — that the US should introduce regional currencies is due not only to the presence of overriding historical-political reasons but, perhaps more importantly, to the fact that the US compensates for its deficiencies as an optimum currency area by having recourse to highly-developed adjustment mechanisms, which it uses in lieu of exchange-rate changes. These, of course, are, firstly, a higher mobility of labour and greater wage flexibility than in the European Union and, secondly, a more significant fiscal transfer capability.

The alleged absence or weakness of these mechanisms in the European Union, compared with the United States, has become the premise on which the sceptics' case essentially rests.

1. The labour mobility — wage flexibility argument

There seems to be broad agreement, both among writers who tend to favour EMU and among those who do not, that, despite the aim of the original Rome Treaty to facilitate the mobility of persons, the labour force in the European Union remains overall comparatively immobile. Whereas 3 per cent of American households move their region of residence in a year, the figure is about 1 per cent in France, Germany and the UK, and lower still in the Mediterranean countries. [111](#) This relative immobility, in turn, is

assumed to lead to country-wide inefficiencies, including relatively wide unemployment disparities between regions, and economic decline in regions suffering from negative shocks, while the unresponsiveness of labour to relatively higher wages available elsewhere leads to upward wage pressure in the latter regions. (Alternatively, low wage-flexibility limits the scope for profitable labour migration to the better-off regions. [112](#)) All of these factors have a negative impact on the European economy's level of productivity and competitiveness. In this respect, the high rates of structural unemployment in Europe, as well as the high interregional unemployment-rate disparities within member states — especially in comparison with those prevailing in the United States — are adduced as proof that monetary union without greater pan-European labour mobility will run up against serious problems.

A closer look at the labour-flexibility question reveals that the latter has two dimensions: first, a longer-term component which relates to the ability (or inability) of the European economy to adjust successfully to the longer-term, structural, requirements of economic growth and development following the transition to EMU *per se*, and, second, a shorter-term, cyclical, component relating to EMU's ability to respond to country-specific shocks (for which purpose, to repeat, exchange rate changes at the national level are deemed most useful).

While acknowledging that the thrust of the critique against EMU relates to the latter aspect, it may be useful to point out that the fact that, in Europe, labour-market inflexibility is in essence a structural, not a cyclical, problem, transcending the type of monetary régime existing at any one time, has certain implications for the analysis which argues the unsuitability of the EU economy for monetary union.

Firstly, a relatively low degree of labour-market flexibility within countries also weakens the case for retaining national exchange rates. An assessment of the prospects for EMU in Europe needs to confront the existence of both relatively low inter-country labour mobility in the EU as a whole, *and* low labour mobility *within* member countries — but not in the way commonly supposed.

Critics interpret the fact of low labour mobility within the member states as an element which compounds EU-wide immobility, thereby allegedly *exacerbating* the risks of monetary union in Europe.

But as Mundell explained:

“The argument for flexible exchange rates based on national currencies is only as valid as the Ricardian assumption about factor mobility. If factor mobility is high internally and low internationally, a system of flexible exchange rates based on national currencies might work effectively enough. But if regions cut across national boundaries or if countries are multiregional, then the argument for flexible exchange rates is only valid if currencies are reorganized on a regional basis.” [113](#)

And where regions do cut across national boundaries, a flexible exchange-rate system, although allowing exchange-rate movements such as to preserve balance-of-payments equilibrium between countries facing a relative shift in (cross-border) regional demand, will not serve to correct the balance-of-payments situation between national regions, which was the original problem. In this case a flexible exchange-rate system will “not necessarily [be] preferable to a *common currency* or national currencies connected by fixed exchange rates.” [114](#)

Hence, if it is true that, presently, labour mobility is low within the individual member states, the

flexibility of the external price of the national currencies can not have performed effectively the stabilisation function attributed to it, with varying rates of unemployment or inflation among different regions nationally ensuing as a result. To put it differently, multi-regional, multi-sectoral countries with an independent exchange-rate policy too require labour-market flexibility; but current currency zones in terms of their labour-mobility characteristics are not optimal, which implies that eliminating national currencies and introducing the euro will not necessarily increase the mismatch between economic regions and currencies on this score. Only if countries were homogeneous, uniform units (or internal labour mobility and factor-substitution possibilities were so perfect as to make them look that way), would the case for retaining the national exchange rate remain strong. In all other cases, adjusting to a shock will require a certain amount of resource-reallocation among sectors and regions, whether or not the external value of the currency changes. [115](#)

Indeed, evidence from that most obvious of indicators of the long term adjustment-capability of the exchange rate, *viz.* interregional income disparities, [116](#) shows that the latter *within* member states are not less, but *more* pronounced than income disparities *between* member states. The latest figures from Eurostat (1995) indicate that the income gap (in *per capita* terms) between Denmark, the EU's most prosperous country (bar Luxembourg), and Greece, the least well off country, is 1.76-to-1. By comparison, the income gap between, say, the region of Hamburg and the eastern German *Länder* is 4-to-1; that between Lombardy and Calabria is 3-to-1; that between the Paris region and Corsica or Languedoc-Roussillon is 2-to-1; that between Brussels and Hainault (80 kms away) is also 2-to-1. Therefore, the evidence suggests that the costs of eliminating the national exchange rate as a domestic adjustment mechanism will be considerably lower than is usually thought: the possibility of recourse to exchange-rate adjustment (albeit in the context of an exchange-rate régime, the ERM, which is not totally flexible, even if it displayed characteristics of flexibility when national divergences became unusually large) has not played a very successful role in averting interregional imbalances within existing national economies, owing to labour immobility; this will be similar under EMU.

Therefore, on the one hand the costs associated with the loss of flexibility of the national exchange rate as an adjustment instrument will probably be low — though not entirely negligible — in economies which had relatively immobile labour forces to begin with; on the other hand, monetary union may encourage more equilibrating capital flows. It is worth recalling the argument that the monetary union itself, by encouraging greater *capital* flows across member states, may actually end up increasing equilibrating factor movements as a whole — in the event, through greater capital movements. The latter may act as a supplementary adjustment mechanism. [117](#) Also, the elimination of the exchange rate and the introduction of a single currency may exert new pressures for greater intra-country factor mobility and structural adjustment by reason of the greater competition that will emerge, which the possibility of recourse to devaluation previously tended to dampen or postpone. Ascertaining the balance between these negative and positive factors will be an *ex post* empirical matter.

Secondly, though there is no denying the higher structural unemployment prevalent in Europe compared with the United States, it is not perfectly clear that US workers respond significantly more readily than their European counterparts to *short-term* fluctuations [118](#) (to repeat, the kind whose adverse effects exchange-rate adjustments are supposed to be more effective at countering), as distinct from long-term structural changes. Only if this can be shown to be the case — and the figures on labour mobility referred to above are necessarily *aggregate* figures — will it make sense, analytically, to say that the loss of the

exchange rate as a policy instrument in Europe will entail significantly greater costs than those which prevail in the United States as a result of US monetary union. Some authors have indeed argued that region-specific shocks in the United States tend to assume a predominantly permanent character, in the sense that they have a tendency to alter regional conditions permanently. ¹¹⁹ Under these circumstances, where jobs decline permanently, and where it is not clear whether labour emigration is a cause or an effect of permanent changes, the argument that US labour is highly responsive to *temporary* fluctuations becomes moot on methodological grounds, in the sense that this assumed higher responsiveness cannot be readily observed. This observation is a mere reflection of the difficulties sometimes involved in attempts to distinguish “long-term” from “short-term” trends in the economy.

Thirdly, the aforementioned arguments regarding Europe’s labour market inflexibility neglect the fact that labour *non*-migration may be a rational response, reflecting a free choice (on which economic analysis cannot pass judgment merely on production-efficiency grounds); and at times when migration does occur it may be no more than a second-best substitute for private capital inflows.

For one thing, labour’s unresponsiveness to potential nominal wage gains through emigration ¹²⁰ — and its apparent willingness to accept a range of other, nominally sub-optimal solutions, ranging from lower wages to underemployment to outright unemployment — may be rational, and consistent with welfare-maximization in the currency area, in the sense that the potential emigrants (i) are merely responding to the fact that governments frequently subsidise loss-making industries, discouraging job-seeking moves on the part of workers, (ii) are taking into account, and responding to, possible external congestion costs in the area of potential inflow (*e.g.* rising rents, overburdened public services), (iii) are choosing — at least for some time — to forgo jobs and/or higher wages elsewhere on the calculation that staying on in the region with which they identify both linguistically and culturally provides them with more-than-offsetting non-pecuniary forms of income, ¹²¹ especially if there is a chance that the observed downturn in local economic activity is temporary, and (iv) are merely acknowledging the fact that their skills are not transferable between sectors and occupations.

For another thing, perfect labour mobility may carry with it economic costs of its own. High rates of emigration from certain regions — which is what would occur in a friction-less world — could lead, as far as the region of out-migration is concerned, among other things to a vicious circle of underutilised social overhead capital, declining local tax receipts, deteriorating public-service provision and, exacerbating even further the vicious circle, additional, spill-over effects in the form of a higher rate of emigration than would otherwise be the case. In short, as some economic and social agents and factors are less mobile than others (*e.g.* fixed capital investment and housing are less mobile than portfolio capital and savings; young, single people are presumably more mobile than middle-aged, two-income families with children), regional factor-proportions, disaggregated qualitatively, instead of improving thanks to the outflow of labour from the sector afflicted by the shock, may actually become worse, and thus turn a sector-specific shock within an area into a region-wide disaster. In this case, the problem of labour immobility and unemployment may have to be addressed by policies to attract capital into the region. This, of course, is precisely the object of “regional policy”, of which there is a long tradition in Europe, both at national and EU levels (though, admittedly, at EU level it is of redistributive, rather than a countercyclical, nature). This analysis, far from repudiating any benefits associated with a high spatial elasticity of labour (as argued above, the most effective case probably being that of chronically-depressed, resource-poor and/or geographically-isolated regions), aims to point out that the neo-classical presumption regarding the intrinsic desirability of high labour mobility applies better when,

first, the problem is not transitory (*i.e.* it is not, strictly speaking, in the nature of a “shock”, but rather of a long-term trend), second, the region of emigration is as homogeneous or occupationally-uniform as possible (*i.e.* the problem does not inflict significant external diseconomies on others employed in other sectors within the region) and, third, all factors are equally mobile, not just certain sub-categories of labour and capital. On the contrary, if the problem is in the nature of a shock, wage flexibility and regional incentives to capital and labour may, in the longer run, prove superior to labour emigration. (If the shock were country-specific and uniformly country-wide, presumably the policy response would have to be decided at “European” level since the whole country would have to be viewed as an “afflicted” region.)

Fourthly, higher labour mobility in the United States may be a *response* to greater specialisation between states in the US compared with the European Union. However, as similar developments may occur in Europe as part of the Single Market, and indeed the single currency, greater labour mobility in the EU may (or may not) also emerge in parallel. Still, as argued above there is little reason to suppose that future specialisation in Europe will be country-based rather than economic region-based.

Lastly, it may, for analytical and general purposes, be worth examining the possible significance (if any) of the “labour-market inflexibility” problem under EMU in relation to the future operational requirements of the European economy (*i.e.* requirements which go beyond the need to cope with country-specific shocks). Often, critics tend to underestimate the fact that monetary union as such will not *require* (though it may end producing) significant factor flows within or, even less, between countries.

To take the “static” case first: the single currency is supposed to facilitate free trade thanks to the elimination of transaction costs of currency exchange and the eradication of price discrimination between national markets, as practiced sometimes by firms. These gains represent merely a refinement of the present situation, not the ushering in of a new era of trade liberalization. And as reaping the full benefits of free trade between countries does not require factor movements between countries, but rather factor mobility within countries, the realisation of the trade-related, static gains from monetary union does not pre-suppose any change in the degree of cross-border spatial elasticity of labour, and is, in fact, analytically independent of the latter. In any event, most writers agree that eliminating both exchange-rate volatility and transactions costs completely will yield only marginally more trade inside Europe; as a result, the static impact of the single currency, in quantitative terms, is not expected to be very great — around 0.3 to 0.4 per cent of EU GDP, [122](#) though the ending of price discrimination between national markets may raise this further [123](#) (on-going benefits which will be offset to some extent by the one-off cost of conversion to the euro). In short, the static case for a single currency is independent of the inter-country labour-mobility argument and — if the size of the expected gains is any indication — only marginally linked to the intra-country labour-mobility argument.

In a more dynamic context of economies of scale and potential agglomeration economies, factor movements do play an important part. And the dynamic benefits associated with the single currency, while generally played down by U.S. experts, have the potential to be much larger than the static ones, being also *cumulative* in nature. [124](#) However, the dynamic benefits in the case of EMU do not seem to stem from additional economies of scale or of agglomeration as such — factors which normally can be expected to generate substantial factor movements — but, rather, to come from the raising of the rate of growth of output through higher investment in general; the marginal productivity of capital is expected to

increase as a result of the improvement in the financial environment, in particular, less volatile, and lower, interest rates. ¹²⁵ This will tend to produce “horizontal” benefits, across industries and sectors, large as well as small firms, and not merely privilege those with an already-existing competitive advantage, as in the case of trade- and factor-liberalisation. Now as most new investment, at least among existing firms, is actually *in situ* investment, the anticipated raising of investment attendant upon these developments will not, *prima facie*, require any significant labour movements or, indeed, significant new quantities of labour: new capital investment of this sort can be job-creating, but it can also be labour-saving. And as regards any *entirely new* investment resulting from these (cost-side) effects, or from the more general raising of the economy’s average level of productivity and income (the demand-side effects), new investment being more mobile than additions to existing investment, it will be able — *ceteris paribus* — to follow, rather than lead, the geographical distribution of labour. Improving the allocation of capital (in addition to lowering its cost) will actually help to mitigate the unemployment problem.

Recent evidence on industrial investment patterns in the European Union tends to corroborate this analysis. In 1997, for example, 28 per cent of investment was considered “replacement” investment and 31 per cent “rationalisation” investment. “Extension” investment accounted for 28 per cent of the total, while “others” accounted for 13 per cent. Among these four categories, only the last is directly mobile, while the other three are location-bound. Among the first three, only “extension” investment carries with it the possibility of new job creation, and therefore the potential for inward worker relocation. ¹²⁶ If this is the general framework within which investment patterns take place in space, *ex ante* it will not be possible to predict precisely the corresponding employment effects of a raising of the level of aggregate investment involving both capital-deepening and capital-widening, although there is no *a priori* reason to suppose that, in terms of their magnitude, these spatial effects in terms of employment patterns will come anywhere near the effects that can be expected from a liberalisation of capital movements *per se*. By reason of their tendency to be spread uniformly across regions and sectors within countries, the dynamic effects of the single currency in the long run will probably not call for major additional labour movements.

In sum, the conditions for the great bulk of potential static and dynamic changes have already been put in place in the European economy via the Common Market and latterly the Single Market. The additional changes in the spatial organisation of the economy that can be expected as a result of the single currency will be relatively minor, after perhaps an initial period of adjustment, which most commentators contend will be accompanied by a small rise in unemployment, as industries rationalise. Consequently, any need for additional labour movements will be minor too. The argument that EMU will require a significant increase in the degree of labour mobility on long-term structural-adjustment grounds appears, on this evidence, to be unwarranted.

The upshot is that labour mobility undoubtedly can assist in the working of a single market; it will also help mitigate the consequences of country-specific shocks, although a recurrent theme of this essay has been that, with continuing economic and monetary integration, country-specific shocks will be less and less visible in comparison with cross-border economic-region-specific shocks. Addressing the latter will also require “real”, as opposed to national “monetary”, adjustments. However, labour-market flexibility by itself can not *guarantee* anything (witness the British case so touted in the United States for allegedly proving the superiority of the US “entrepreneurial” model and the inferiority of the continental European “social market” approach: the UK has a below-average unemployment rate, no doubt largely as a result

of the greater flexibility of its labour markets (primarily, downward wage flexibility); yet it has gone from being a country enjoying a *per capita* income just above the EU average to becoming the fifth poorest EU member state, [127](#) having been overtaken some time ago by Italy, and recently by Ireland [128](#)). The extent to which a single market *with a single currency* will require, for its operation, additional labour flows — which is not the same as a higher *rate* of labour mobility — within and perhaps even between member states, can be exaggerated. In the United States, economists have found that most of the adjustment to an adverse shock of employment is through out-migration of labour rather than through the in-migration and creation of jobs because, in general, adjustments in relative wages are insufficient. [129](#)

The lesson for Europe is that there will be a need for greater wage flexibility. [130](#) This may serve to dampen the output-cost of both voluntary and involuntary labour immobility in Europe. Certainly there is no room for wage demonstration effects of the type observed in the former GDR following German reunification. [131](#) One needs to bear in mind that (i) the European Union in the past has coped with changes, *viz.* goods and factor market liberalisation among member states, much more important than those that can be expected from monetary union *per se*; (ii) since the currency turbulence of 1992-93 the EU has returned to being a zone of relative exchange-rate stability, and exchange-rate adjustments have been prevented from acting as a substitute for intra-country labour mobility or downward wage flexibility (making EMU not so different from the present situation), (iii) in the presence of limited intra-country labour mobility (as is the case in Europe today), flexible exchange rates cannot play their equilibrating role to the full, and (iv) it is not clear to which extent countries which have employed in the past the instrument of exchange rate adjustment have benefited in the long run. [132](#)

In sum, labour market flexibility, including mobility and wage flexibility, will be necessary for a successful and dynamic European economy with or without EMU (the corollary of which is that if the European economies have survived until now with low labour market flexibility, they will no doubt also do so under EMU). The issues and dilemmas posed by the labour market flexibility question in Europe have probably been put best, if somewhat dramatically, by Samuel Brittan: “If labour costs can be made more responsive to market conditions, EMU will work. If labour market problems are left to fester, EMU will not work. But nor will anything else.” [133](#)

2. Fiscal policy in the European Union

As with the aforementioned issues, so the question of the fiscal transfer mechanism has raised considerable controversy. The main argument is that, since the European Union lacks a central government, it lacks the fiscal tools that would enable it to dampen the effects of regional-specific shocks, in contrast to what obtains in unitary states. This weakness — in conjunction with the Maastricht Treaty’s constraints on the conduct of countercyclical fiscal policy at national level — is, it is argued, a potentially serious flaw which could prevent the smooth functioning of EMU, or even lead to its break-up.

Most American authors stress the efficacy of the US federal tax system in acting as an insurance against some of the more severe consequences of asymmetrically-spread adverse economic occurrences. The figures which have been advanced for the percentage of income change which is offset by the federal tax system vary, depending on the underlying assumptions, from 40 per cent [134](#) to 8 per cent. [135](#) The main reason for such variance is that the higher figures do not sufficiently disaggregate effective assistance so as to distinguish between “redistribution” effects (through policies designed to offset long-term

inter-state income-level disparities) and “stabilisation” effects (temporary transfers extended in response to cyclical fluctuations), whereas the lower figures refer only to the “stabilisation” effect. ¹³⁶ (A progressive income tax system, including its “automatic stabilisers”, contains both redistributive and stabilisation components.) Canadian figures, though indicative of a strong, long-term, redistributive “regional policy” in that country, suggest even less “stabilisation” effects from that country’s federal budget than in the United States. ¹³⁷ And as regards state budgets, those in the United States apparently have played little part in countering adverse effects because all states (except Vermont) have either statutory or constitutional balanced-budget requirements, although the restrictions are not all equally binding. ¹³⁸ In fact, state and local budgets often record surpluses (understandable enough during periods of prosperity), which during downturns at least should tend to exacerbate asymmetrical shocks. ¹³⁹ Of course, in these circumstances, much more will be expected, by way of stabilisation, from the federal budget.

In contrast, the philosophy of the Maastricht Treaty is that adjustment will be accomplished through different national budgetary policies — albeit within the 3 per cent deficit/GDP rule — given that the EC budget, anyway amounting only to 1.27 per cent of Community GDP by 1999, always has to be balanced and receipts and payments are not sensitive to short-term income fluctuations.

As mentioned earlier, American economists almost unanimously agree that EMU cannot survive without a system of inter-state transfers, or, as it is otherwise known, some form of “fiscal federalism”. In effect, they are following in the footsteps of the influential McDougall report, ¹⁴⁰ which argued that, unless drastically revised, the EC budgetary position, as found in 1977 (current expenditures amounting to about 0.7 per cent of Community GDP, with the CAP accounting for about two-thirds of this), was likely to jeopardise the success of any subsequent monetary union in Europe. The latter ideally would require that at least 20 per cent of government taxes in the European Union were available for redistribution through the EC budget as a whole, the latter having to expand to perhaps 5-7 per cent of GDP (excluding defence) to provide equalisation and stabilisation functions equivalent to those enjoyed by existing federal countries, such as the United States, Canada and Germany. ¹⁴¹ This contrasts with the current situation in Europe, where the EC budget takes an average of around 1.4 per cent of EU tax revenues, leading to a total annual budget of ECU90bn (about 1.17 per cent of EU GDP). Yielding to the political reality prevailing at the time, the MacDougall report proposed — for the “pre-federal”, as it was called, period of integration — a relatively small, but high-powered, budget: 2-2.5 per cent of EC GDP, concentrating on structural, cyclical, employment and regional policies, coupled with progressive taxation. This would purportedly result in a 10 per cent reduction in inter-regional disparities inside the Community, while also providing an effective insurance against short-term, EC-wide (symmetric) economic fluctuations (through allowing the Community limited powers of borrowing).

Despite some subsequent criticism to the contrary, ¹⁴² the MacDougall report allowed for the distinction between the “redistributive” function of a budget and its “stabilization” function in the context of asymmetric shocks. It pointed out that “the absence between Community members of the substantial compensatory public finance mechanism that works between regions inside integrated states is thus of great importance as an obstacle to fuller Community integration”. ¹⁴³ The report did make proposals for countering cyclical problems in particular regions. Certain changes in Community expenditure and revenue during the “pre-federal integration” phase were suggested, *viz.* EC participation in regional

policy aid, labour market policies, a limited budget equalisation scheme, a Community unemployment fund, cyclical grants to local or regional governments and a conjunctural convergence facility. The last three measures would cost at least between 5 and 10bn units of account *per annum* (the actual EC budget expenditures in 1977 being a little over 10bn, or 0.7 per cent of EC GDP) if they were to have any significant impact on the regions concerned. [144](#)

More recently it has been argued that an overall budget of as little as 2 per cent of the EU's GDP could be used to effect redistributions of nearly 20 per cent *at the margin* between EMU members, provided that the budget were targeted specifically for this purpose, and not be used, as at present, for pre-ordained expenditures, *e.g.*, on agriculture or regional subsidies. [145](#) Switzerland, for example, is a country where approximately 20 per cent of income is redistributed at the margin through the central budget. [146](#) But in the case of the European Union, an EC budget equivalent to 2 per cent of EU GDP and designed exclusively to counteract unequal cyclical fluctuations across member states would eliminate the important redistributive and developmental roles it is currently entrusted with. On the above numerical assumptions, this means that the EC budget could maintain its current functions as well as perform the above stabilisation role only if it were increased from the current nominal 1.27 per cent (1999) to approximately 3.27 per cent of EU GDP. (This figure could be lowered if national contributions were switched to a system of progressivity, a redistributive feature which today is largely absent from fiscal policy at the EU level.) Such budget increases are not currently on the agenda. However, it must be pointed out that raising the EC budget by another two percentage points of EU GDP would not necessarily imply permanent net transfers from one set of countries to another, as is the case presently: cyclical differences can be accommodated without any net inter-country transfers over time — provided they are truly cyclical, and therefore impact all member states with equal probability/frequency. Therefore, the additional 2 per cent of GDP posited here would be more in the nature of an insurance fund to be financed initially on a one-off basis (perhaps supplemented over time by additional member-state contributions to reflect the trend growth in the average EU income level). In this sense, the fund would not represent a burden re-imposed every fiscal year; once set up, it would be essentially self-financing. [147](#)

Under present arrangements, EMU will have to operate without fiscal transfers. The prevailing view in the European Union appears to have shifted from advocacy of a centralised approach *à la* McDougall toward reliance on a more decentralised one, more in tune with current notions about the role of “subsidiarity”. In this world, relatively greater weight will be placed on *national* fiscal policy, as one of the more important remaining instruments, as well as supply-side reforms and market mechanisms. The ability of the Union and its member states to perform the desired stabilisation function in the event of adverse, country-specific shocks therefore will depend largely on the responsibility of member states' fiscal behaviour over the cycle, accumulating surpluses in favourable years in order to provide themselves with the means to ride out the difficult ones. (It bears reminding, in this regard, that many countries in Europe have lived for many years without fiscal federalism, as did the United States before 1929, despite a locked exchange rate against the D-mark; therefore conditions in EMU may not actually be much different.)

The Maastricht Treaty (and the Stability Pact) do not allow fiscal deficits to exceed 3 per cent of GDP. This — it is claimed — will tend to reduce the flexibility of national fiscal policy in the event of a downturn — *unless* national governments aim at a balanced budget or surplus over the economic cycle:

automatic fiscal stabilisers require movements of the deficit up (or down) of some 3-4 per cent of GDP in order to counteract effectively recessionary (or inflationary) tendencies. In the absence of a centralised system of countercyclical transfers, therefore, governments will have to strive for budget balance over the longer period. This notion is implicit in the Maastricht fiscal deficit rule.

Most writers in the United States draw pessimistic conclusions from these observations. They consider that the Maastricht Treaty's requirements dangerously constrain flexibility of fiscal policy, to the point where the — otherwise legitimate — aim of high and rising debt prevention will end disabling the only real macroeconomic lever left to governments, *viz.* fiscal policy. This argument, however, is difficult to sustain, unless one believes either:

- (i) in the need for budget *deficits* over the cycle (which, unless growth were consistently strong over the long period, would eventually lead to ballooning public debt; but strong growth presumably obviates the need for an expansionary fiscal policy year after year). A policy of budget deficits over the cycle anyway falls outside the scope of fiscal policy as a *countercyclical* instrument. And sustained budget deficits — which shift the costs of fiscal policy on future generations, in contrast with a policy of taxation, which directs the costs at the current generation — are probably not advisable in Europe given the current demographic situation, the ageing of the population and the looming pension funds problem; or
- (ii) in the inability of a 3 per cent budget deficit to address effectively a downturn. This might be the case if a downturn re-asserts itself before the country in question has had a reasonable chance to correct its finances following the previous downturn. The Stability and Growth Pact does provide for exemptions from fines when the 3 per cent budget deficit rule is breached. The exemption is automatic in the event of a natural disaster or if the country experiences a fall in GDP of 2 per cent or more over a year. If the country experiences a fall in the range of 0.75-2 per cent, Ecofin will have discretion in the levying of fines. With a fall smaller than 0.75 per cent, the implication is that fines will be levied, though this will require the agreement of the ministers in Ecofin. According to some, this is still too restrictive.

A different framework for fiscal policy might have aimed to ensure not that each member state respected the 3 per cent rule at all times, but that the GDP-weighted budget deficits of the EU member states as a whole did not exceed 3 per cent of EC GDP (since this is considered the magic number) at any one time. This would allow for national budget deficits to exceed temporarily the 3 per cent mark (with a maximum ceiling of 4-5?) to allow for some discretionary spending over and above the spending induced by automatic stabilisers, provided certain conditions held, *e.g.* that the country in question had a relatively high savings rate (so as to limit the risk of triggering an unsustainable public debt process), and/or found itself in a “liquidity trap”, while one or more other countries simultaneously offset that portion of the country's budget deficit which exceeded the 3 per cent mark with a lower deficit (or surplus). Clearly, this would require intense fiscal cooperation and, indeed, a binding supervisory role for Ecofin to ensure that such exceptions to the 3 per cent rule did not lead either to unsustainable public debt situations, or to long-run departures from overall balance in the individual national budgets (as opposed to long-run balance *on average* in the Union as a whole, which could lead to cross-border budgetary “free rider” problems).

In reality, matters will be complicated by the existence of externalities such as result from the use of these policies by small and/or open economies. The greater the spillover of any regional stabilisation benefits to other regions (countries), the smaller the incentive for the regions (countries) to use them since they have to bear the burden in terms of higher debt or tax rates. [148](#) The way out of this dilemma is

a coordinated stabilisation policy. In turn, this will encounter the problem that different countries will have differing models and appreciations of the world. Each country presumably will consider its budget as optimal, and then argue that *other* countries should tighten or relax their position. The “simplest” approach will be to intensify mutual surveillance and peer pressure. This is the framework and direction in which the work of the Ecofin Council will have to develop in future.

When examining the Maastricht Treaty’s provisions in relation to the future conduct of fiscal policy, what is required is a comparison not between an assumed situation of ineffective and inflexible fiscal policy-making and an idealised world of full fiscal freedom successfully averting all severe cyclical fluctuations, but one between, on the one hand, a situation of responsible fiscal management over the cycle and, on the other, the real-life, recent experience of quasi-permanent fiscal deficits prevented, by pre-existing inflationary tendencies (at least partly attributable to fiscal mismanagement) and/or rising public debt, from performing their full stabilising function. Aiming for budget balance over the longer period in fact would be a return to the simple version of the original Keynesian policy prescription, much discredited in recent times — its new-found sympathizers notwithstanding — as a result of government abuse. And allowing for budget deficits considerably in excess of 3 per cent of GDP begs the question of the effectiveness not only of discretionary additions to an expansionary fiscal policy, but of fiscal policy as a countercyclical instrument itself in a totally open economy.

The more open and integrated the economies of the member states become in respect of trade and capital flows, the less effective national instruments of economic policy become. Multiplier effects on domestic demand of tax or expenditure changes are dampened by a high propensity to import. Under present arrangements there will be continued scope for deciding the government spending/taxing levels, even if decisions over the deficit nominally appear more constrained. Unless, or until, coordination or direct fiscal action at a “higher” level of government are instituted with a view to addressing this question of major spillover or leakage effects, greater emphasis than in the past on national management by microeconomic policy no doubt increasingly will be a concomitant of the relative shift away from the traditional tools of national macroeconomic policy, especially monetary policy. However, increasingly this shift already is taking hold worldwide, and not just in Europe, as a result of globalisation of capital and other markets; indeed, the 3 per cent budget deficit “rule” increasingly is becoming accepted as an informal benchmark around the world. Keynes, after all, did not assume an open, globalised economy.

V. American “Euro”-Scepticism: A Suggested Interpretation

American views with regard to the euro, as explained above, range from the supportive (the official view), the cautious (the Treasury and some economists), to the negative (other economists). These views deserve to be taken seriously insofar as they represent the opinions of experts who have no direct personal, professional or national stake in the issue. However, as most of them acknowledge, the arrival of the euro will also have important international political, economic and financial repercussions, which (though this tends to be stressed less) inevitably impinge on U.S. interests.

The risks associated with a failure of EMU from the U.S. standpoint have been outlined above. [149](#)

Conversely, the potential consequences of success are not only uncertain, but also ambivalent. As mentioned earlier, a successful monetary union will complete and enhance the attractiveness of the Single Market, of whose positive features corporate America has been, and no doubt will continue to be,

a prime beneficiary. But, in contrast to previous stages of economic integration in Europe, the euro also conceals potential costs to the U.S. economy. As argued above, the balance of benefits and costs of European monetary union from the European standpoint is difficult to ascertain, depending as it does partly on difficult-to-measure, *ex ante*, potential dynamic gains; *a fortiori*, so it will be with respect to its impact on the United States. Therefore, a clear, widely-subscribed-to stance on the part of U.S. experts cannot in principle be expected.

That said, one cannot but help noticing a fairly strong sceptical tone underlying U.S. experts' opinions. This scepticism usually takes the form of pessimistic conclusions drawn from positive analysis even when the latter in principle allows of multiple outcomes (and therefore a range of interpretations or conclusions). In one sense, this is a natural reflection of the uncertainties surrounding a project whose success depends on the successful introduction of a large number of economic, social, institutional and technical innovations, adjustments and changes, often of a fairly significant nature, whose role European governments, in their desire to forge ahead, arguably unwittingly or otherwise, may tend to underestimate. But in another sense, the scepticism may well be an indirect product of the qualitative changes that a successful EMU will introduce both to the US-EU relationship and to the international monetary system.

These changes all potentially involve costs for the US economy and US economic management.

Firstly, the reduction in seigniorage benefits, broadly defined. ¹⁵⁰ With the increasing development and sophistication of financial systems, seigniorage in the modern, globally integrated world has diminished appreciably — except in the United States. Over the past decade, the US has been able to continue reaping these benefits thanks to the substantial international demand for dollars, based on the fact that the dollar is widely used for trading purposes. This, *e.g.*, has enabled the United States to run its very large current-account deficits throughout the 1980s largely through Japanese finance. Were the euro to partially displace the dollar in this role — some economists predict that, ultimately, the dollar and the euro are each likely to end up with about 40 percent of world finance ¹⁵¹ — this advantage to the United States would be reduced. The rise of the euro could help the European economy, but at the expense of the United States — although it is impossible to say exactly by how much.

Secondly, the enhanced efficiency of Europe's capital markets — a result which is expected to follow from the increased liquidity and reduced transaction costs associated with a transition to euro-denominated government and corporate bond markets and equity markets — is, according to some economists, likely to raise the growth rate in Europe by a substantial amount, perhaps as much as 0.5 percentage points *per annum* — and to reduce it somewhat in the United States. ¹⁵² To the extent that higher growth in the European Union stimulates more exports from the United States (or higher profits for US firms in the EU), the improvement in Europe's capital markets and the growing role of the euro will not be entirely at the expense of the United States' economic interests. Developments here will not necessarily be in the nature of a zero-sum game. ¹⁵³ But it is difficult to argue that there will be *no* loss for the US economy since the greater activity in the European capital markets will be a direct result of the arrival of the euro, implying a reduced demand for dollars. The cost to the United States of this relative shift of financial business to the European capital markets will not, in all likelihood, be wholly offset by a greater induced demand for US exports (US imports representing about 20 per cent of the EU's total imports).

Thirdly, the arrival of the euro will also place greater constraints on the conduct of American economic policy. The emergence of a rival currency will tend to penalise the dollar more strongly than in the past — in the form of portfolio diversification out of dollar assets — in the event that the American authorities perpetrate policy mistakes, such as the over-expansionary monetary policy of the 1970s and the over-expansionary fiscal policy of the 1980s. Thus, while the future of the dollar will remain mostly in the hands of U.S. policy-makers, their range of options will probably be narrower than in the past. [154](#)

Finally, the European authorities, representing an economy which is more self-sufficient than were, previously, the individual member states, will be less vulnerable to movements in the dollar-euro exchange rate. Europe will therefore begin to enjoy comparatively greater freedom in the area of economic policy (the conduct of which was often constrained in the post-war period by the United States' — asymmetric — ability to treat the external value of the dollar as an issue primarily affecting the rest of the world, rather than the United States). Consequently, the European authorities will have less of a need to respond with reflationary or contractionary macroeconomic policies not of their choosing, and, in particular, less of an incentive to intervene — if, for example, the dollar depreciates as a result of a rise in the US current account deficit — in order to buy dollars. European authorities could choose to do so only if they obtained something in return. [155](#) If this reasoning is correct, their bargaining power in the framework of the international system will be enhanced.

These areas will no doubt come under closer scrutiny in the future, on both sides of the Atlantic. It will be important to explore them further not only in a bilateral context, but also within an international setting, with a view to arriving at mutually beneficial solutions through cooperation, rather than loss-making outcomes through competition or neglect.

VI. Conclusions

The purpose of this paper has not been to “prove” in any conclusive sense the case for monetary union in Europe. Rather, it has attempted to examine the arguments usually advanced in the United States as to why the European economy's features do not make it a suitable candidate for currency union, and has not found these arguments totally convincing or unassailable.

This in itself does not prove the case for monetary union in Europe — although indirectly it may help to strengthen it. Also, EMU's critics — traditional supporters of flexible exchange-rate systems perhaps apart — typically remain silent with respect to possible options for alternative régimes in the Single Market context, or at least do not critically address the problems confronting those régimes.

This analysis serves, further, to remind that European monetary union involves comparisons between either highly imperfect (*i.e.* sub-optimal) situations (pre-EMU and post-EMU), or situations highly incomparable (the US and the EU). When two imperfect situations are compared, the one aspired to is presumed to be superior to the one it is meant to replace by virtue of the changes that — one hopes — will accompany its establishment. Therefore, any attempt at expressing a view as to EMU's prospects must also make a substantial allowance for possible economic and institutional changes to come, whose prospects for success cannot be assessed in terms of economic analysis alone. Induced changes have been permanent features of European integration over the years, not least in those countries originally least similar to the “core”, and their positive evolution has always involved a measure of uncertainty. True, in

the case of EMU there do not appear to be any significant safeguard mechanisms (analogous to the Delors Package I, which was supposed to act as a cushion for the less-developed regions of the Community in the face of possible divergence tendencies following single market liberalisation, or to the Delors Package II and the Cohesion Fund in relation to the preparatory stages of EMU). But if there is any value to the analysis of the earlier sections, it is to show that the changes required by EMU, using the Single Market, the pre-EMU situation or, indeed, the US situation as benchmarks, are much smaller than claimed by the euro's critics.

Clearly, the questions posed by EMU transcend the conventional framework of international economic relations, and penetrate into the realm of "high politics". In such a context, understanding the role of labour markets and fiscal transfer mechanisms for currency union is a necessary, but not sufficient condition for comprehending America's reactions to EMU. True, *failure* of EMU could lead to instability in Europe at a time when the Union requires sound economics and stable politics to successfully embark, in the interests of the West as a whole, on the next vital strategic project, *viz.* enlargement to the East. An economically weakened Europe would also place strains on the US economy in the sense that it could constrain growth in the latter through the effects of interdependence, as well as conceivably lead to calls for financial assistance to Europe. The possibility of a negative outcome partly explains US interest in, and preoccupation with, EMU. But *success* of monetary union will be of no less concern to the United States: the latter is likely to produce a *relative* shift of economic activity away from America towards Europe. True, more growth in Europe may lead to higher incomes than otherwise in the United States, to the satisfaction of most observers there. But it is the fact of the relative shift which occupies the minds of global strategists. This latter development of itself will not necessarily challenge the post-war transatlantic and world hierarchical order, being also of uncertain magnitude. Such a challenge could come about only as a result of more fundamental changes, such as consistently higher rates of technological innovation in Europe than in the US, of which there is little evidence so far. But it is a step in that direction.

Endnotes

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The author wishes to thank Professor Jeffrey Frieden of Harvard University for his invaluable comments. [Back.](#)

Note 1: Over the years, the United States has remained the EU's single most important trade partner, maintaining an average share for both exports and imports of just under 20 per cent. Christopher M. Dent, *The European Economy, The Global Context*, Routledge, 1997, p. 170. However, US trade with Asia has exceeded trade with the European Community ever since the late 1970s. But the economic relationship as a whole remains the most important in the world. President Clinton himself emphasised this in Berlin on 13 May 1998, adding, first, that US companies invested as much in Europe as in all the other countries in the world combined, second, that transatlantic trade was worth over \$500bn a year and, third, that one in twelve factory workers in the US was employed by European-owned companies;

reported in the *Financial Times*, 14 May 1998. [Back.](#)

Note 2: Any potentially discriminatory effects against the US arising from the creation of the Customs Union and the introduction of the Common External Tariff (CET) were basically counterbalanced by the Kennedy Round's trade liberalizing results and the heavy US investment which took place behind the CET. Admittedly, the Common Agricultural Policy has been a constant irritant. On the question of EU-US trade relations, see for example Christopher M. Dent, *ibid.*, pp. 210-16. [Back.](#)

Note 3: Seigniorage is traditionally defined as the net revenue a *government* (or any money-issuing body) earns by issuing currency. The more modern definition equates seigniorage with the net gains, in terms of additional real or financial assets, a *country* enjoys from the readiness of foreigners to hold its currency. In this — wider — definition, the latter advantage may also be interpreted as deriving from a high prior *credit-worthiness* (which partly explains the willingness of outsiders to hold the currency in question). The element of credit-worthiness, however, is very difficult to quantify, with the result that “seigniorage” also becomes difficult to quantify accurately in an international setting. [Back.](#)

Note 4: “EMU Survey”, *The Economist*, 11 April, 1998, p. 17. The Federal Reserve has estimated that 55-70 per cent of US banknotes in circulation, \$373bn at the end of 1995, were outside the United States. (Richard D. Porter and Ruth A. Judson, “The Location of U.S. Currency: How much Is Abroad?”, *Federal Reserve Bulletin*, October 1996.) In contrast, a *New York Times* editorial (reprinted in the *International Herald Tribune*, 4 May 1998) quotes estimates putting the benefits at a few billion dollars, a small sum in an \$8 trillion economy. Further, it is estimated that, today, 47.6 per cent of world exports are denominated in dollars, but only 15.5 per cent in Deutsche Marks, the only European currency used extensively in international trading. (Norbert Funke and Mike Kennedy, “International Implications of the European Economic and Monetary Union”, OECD Working Papers No. 174, Paris: OECD, 1997; *International Herald Tribune*, 16 and 20 April 1998.) National governments or central banks held a total of \$1,481bn of foreign exchange in their official reserves at the end of 1996. Of this, at least 64 per cent were denominated in US dollars, 14 per cent in German marks, 6 per cent in yen, 3 per cent in pounds sterling, and lesser shares in other currencies. IMF, *Annual Report*, 1997, Table I.2. [Back.](#)

Note 5: The US current account deficit is forecast to reach \$230bn in 1998. *Financial Times*, 14 April 1998. [Back.](#)

Note 6: C. Fred Bergsten, “The Impact of the Euro on Exchange Rates and International Cooperation”, in Paul R. Masson, Thomas H. Krueger and Bart G. Turtelboom (eds.), *EMU and the International Monetary System*, proceedings of a conference held in Washington, D.C. on March 17-18, 1997, International Monetary Fund, 1997, pp.17-48. [Back.](#)

Note 7: The 11-country euro-area presently has a current account surplus of 1.8 per cent of GDP. *Financial Times*, 14 April 1998. [Back.](#)

Note 8: C. Fred Bergsten, “The Dollar and the Euro”, *Foreign Affairs*, July/August 1997. [Back.](#)

Note 9: Richard Cooper argues that it will take a very long time, if not decades, for Europe to develop a market analogous to the (highly-liquid) US treasury-bill market; according to Cooper, this is a prerequisite if the euro is to emerge as an international reserve currency. See his *Key Currencies After the Euro*, Weatherhead Center for International Affairs, Harvard University, Working Paper Series, Paper

No. 98-3, February 1998. [Back.](#)

Note 10: Richard Portes and Hélène Rey, *EMU: Prospects and Challenges for the Euro*, CEPR, April 1998. According to the authors, the euro will rival the dollar's international role in as little as five years, particularly if the UK, with its large capital market, joins EMU. See also their article "Struggle for world status starts" in the *Financial Times*, 30 April 1998, p. VIII. [Back.](#)

Note 11: Just three years prior to that — it has to be said — the United States at Bretton Woods had not accepted a plan to underwrite large amounts of unconditional liquidity to Europe — the Keynes plan. [Back.](#)

Note 12: Geir Lundestad, "Empire" by Integration; The United States and European Integration, 1945-1997, Oxford University Press, 1998; this quote, p. 4. [Back.](#)

Note 13: This framework comprised the Marshall Plan and the OEEC and, much more importantly, NATO. Gradually, the GATT also came to constitute an important building block of this framework. To a large extent, this "Atlantic framework" was a code phrase for overall American leadership. [Back.](#)

Note 14: Lundestad, *op. cit.*, p. 18. [Back.](#)

Note 15: *Ibid.*, chapter 4. [Back.](#)

Note 16: *Ibid.*, pp.51-52. Britain's fundamentally ambivalent stance vis-à-vis European integration is perhaps best captured by Winston Churchill's famous "Zürich speech" of 19 September 1946, in which he spoke eloquently of the need to "build a kind of United States of Europe", primarily as a means of containing the Soviet threat, but with the United Kingdom remaining on the outside, acting only as a "friend and sponsor". [Back.](#)

Note 17: This theme underlies, *e.g.*, successive Presidents' foreign policy reports. [Back.](#)

Note 18: In theory, political motivations could, conceivably, be sufficient to "explain" monetary union — which is exactly what most U.S. critics would argue. However, this and other sections argue that there is a strong *economic* rationale for it not necessarily dependent on broader political or political economy considerations, thereby reinforcing any political motivations in the minds of political leaders. [Back.](#)

Note 19: The UK, of course, argues — *for now* — that a single currency is not a precondition for the success of the single market — hence its whole-hearted support for the latter, and its rejection of the former. Whether this view is correct or not will be answered to a considerable extent by whether or not the UK finally decides to join EMU. [Back.](#)

Note 20: Eichengreen argues that monetary integration will probably need to accompany commercial integration for reasons of "political equilibrium": although a customs union does not, strictly speaking, require a common currency to afford net gains (countries remove trade barriers and restructure along lines of comparative advantage), mounting protectionist pressures resulting from a possible misalignment of exchange rates and the ensuing exchange-rate swings between trading partners are a potent justification for introducing a common currency. (Barry Eichengreen, "A More Perfect Union? The Logic of Economic Integration", *Essays in International Finance*, No. 198, June 1996, International Finance Section, Department of Economics, Princeton University.) This view may underestimate the

difficulties involved in re-introducing concrete trade-restraining measures in the Single Market (*e.g.* voluntary export restraints, subsidies to afflicted industries, etc.), as suggested by the fact that, to date, there are few, if any, examples of actual measures of this nature being introduced. Nonetheless, theoretically such threats could, absent the euro, one day become real, and lead to real trade-restraining countermeasures. Eichengreen goes on to argue, however, that a single currency does not in itself preclude the possibility of misalignments either, and could possibly lead to anti-EMU political pressures by giving rise to large unemployment differentials across countries (and high unemployment levels within specific countries). This will require adjustments in the labour market such as to prevent increases in unemployment becoming large enough to provoke resistance to continued participation in EMU. On balance, he claims nonetheless that monetary unification provides the more stable long-run solution and that in the longer run labour markets will have to adapt. [Back.](#)

Note 21: See below, sections IV.d.1 and V. [Back.](#)

Note 22: The Hague European Council came to a number of important decisions, including a decision on enlargement (affecting the UK, Denmark and Ireland), on financial autonomy (the own-resources system) and on “deepening” (involving the extension of the powers of the European Parliament, the creation of a system of foreign-policy coordination, and a decision for the establishment of EMU). [Back.](#)

Note 23: See, *e.g.*, Lawrence B. Krause and Walter S. Salant (eds.), *European Monetary Unification and its Meaning for the United States*, The Brookings Institution, 1973. [Back.](#)

Note 24: See, further, Loukas Tsoukalis, *The New European Economy Revisited*, Oxford University Press, 1997, p. 143. [Back.](#)

Note 25: Why this view was not shared by policy-makers in the UK and Scandinavia is an interesting question. The UK assessment presumably was (and still is) that freedom to conduct monetary policy nationally was more important than the possible benefits of a stable exchange-rate régime (a view reflecting also British instincts about European cooperation in general), while the Scandinavian countries have traditionally relied on their exchange rates to maintain the competitiveness of their paper-and-forestry-products-sectors. [Back.](#)

Note 26: The cost to producers of obtaining insurance on the forward currency market, the costs to consumers associated with less-than-full price transparency, etc. Of course, the elimination of these costs will come at a price. [Back.](#)

Note 27: Whether or not the benefits of the single market can be better achieved in principle via a system of *flexible* exchange rates is, of course, the crux of the matter. The flexible exchange-rate system is not popular in Europe because it implies the possibility of “competitive devaluations”, at the expense of others, therefore possibly leading to calls for protectionism. Barry Eichengreen makes the point that a system of flexible exchange rates has, in effect, no “monopoly” on the ability to create tensions between trading partners when exchange rates get out of line, causing trading partners to question their commitment to free trade. As the historical experience of the 1930s and the 1970s shows, a pegged system can also, when exchange rates become misaligned, lead to protectionist pressures or to tendencies to defer trade liberalisation. (Barry Eichengreen, “A More Perfect Union? The Logic of Economic Integration”, *op. cit.*) Actually, assessing the relative merits of the two systems in the context of the

European Union is a somewhat different exercise given that intra-EU trade takes place in a setting, *viz.* the Single Market, where — experience suggests — trade-constraining policies are much more difficult, if not impossible, to introduce in a systematic fashion, compared with what obtains in the global trading system. A comparison of the two systems in the EU setting requires an appraisal of the impact and/or effectiveness of the accompanying adjustment mechanisms. Under flexible exchange rates, the adjustment to the emergence of a balance-of-payments problem in country A (assuming no possibility of recourse to explicit protectionist measures on the part of country A's trading partners) will involve at least a partial transmission of the problem to country A's trading partners, in the form of increased imports and higher unemployment. In contrast, under a fixed exchange-rate system, the burden of adjustment falls almost wholly on country A (in the form of pressures to adjust “real”, as opposed to “monetary”, variables). Under EMU, the advantage of a more orderly trading relationship between the member states will have to be balanced against the dislocations that can be created within a country as a result of the loss of the exchange rate as an adjustment mechanism following a country-specific shock. EU governments have evidently opted for the advantages of EMU. The question of the importance of these risks under EMU is addressed in greater detail in section IV. [Back.](#)

Note 28: To preserve the narrow-band EMS, the Bundesbank would have had to behave more like a central bank of Europe and less like the central bank of Germany. But this it could not do because taking account of developments in Europe as a whole would have contravened its constitutional obligation to be concerned with price stability in Germany. Of course, the German government could have chosen to raise taxes instead, but this would have limited the inflow of capital that accompanied the raising of German interest rates. In any event, monetary unification was a readier goal to strive for for governments than some form of common fiscal policy-making, which was neither in the cards, nor acceptable in view of its political connotations and/or implications. [Back.](#)

Note 29: See, *e.g.*, Peter B. Kenen, *Economic and Monetary Union in Europe; Moving Beyond Maastricht*, Cambridge University Press, 1995, Chapter 7. [Back.](#)

Note 30: The Delors Report of 1989 and the 1991 Maastricht Treaty were the intellectual and legal foundations, respectively, of the final decision to proceed with EMU. The Report formed the basis of the EMU chapter in the Maastricht Treaty. Committee for the Study of Economic and Monetary Union, *Report on Economic and Monetary Union in the European Community*, Luxembourg, Office for Official Publications of the European Communities, 1989. [Back.](#)

Note 31: The complete liberalisation of capital movements (in eight member states) coincided with the first stage of EMU which began on 1 July 1990. Article 73e of the Maastricht Treaty stipulated that member states which, on 31 December 1993, enjoyed a derogation with respect to freedom of capital movement obligations, would be entitled to maintain, until 31 December 1995 at the latest, these restrictions on movement of capital. Thus, freedom of capital movements, two-year derogations aside, became a feature of the second stage of EMU, as of its opening date, 1 January 1994. [Back.](#)

Note 32: Tommaso Padoa-Schioppa, *The Road to Monetary Union in Europe: The Emperor, the King, and the Genies*, Oxford: Clarendon Press, 1994, chapter 6. [Back.](#)

Note 33: The argument put forward by most American critics of EMU that a single currency *technically* is not needed to run either a free-trade area or a single market seems to miss the point, which is to create conditions conducive to a more flexible reorganisation of factor markets in a system presently

characterised not only by comparative wage rigidity (and relative inter-country labour immobility) but also by *intra*-country labour immobility. The EU, of course, has never, since its inception, aspired to be a free-trade area (or to emulate NAFTA), a simpler, in terms of the hierarchy of integration models, form of economic integration. It has always held the US economy itself as its model. European countries' past experience with flexible exchange rates as well as quasi-fixed exchange rates cannot be said to have contributed impressively to greater factor-market flexibility, perhaps the opposite (although some economists would certainly claim that the discipline afforded by the ERM in recent years has contributed to a gradual introduction of greater flexibility, for example, in the Italian labour market). Conversely, the reason the NAFTA countries no doubt do not proceed to economic and monetary union (apart from the political reasons militating against such a move) is because a single currency is not required to deliver the gains from free trade in a system in which the liberalisation of factor movements (in this case labour) between trading partners is not contemplated. Incidentally, J. McCallum makes the important point that borders have not altogether disappeared between the U.S. and Canada: he shows that the "relatively innocuous" Canada-U.S. border continues, contrary to expectations, to have a decisive effect on continental trade patterns; "National Borders Matter: Canada-US Regional Trade Patterns", *American Economic Review*, June 1995, pp. 615-23. [Back.](#)

Note 34: Paul A. Volcker, "An American Perspective on EMU", in Paul R. Masson, Thomas H. Krueger and Bart G. Turtelboom (eds.), *EMU and the International Monetary System*, proceedings of a conference held in Washington, D.C. on March 17-18, 1997, International Monetary Fund, 1997, pp. 254-259; this quote, p.255. [Back.](#)

Note 35: C.R. Henning notes that, during the Bush administration, Treasury secretary Nicholas Brady "largely ignored the European negotiations leading to the Maastricht treaty, only to object later to what he perceived to be its constraints on European growth and employment". C. Randall Henning, "Europe's Monetary Union and the United States", *Foreign Policy*, Spring 1996, p. 84. [Back.](#)

Note 36: *Public Papers of the Presidents. George Bush*, 1991, pp. 1591-2. [Back.](#)

Note 37: *Public Papers of the Presidents. William J. Clinton*, 1994, p. 20. [Back.](#)

Note 38: See, e.g., C. Randall Henning, "American Interests and Europe's Monetary Union", a statement before the Committee on Budget, United States Senate, 21 October 1997, Institute for International Economics. [Back.](#)

Note 39: *Ibid.* [Back.](#)

Note 40: Some American authors claim that, to the extent that there has been concern in Washington, it is not that European policy might become "too effective", but — in the circumstances — rather the opposite, *viz.* that the EU might be too incoherent a bargaining partner for the United States, acting in too disjointed a fashion to make a positive contribution to international cooperation. This is reminiscent of analogous preoccupations expressed in the U.S. at the time of the publication of the Werner Report (see above, p. 7 fn 2). That said, Washington's sympathetic stance toward the development of the European Security and Defence Identity (approved at the NATO January 1994 summit in Brussels) can be explained by the fact that the latter was to be firmly anchored within NATO. Further, the Berlin NATO ministerial meeting of 3 June 1996, even though deciding to allow the (resource-poor) WEU to conduct its own military missions using NATO assets, agreed to reserve for NATO (perhaps naturally enough)

the final word on the use of these assets. These developments merely confirmed that the WEU was in no position to contest the supremacy of NATO, even in the areas of humanitarian, peacekeeping and peacemaking missions, a niche the WEU had tried to carve out for itself with the June 1992 Petersberg Declaration. See also Philip H. Gordon (ed.), *NATO's Transformation, The Changing Shape of the Atlantic Alliance*, The International Institute for Strategic Studies, Rowman & Littlefield Publishers, Inc., 1997. Furthermore, the Amsterdam Treaty conference failed to adopt an initiative supported by WEU members (bar the UK) to integrate the WEU into the European Union due to opposition from the UK and the Union's neutral/non-aligned members. [Back.](#)

Note 41: See the US Treasury Secretary's statements, as reported in the *International Herald Tribune*, 21-22 February 1998. [Back.](#)

Note 42: The US Deputy Secretary of the Treasury's views are presented in "American Eyes on EMU", *Financial Times*, 22 October 1997. [Back.](#)

Note 43: Anthony Laurence Gardner, *A New Era in the US-EU Relations? The Clinton Administration and the New Transatlantic Agenda*, Aldershot: Avebury, 1997; C. Randall Henning, "Europe's Monetary Union and the United States", *Foreign Policy*, Spring 1996, pp. 83-100; Alan Friedman, "U.S. is Waking Up to EU Monetary Union", *International Herald Tribune*, 30 September 1996, p. 1. [Back.](#)

Note 44: On the expectations of corporate America in the run-up to the euro, and its confidence in the benefits to be derived from the intensification of competition in the European market, see, e.g., *The Financial Times*, 2 June 1998, p. 3. [Back.](#)

Note 45: This overall low-key interest is at odds with the situation in Europe, where EMU has been at the top of the political agenda for many years: as a highly constraining framework of economic policy, amounting to a new orthodoxy cutting across the main political ideological currents; as a crucial focal point around which revolves the whole debate between Euro-sceptics and pro-integrationists; and, finally, as a possible vehicle for transporting European integration to higher levels. Indeed, as mentioned above, the European Union is criticized by many, in the US as well as in Europe, for being excessively self-absorbed with EMU; this has allegedly diverted Europe's attention from more important issues both within the Union and in its relations with the outside world, including the need to push through the internal institutional reforms deemed as a pre-requisite for the planned future enlargement of the European Union; devising a proper response to the deteriorating unemployment situation through the necessary structural reforms; all of which somehow risk undermining the EU's aspiring role as a significant actor in international affairs. Again, this is at odds with the tacit European view — or hope — which holds that, if ultimately successful, the single currency could help Europe play the long-aspired-to greater international role that has eluded her because of her lack of success in building an effective common foreign and security policy. [Back.](#)

Note 46: Prominent in this field are C. Fred Bergsten and C. Randall Henning. See Bergsten's "The Dollar and the Euro", *Foreign Affairs*, July/August 1997 (and an abridged version in *The International Herald Tribune* entitled "Expect a Big Euro, and Start Trans-Atlantic Planning", 8 May 1998); see also, among other articles, Henning's "Europe's Monetary Union and the United States", *Foreign Policy*, Spring 1996, *op. cit.*, and "Cooperating with Europe's Monetary Union", *Policy Analyses in International Economics* 49, The Institute of International Economics, May 1997. These two authors are probably the exceptions to the rule, insofar as they regard EMU, on the whole, as a potentially favourable

development from the point of view of all those participating in the international system. [Back.](#)

Note 47: European experts also acknowledge that the potential dynamic benefits are difficult to measure; nonetheless, in making their case for EMU, invariably they attach even greater importance to these than to the static benefits. See below, sections IV and V. [Back.](#)

Note 48: Martin Feldstein, “The case against EMU”, *The Economist*, 13 June 1992, pp. 19-22. Feldstein’s arguments have since formed the core of the attack on EMU. Its most important elements are taken up below in section IV. [Back.](#)

Note 49: See Barry Eichengreen and Jeffrey Frieden, “The Political Economy of European Monetary Unification: an Analytical Introduction”, in Barry Eichengreen and Jeffrey Frieden (eds.), *The Political Economy of European Monetary Unification*, Westview Press, 1994, p.5. [Back.](#)

Note 50: See “Euro? Americans Wonder What to Make of It”, *International Herald Tribune*, 9 March 1998. [Back.](#)

Note 51: *Ibid.* [Back.](#)

Note 52: Lester Thurow, statements published in *La Repubblica*, 28 February 1998; reported in *Agence Europe*, 2-3 March 1998. [Back.](#)

Note 53: For a different view which stresses that the dollar will not fall against the euro (but their exchange rate will probably be volatile), see Robert N. McCauley, “The Euro and the Dollar”, Bank for International Settlements Working Papers, Working paper No. 50, November 1997. The important issue of the future euro-dollar exchange rate and its behaviour is addressed in a number of papers published in Paul R. Masson, Thomas H. Krueger and Bart G. Turtelboom (eds.), *op. cit.* [Back.](#)

Note 54: Martin Feldstein, “EMU and International Conflict”, *Foreign Affairs*, November/December 1997, pp. 60-73; this quote, p. 60. More recent articles in the press include “Europe’s New Challenge to America”, *The New York Times*, 7 May 1998, and “Monetary Union Could Provoke Conflicts in Europe”, *International Herald Tribune*, 8 May 1998. [Back.](#)

Note 55: The Werner Report itself described monetary union as a major route toward political unity. [Back.](#)

Note 56: See, e.g., Jeffrey Sachs, in *Economic and Monetary Union in Europe: Implications for Global Capital Markets, Trade and Investment*, *op. cit.*, p. 8. Sachs contends that the view (held mainly in France) that the European countries’ role in the world will be enhanced if the euro becomes a reserve currency is based on a serious overstatement of the importance of the dollar’s role as a reserve currency. Implicitly, his argument is that the real importance of the US economy in the world derives more from its “real” economic size and strength and less from its international financial role. [Back.](#)

Note 57: The absence of such an arrangement today in the EU is a key item of the American critique. For example, Benjamin Friedman argues that unless the EU develops a serious political union, including a fiscal transfer mechanism designed to mitigate the effects of country-specific shocks, it is doubtful whether EMU will survive. See “Economic and Monetary Union: Source, Problems, and Prospects”, in *Economic and Monetary Union in Europe: Implications for Global Capital Markets, Trade, and*

Investment, Weatherhead Center for International Affairs, Harvard University, results of a conference held on 27 January 1998, p. 2. [Back](#).

Note 58: The question of the new ECB's credibility in the eyes of the European public (especially in comparison with the well-known trust shown by the German public towards the Bundesbank) is addressed by Rudiger Dornbusch in "In praise of hard money", *Financial Times*, 18 June 1998. According to Dornbusch, "[t]he precedent will be hard to match." [Back](#).

Note 59: The argument sometimes heard is that, with a single currency, governments will have the ability to borrow partly at other governments' expense, in the sense that their extra demands on the capital market will tend to force up the interest rate across Europe, rather than force up merely their own interest rate. This financial "externality" will, it is said, encourage more borrowing. However, the effect is unlikely to be large, because in a world of global capital markets one country's borrowing, however large, will not have an appreciable effect on euro interest rates. Furthermore, with a single currency, governments will not be able to reduce the burden of their debts by letting inflation rise. Ultimately, they will have to finance their borrowing through explicit taxes, not through the hidden tax of inflation. This, in principle, should help to encourage sound public finance. [Back](#).

Note 60: International Monetary Fund, *World Economic Outlook — October 1997 IMF World Economic Outlook, Oct. 1997 — I Global Economic Prospects and Policies-Advanced Economies*. By comparison, latest US figures put the unemployment rate, in April 1998, at 4.3 per cent, a 28-year low. *International Herald Tribune*, 9-10 May 1998. [Back](#).

Note 61: Of course, there is no American monopoly in this area, and many European sceptics, including some national politicians and high-ranking officials, express exactly the same doubts. [Back](#).

Note 62: Naturally, "political integration" means different things to different people. However, among economists it is common to regard the centralisation of central government taxation and spending as indicative of a passing to a stage, if not definitionally identical with, at least presupposing a high degree of political integration. [Back](#).

Note 63: See, e.g., "Dutch coalition party leader to challenge Kok", *Financial Times*, 27 April 1998. [Back](#).

Note 64: Already, the British Treasury is preparing a national plan for converting sterling into euros, to be submitted by the end of the year. According to this plan, all British companies will be able to use the euro for filing accounts, paying taxes and issuing shares. This is considered the clearest sign that the British government is determined to take the UK into the monetary union early in the next decade. *Financial Times*, 1 May 1998. [Back](#).

Note 65: Indeed, according to one view that emerged in Britain (which was in fact shared by Kenneth Clarke, the UK's former chancellor of the exchequer), adopting a common currency need not bring with it a loss of sovereignty at all, being more in the nature of a technical development which enhances economic integration. If it is correct that the link between money and sovereignty is less than perfectly clear, in this view it would follow that the case for or against a single currency depended on its direct costs and benefits, not on the broader political case for or against a federal Europe. However, this view may be overly simplistic, but for good "electoral" reasons. [Back](#).

Note 66: See, for example, Jürgen von Hagen and Michele Fratianni, “The Transition to European Monetary Union and the European Monetary Institute”, in Barry Eichengreen and Jeffry Frieden (eds.), *The Political Economy of European Monetary Unification*, Westview Press, 1994, p.146. [Back.](#)

Note 67: The government of at least one major country — France — is generally thought to have been thrown out of office by a perception, among the electorate, that EMU was associated with high unemployment. [Back.](#)

Note 68: Probably the three most significant innovations introduced by the Amsterdam Treaty — consisting in a net move toward a more supranational structure — are: (i) the transfer of most of the 3rd pillar’s subject-matters (Justice and Home Affairs) to the communitarian 1st pillar, (ii) the extension of the European Parliament’s co-legislative (alongside the Council) authority to practically all legislative acts and (iii) the introduction of qualified majority voting in the implementing decisions of the Common Foreign and Security Policy. In contrast, taxation and social policy — those areas most closely related to EMU — were essentially left unchanged. [Back.](#)

Note 69: Interestingly, but also consistent with experience, the British and Danish governments were the ones to oppose at Amsterdam most vehemently any relinquishing of national sovereignty — hence the British and Danish opt-outs in those third-pillar areas which have been transferred to the first pillar. [Back.](#)

Note 70: A special protocol annexed to the Amsterdam Treaty stipulates that: “At least one year before the membership of the European Union exceeds twenty, a conference of representatives of the governments of the Member States shall be convened in order to carry out a comprehensive review of the provisions of the Treaties on the composition and functioning of the institutions.” [Back.](#)

Note 71: This argument does not preclude the possibility of leading political figures making public statements to the effect that EMU will “give a mighty push” to the process of political union. It merely aims to point out that domestic political constraints do not always permit a complete congruence of words and deeds. See, *e.g.*, recent statements by Chancellor Kohl, *Financial Times*, 22 April 1998. Another argument is that what could not be achieved voluntarily at Amsterdam will be forced upon governments and voters by EMU; but this can hardly be considered an effective means of pursuing integration in the face of the well-known and well-recognised need to involve Europe’s citizens in the process, as opposed to presenting them with *faits accomplis* (which the Maastricht Treaty is generally considered as having done — to the detriment of EU governments and the integration process as a whole). [Back.](#)

Note 72: R. A. Mundell, “A Theory of Optimum Currency Areas”, *American Economic Review*, November 1961, pp. 509-517; adapted in Robert A. Mundel, *International Economics*, Macmillan, 1968, pp. 177-186. It is interesting to recall an often-forgotten fact, *viz.* that the thrust of Mundell’s argument was intended to caution against the practicability, in certain cases, of a system of *national* currencies connected by flexible exchange rates. [Back.](#)

Note 73: That European economic integration as a whole is an exercise involving, over time, much economic pain, in the name of efficiency and competitiveness, is plain enough, especially from the weaker members’ point of view. Why the final stage of EMU should be considered any different by its critics is not entirely clear. [Back.](#)

Note 74: Delors Report, *op. cit.* p. 21. [Back.](#)

Note 75: *Ibid.*, p.32. [Back.](#)

Note 76: *Ibid.*, pp. 20-24 and 32. [Back.](#)

Note 77: *Ibid.*, pp. 21 (par. 26) and 23 (par. 29). [Back.](#)

Note 78: *Ibid.*, p. 23 (our emphasis). [Back.](#)

Note 79: Experience suggests that an independent monetary policy can be abused. The case of Italy is often referred to in an effort to demonstrate that countries with structural problems cannot escape them by devaluing their currencies. The same has been said of the UK over the past three decades. It has been argued by some that the UK in the past has used its monetary freedom to devalue and put off the need for inevitable real adjustments. [Back.](#)

Note 80: The exchange rate will work as an effective mechanism for long-run adjustment only if real wages can adjust flexibly. But nearly all commentators accuse European labour markets at present of being generally characterised by real-wage rigidity: that is the principal reason why unemployment performance in Europe has been generally poor, even without the euro. Those who argue in favour of retaining the exchange rate as a policy instrument will need to explain why workers are more likely to accept a fall in real wages as a result of devaluation than as a result of the current bargaining process. If real wages are flexible, adjustment to long-run divergence is feasible whether inside or outside EMU. [Back.](#)

Note 81: See, *e.g.*, Charles Engel and John H. Rogers, “A Retrial in the Case Against EMU”, preliminary paper, 2 March 1998; also, J. McCallum on the cross-border effect on prices of Canada-U.S. trade, *op. cit.* [Back.](#)

Note 82: According to French officials, the ejection, in 1992-93, of sterling and the lira from the ERM — and the ensuing “competitive devaluations” — caused a loss to the French economy equivalent to nearly 1 per cent of GDP. Reported in the “EMU Survey”, *The Economist*, 11 April 1998, p. 7. [Back.](#)

Note 83: Tamim Bayoumi and Barry Eichengreen, “Shocking Aspects of European Monetary Unification”, in Francisco Torres and Francesco Giavazzi (eds.), *The Transition to Economic and Monetary Union in Europe*, Cambridge University Press, Cambridge, 1992. [Back.](#)

Note 84: Barry Eichengreen and Jeffry Frieden, *op. cit.*, pp. 8-9. [Back.](#)

Note 85: Lorenzo Bini Smaghi and Silvia Vori, “Rating the EC as an Optimal Currency Area: Is it Worse than the US?”, in Richard O’Brien (ed.), *Finance and the International Economy*, Vol. 6, The AMEX Bank Review, Oxford University Press, 1992, pp. 80 and 86. [Back.](#)

Note 86: *ee*, for example, Niels Thygesen, “Why Economic and Monetary Union Is an Important Objective for Europe”, *S.A.I.S. Review*. [Back.](#)

Note 87: See, for example, Paul Krugman, “Integration, Specialization and Regional Growth: Notes on 1992, EMU and Stabilization”, in Francisco Torres and Francesco Giavazzi (eds.), *op. cit.* Sukkoo Kim has argued that, whereas U.S. regional specialisation of manufacturing industry rose substantially

between 1860 and the turn of the twentieth century, it flattened out during the inter-war years, and then fell substantially and continuously since the 1930s as factors of production became increasingly more mobile relative to final goods. This examination of long-term trends in the U.S., however, does not offer a comparison with current patterns in Europe; but it does implicitly suggest that, *ceteris paribus*, in Europe, too, EMU in the long run (provided it is accompanied by sufficient factor movements) will contribute to regional despecialisation and industrial delocalisation, rendering the EU's economies more susceptible to symmetrical, rather than asymmetrical shocks. Sukkoo Kim, "Expansion of Markets and the Geographic Distribution of Economic Activities: the Trends in U.S. Regional Manufacturing Structure, 1860-1987", *Quarterly Journal of Economics*, Volume CX, Issue 4, November 1995, pp. 881-908. [Back](#).

Note 88: *Ibid.*, p. 81. [Back](#).

Note 89: Bini Smaghi and Vori, *op. cit.*, p. 86. [Back](#).

Note 90: Centre for Economic Policy Research, *Is Bigger Better?: The Economics of EC Enlargement*, CEPR, London, 1993. [Back](#).

Note 91: See D. Cohen and C. Wyplosz, "The European monetary union: An agnostic evaluation", in R. Bryant, J. Frenkel, P. Masson and R. Portes (eds.), *Macroeconomic Policies in an Interdependent World*, 1989, Washington, D.C.: Brookings Institution, 1989; Commission of the European Communities, "The impact of the internal market by industrial sector: The challenge for the Member States", *European Economy/Social Europe*, special issue, 1990; A.A. Weber, "Reputation and credibility in the European Monetary System", *Economic Policy*, Vol. 12, 1990. [Back](#).

Note 92: Bini Smaghi and Vori, *op. cit.* [Back](#).

Note 93: Some cross-border differences *within* sectors may continue to exist, *e.g.* resulting from differing labour market regulations, including statutory and agreed frameworks for collective bargaining, employee representation, etc. However, this is not inconsistent with longer-term *tendencies* to factor-price equalisation within the sectors concerned. And already there is increased coordination between trade unions and employers' associations in contiguous regions. But the creation of an EU framework of employment regulation (as distinct from cooperation) still seems some way off, and employment *policy* will continue to remain within the purview of national governments, as confirmed by the employment chapter in the new Amsterdam Treaty. [Back](#).

Note 94: Christopher M. Dent, *op. cit.*, p. 37-8. [Back](#).

Note 95: Martin Feldstein is one of the few critics who offers a concrete example. In *The Economist* article of 1992 (*op. cit.*), he cites the (hypothetical) case of a British manufacturer contemplating an export drive in France, who ends up being thwarted in his efforts by an unforeseen fall in the dollar and the ensuing advantage obtained by competing American producers. He argues that if Britain had been free to devalue its currency, the pound might have fallen in line with the dollar. There is no mention of the costs to the rest of the British economy resulting from the effects of dearer imports across-the-board. [Back](#).

Note 96: Many economists have argued that the east Asian financial crisis of the winter of 1997-1998 was exacerbated by the inordinate fall of currencies, making all dollar-denominated debts almost

impossible to service. Once EMU occurs in Europe, this type of “undershooting” by definition cannot occur. [Back.](#)

Note 97: Despite the common monetary policy, there will remain some differences in interest rates reflecting differences in the markets’ perception of the riskiness of government assets. But national governments will not be able to manipulate this difference for reasons of macroeconomic management. [Back.](#)

Note 98: The Irish case is usually invoked as a case in point. The Irish economy has been exhibiting annual rates of growth of between 7 and 10 percent for a number of years, with the pressures being reflected in asset price inflation, especially in the Dublin property market. Under EMU, a pre-emptive rise in interest rates of course will no longer be possible. [Back.](#)

Note 99: The 1997 results show that a core group of euro-11 countries, including Germany, France, Italy, Austria, Luxembourg and Belgium had annual rates of growth below the EU average of 2.6% (1996: 1.7%), with Italy’s the lowest (1.4%), whereas a “periphery”, including Ireland, Spain and Portugal had significantly above-average rates of growth, with Ireland’s being the highest (8.3%) (Eurostat, 27 March 1998, reported in the *Financial Times*, 28-29 March 1998). Any EU-wide interest rate set on the basis of average conditions would, under these circumstances, probably be too high for the former group of countries, and too low for the latter group of countries. See “Europe Grows Apart”, *The Economist*, 7 March 1998. [Back.](#)

Note 100: The argument is that endowing the faster-growing region with more factors of production via capital inflows will ease the assumed shortage of domestic factors presently called upon to satisfy the country’s growth needs. However, it is worth pointing out two counter-arguments, one static, the other dynamic: first, to the extent that substitution possibilities on the factor-substitution frontier are not perfect, the inflow of additional capital may end exerting even more upward pressure on wages; second, capital inflows may conceivably lead to an *acceleration* of the underlying growth process, and thereby contribute to the inflationary process already under way. [Back.](#)

Note 101: At present, European portfolio capital shows a distinct bias in favour of the home country. According to Merrill Lynch, only Ireland, the Netherlands and the UK invested between 15 and 28 per cent of their financial assets abroad in 1996. Once currency risks are eliminated, investors are expected — on standard portfolio theoretical grounds — to place the majority of their assets in other euro-zone countries. *Financial Times*, 30 April 1998. [Back.](#)

Note 102: Even today, exchange-rate policy typically has a varied and unequal impact on different sectors of the national economy. In the case of Greece, for example, the former “hard drachma” policy (modified by the 13.8 per cent devaluation of 14 March 1998, intended to ease the drachma’s entry into the ERM), which was adopted to help combat inflation, reportedly had an uneven adverse impact on exporting sectors: the hardest hit were traditional industries, whose activity grew slowly, at best, or stagnated or shrank, at worst. These sectors include textiles, ready-to-wear apparel and steel. Despite progress made by exporting sectors employing advanced technology, such as telecommunications equipment, electronics and measuring instruments, most Greek exports are considered “traditional”. That said, among the “traditional” sectors, some very high-technology products can be found, both in industry and in agriculture. Fish-farm products, for example, are high technology, and all the goods Greece exports in this sector belong to this category. Production units exporting in the technologically

more-sophisticated sectors are expected ultimately to benefit relatively more from the recent devaluation; the latter is not considered capable on its own of enabling traditional, low-tech sectors to address effectively their *structural* weaknesses: typically, the latter sectors are characterised by low value-added, reflecting a high import-content; the cost of raw materials, intermediate goods and energy used in the manufacture of many products destined for export will largely offset — it has been argued — the higher revenues flowing from the devaluation. See the remarks by Christina Sakellaridis, president of the Panhellenic Federation of Exporters, reported by the *Athens News Agency*, 11 April 1998. [Back.](#)

Note 103: See Gillian Garcia and Carl-Johan Lindgren, “Averting the Crash: Economic Institutions and Financial Sector Soundness” in *S.A.I.S. Review*, Winter-Spring 1998, Volume XVIII, Number One, pp. 19-34. These authors in their typology also refer to “political”, “natural disasters” and “social and cultural” causes of financial unsoundness; however, these are factors which they describe in connection with observed financial crises in developing countries. [Back.](#)

Note 104: See *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks*, Washington, Office of the Comptroller of the Currency, 1988. [Back.](#)

Note 105: The positive role of economy-wide banks (and the problems that can accompany their absence) can be understood in light of the U.S. experience: three-fifths of bank failures which occurred between 1980 and 1994 happened in only five states, California, Kansas, Louisiana, Oklahoma and Texas. This is attributed to the “local” character of the banks involved. *Financial Times*, 14 April 1998. [Back.](#)

Note 106: By way of example, the tendency to political interference, observed in some countries, aimed at alleviating the debt burden on certain classes of customers (*e.g.* farmers), may end up not only causing (usually state-owned) banks to become insolvent, but a more general destruction of the “credit culture”, *i.e.* the discipline to repay loans. [Back.](#)

Note 107: See, *e.g.*, Jeffrey Sachs, in *Economic and Monetary Union in Europe: Implications for Global Capital Markets, Trade and Investment*, *op. cit.*, p. 9. [Back.](#)

Note 108: Interestingly, in the United States during the Great Depression it was not the Federal Reserve, but a purpose-built institution called the Reconstruction Finance Corporation, which fulfilled the lender-of-last-resort function. On the depositors’ side, again it was not the Fed which guaranteed depositors’ savings, but a relatively anonymous institution named the Federal Deposit Insurance Corporation. (See John Kenneth Galbraith, *Money, Whence it Came, Where it Went*, Houghton Mifflin Company Boston, 1975, p. 117). This is just to indicate the variety of institutional arrangements that can be devised by authorities to address these particular issues, from which the political and monetary authorities in Europe no doubt will be able to draw inspiration. Also, the recent experience with the Crédit Lyonnais case in France suggests that banking crises probably will be brought to the attention of both the national and the Community authorities before actual bankruptcy is declared, and dealt with as a *state-aid* (fiscal) problem, rather than as a lender-of-last-resort (monetary) problem. [Back.](#)

Note 109: The international banking industry is currently reviewing rules defining the type of capital banks must hold as protection against losses. See “Banking industry divided on safety net rules”, *Financial Times*, 6 April 1998. [Back.](#)

Note 110: See Robert Mundell, *op. cit.* [Back](#).

Note 111: David Currie, *Will the Euro Work?*, a report prepared for the Economist Intelligence Unit, 9 January 1998. [Back](#).

Note 112: For example, the O.E.C.D. cites the phenomenon of Germany's recent move to discourage inward labour mobility by imposing minimum wages in the construction sector, where firms from lower-wage countries (such as the United Kingdom, Portugal and Spain) had been winning a growing number of contracts. *Preliminary Edition of OECD Economic Outlook No. 6*, released 8 April 1998. [Back](#).

Note 113: Mundell, *op. cit.*, the 1968 adaptation, pp. 181-2. [Back](#).

Note 114: *Ibid.*, p. 180. Our emphasis. [Back](#).

Note 115: As argued in section IV.b, under a free-floating régime, a change in the exchange rate in response to a shock will typically affect various sectors and regions in different ways, not all of them positive. This in itself will require adjustments through goods- and factor-price movements as well as factor movements. [Back](#).

Note 116: This indicator is arguably more useful than interregional unemployment data, or indeed, data on rates of change of regional unemployment, because it will encompass and reflect the effects of current *and* past exchange-rate movements (or non-movements). Thus, one could argue that current national interregional unemployment figures are a result of the post-1993 exchange-rate stability (and are therefore not typical of a non-EMU régime), when it will be important to evaluate data which reflect the effects of the last major period of exchange-rate "flexibility" as well, *viz.* 1992-93. To this end, income figures are probably more useful. [Back](#).

Note 117: A similar argument was made by Tibor Scitovsky in his pioneering essay, "The Theory of the Balance of Payments and the Problem of a Common European Currency", in his *Economic Theory and Western European Integration*, London: George Allen and Unwin, 1958, pp. 79-109. [Back](#).

Note 118: There is at least anecdotal evidence to support the view that at least some US workers also have a preference for staying on in their communities when faced with the relocation of a major employer. The *Boston Globe*, in a three-part series of articles entitled "Closing Time: the Selling of a Company" (15-17 March 1998), described how a company (L.G. Balfour Co.) based since 1913 in Attleboro, Massachusetts, offered its 450 employees a chance to relocate in Austin, Texas when the firm moved there in March 1997; only 29 accepted. The majority of those left behind are reportedly surviving on lower-wage jobs, part-time work or on extended unemployment while in government retraining programs. Though jobs in Massachusetts are as plentiful now as when the company in question began its shutdown a year ago, and the unemployment rate of less than 4 per cent is practically unchanged, the jobs moving in — mostly in the service sector and high tech — are not the same as the ones moving out. [Back](#).

Note 119: Olivier Jean Blanchard and Lawrence F. Katz, "Regional Evolutions", *Brookings Papers on Economic Activity*, 1992, vol.1, pp.1-61. See also Paul Krugman, "Integration, Specialization and Regional Growth: Notes on 1992, EMU and Stabilization", in Francesco Giavazzi and Francisco Torres (eds.), *The Transition to Economic and Monetary Union in Europe*, Cambridge University Press, 1993.

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Note 120: Eichengreen states that “[e]stimates for Europe reveal that the elasticity of migration with respect to unemployment differentials is twice as large in the United States as in either the UK or Italy. In the case of relative wages, the ratio of the US elasticity to the corresponding British and Italian elasticities is even larger.” According to Eichengreen, “[t]his suggests that low levels of labor mobility in Europe reflect not merely legal restrictions but also culture, language and history.” See his “comments” (p. 66) to Olivier Jean Blanchard and Lawrence F. Katz’s “Regional Evolutions”, *Brookings Papers on Economic Activity*, 1992, vol.1, pp.1-61. [Back.](#)

Note 121: Jacques Delors in fact made the point that the tolerance for regional inequalities in the EC as a whole may be higher than in federal countries such as the United States, Canada, Switzerland (even while pointing out that in practice disparities were not that much higher in the EC), given that language and cultural barriers result in a low propensity to migrate. See his “Regional implications of economic and monetary integration”, in the Delors Report, *op. cit.*, p. 81. [Back.](#)

Note 122: Results of a major empirical study conducted by the European Commission in 1990, quoted in Niels Thygesen, *op. cit.*, p. 24. [Back.](#)

Note 123: Thygesen considers *these* gains to be substantially higher than those attributable to savings on the aforementioned direct microeconomic costs; *ibid.* [Back.](#)

Note 124: Richard Baldwin, “On the Microeconomics of the European Monetary Union”, *European Economy*, Special Edition, no. 1, 1991. [Back.](#)

Note 125: The Bundesbank, for one, reportedly expects increased competition in, and integration of, European capital markets after the introduction of the euro to stimulate higher economic growth rates. *Financial Times*, 21 April 1998. [Back.](#)

Note 126: *European Economy*, supplement B, no. 3, March 1998, data reprinted in *Agence Europe*, 27 April 1998. [Back.](#)

Note 127: The fourth poorest among the EU-12. [Back.](#)

Note 128: Eurostat and OECD. The British case demonstrates that there is much more to a successful economy than mere labour market flexibility. The preliminary findings of a McKinsey consultancy report into Britain’s productivity gap (discussed in the *Financial Times*, 15 May 1998) indicate that, without the constraint of a minimum wage (for now), there are more low-skilled, low-wage workers in Britain than in France or Germany. However, this in itself does not make the UK less efficient. More important is the fact that the UK’s share of investment in GDP has been consistently lower than the EU average for decades. Largely as a result, the UK market sector’s output per capita is 40 per cent lower than in the United States, and 20 per cent behind western Germany. One possible explanation which is advanced to explain this phenomenon is that labour-market flexibility may be a factor actually encouraging managers to prefer hiring additional labour in response to an upturn (on the understanding that it will be equally easy to dismiss them in case of a downturn), rather than making long-term investment commitments, which are obviously preferable from a long-term productivity-growth perspective. [Back.](#)

Note 129: While the United States economy currently performs well as regards structural unemployment,

it does less well in respect of regional unemployment disparities. Eichengreen points out that wage relativities across regions in the United States are inflexible enough to permit regional unemployment rates to diverge for six to ten years. See his “comments” (p. 66) to Olivier Jean Blanchard and Lawrence F. Katz’s “Regional Evolutions”, *Brookings Papers on Economic Activity*, 1992, vol. 1, pp. 1-61. [Back](#).

Note 130: Blanchard and Katz, *op. cit.*, pp. 37 and 56. [Back](#).

Note 131: It is impossible to predict whether the wage-demonstration effect will assert itself to any significant extent after EMU. A dampening factor is the current lack of coordination between trade unions across member states. Nonetheless, some authors see in recent events (especially the reactions surrounding the closure of a Renault automotive factory in Belgium) the semblance of an emerging Europe-wide “realm of social movement activity” (not to be confused with a common wage-bargaining approach). See Doug Imig and Sidney Tarrow, “From Strike to Eurostrike: The Europeanization of Social Movements and the Development of a Euro-Polity”, Working Paper Series, Paper No. 97-10, Weatherhead Center for International Affairs, Harvard University, December 1997. [Back](#).

Note 132: See p. 19, fn. 1. Especially in a world of liberalised capital markets, exchange rates cannot neatly distinguish between short-term and long-term disequilibria or disturbances, or indeed speculative attacks. [Back](#).

Note 133: Samuel Brittan, “Some Emu surprises”, *Financial Times*, 5 February 1998. [Back](#).

Note 134: Jeffrey A. Sachs and Xavier Sala-i-Martin, “Federal Fiscal Policy and Optimum Currency Areas”, in Matthew Canzoneri, Vittorio Grilli and Paul Masson (eds.), *Establishing a Central Bank: Issues in Europe and Lessons from the U.S.*, Cambridge University Press, Cambridge, 1992, pp. 195-220. [Back](#).

Note 135: Jürgen von Hagen, “Fiscal Arrangements in a Monetary Union: Evidence from the U.S.”, in Donald E. Fair and Christian de Boissieu (eds.), *Fiscal Policy, Taxation and the Financial System in an Increasingly Integrated Europe*, Kluwer, Dordrecht, Netherlands, 1992, pp. 337-360. One recent study suggests that these days only 10 per cent of any fall in gross state product is compensated via the federal budget; Antonio Fatas, “Redistribution vs. Insurance: Does Europe Need a Fiscal Federation?”, *Economic Policy 26: Prospects and Challenges for the Euro*, CEPR, Blackwell, forthcoming, quoted in *The Economist*, 11 April 1998. [Back](#).

Note 136: Despite the crucial nature of the redistribution-stabilization distinction, American economists continue to this day to repeat unquestioningly the claim that, in the United States, a dollar decline in a particular state’s income relative to the rest of the country is offset by 40 cents in net transfers. See, e.g., Benjamin Friedman in *Economic and Monetary Union in Europe: Implications for Global Capital Markets, Trade and Investment*, *op. cit.*, p. 2. Generally, differences in the level of fiscal variables that are functions of the level of income are essentially redistributive; differences in fiscal variables that are a function of the rate of change of income constitute stabilisation. [Back](#).

Note 137: Tamim Bayoumi and Paul Masson, “Fiscal Flows in the United States and Canada: Lessons for Monetary Union in Europe”, unpublished manuscript, International Monetary Fund, 1991, quoted in Barry Eichengreen, “Fiscal Policy and EMU”, in Barry Eichengreen and Jeffrey Frieden (eds.), *op. cit.*, pp. 167-190; see p. 185. [Back](#).

Note 138: See Barry Eichengreen, *op. cit.*, pp. 183-4. Some authors have even argued that a balanced-budget requirement tends to engender, in effect, a procyclical policy, thereby *accentuating* the effects of asymmetric shocks, J. Stotsky, “Coping with State Budget Deficits”, *Business Review of the Federal Reserve Bank of Philadelphia*, January-February 1991; R. Mattoon and W. Testa, “Caution: State and Local Government Brake for Recession”, *The Federal Reserve Bank of Chicago*, March 1992, No.5. [Back.](#)

Note 139: Bini Smaghi and Vori, *op. cit.*, p. 93. For example, the *New York Times*, 23 April 1998, reports that New York City will end its fiscal year with a surplus of more than \$2bn, the largest ever recorded by the city. [Back.](#)

Note 140: Commission of the European Communities (MacDougall Report), *Report of the study group on the role of public finance in European integration*, Collection Studies, Economic and Financial Series No. A13, Vols. I and II, Brussels, April 1977. [Back.](#)

Note 141: *Ibid.*, p. 14. [Back.](#)

Note 142: Charles Goodhart and Stephen Smith, “Stabilization”, *European Economy*, Reports and Studies, 5, 1993, p. 443. [Back.](#)

Note 143: *Op. cit.*, p. 35. [Back.](#)

Note 144: *Ibid.*, p. 68. [Back.](#)

Note 145: David Currie, *The Pros and Cons of EMU*, a research report of the Economist Intelligence Unit, 20 January 1997. For a wider discussion of fiscal policy under EMU, see Charles Goodhart and Stephen Smith, “Stabilization”, *European Economy*, Reports and Studies, 5, 1993, pp. 415-455; and Jean Pisani-Ferry, Alexander Italianer and Roland Lescure, “Stabilization Properties of Budgetary Systems: A Simulation Analysis”, *European Economy*, Reports and Studies, 5, 1993, pp. 511-538. The latter paper finds that in the United States the federal tax and transfer system absorbs about 17 per cent of a regional shock, compared with 34-42 per cent in Germany and 37 per cent in France. These authors’ conclusion is that “monetary unions can be viable with a lower degree of stabilisation provided by the central government than is often assumed, [and] stabilisation in EMU at the Community level is less needed than in federations due to the large autonomy of Member States regarding spending and taxation decisions” (p. 513). [Back.](#)

Note 146: David Currie, *op. cit.*, chapter 4. [Back.](#)

Note 147: It has been claimed that if such a mechanism were to limit itself solely to softening the financial cost of changes in unemployment that exceed the EU average, this could be done with an even smaller strain on the EC budget, in the order of 0.2 per cent of EU GDP; see “Stable Money-Sound Finances”, report of an independent group of economists, *European Economy*, no. 53, December 1993; see especially pp. 73-78. The basic reason for such a high level of efficiency is that this mechanism is exclusively designed for regional stabilisation purposes, whereas a system of automatic stabilisers, being a by-product of redistributive programs, generates substantial redistributive effects as well. [Back.](#)

Note 148: P. Van Rompuy, F. Abraham and D. Heremans, “Economic federalism and EMU”, *European Economy*, Special Edition No1/91 “The economics of EMU”, chapter 6, pp. 109-135; see pp. 112-13.

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Note 149: Lack of a coherent and constructive interlocutor on international monetary affairs; the risk of regional instability; economic costs deriving from the onset of recession and unemployment in Europe.

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Note 150: Strictly speaking, seigniorage refers to the net gains a government derives from issuing currency, as opposed to debt, which pays interest. The United States, however, because it controls the internationally dominant currency (for various reasons, including its credit-worthiness in the eyes of international investors), is able to issue large amounts of debt denominated in its domestic currency to international investors. Since the dollar is so widely used for trading purposes, the international demand for dollars remains high, including for the purchase of U.S. debt by foreigners, in spite of any risk that the dollar may actually fall in value, deliberately or otherwise. [Back.](#)

Note 151: C. Fred Bergsten, "The Dollar and the Euro", *op. cit.* Bergsten also predicts that the yen, the Swiss franc and other, minor, currencies will end up accounting for 20 per cent of world finance. The closing of the monetary gap between the dollar and the euro will come, according to Bergsten, from a probable portfolio diversification of \$500 bn to \$1 trillion into euros, most of which will come out of the dollar. The ensuing upward pressure on the euro's exchange rate, and the expected dollar-euro exchange-rate volatility, will require intensive cooperation, both across the Atlantic and in multilateral settings. Even if the \$500-1,000bn estimate proves in the end to have been an exaggeration, it remains a fact that the emergence of a new reserve currency has major attractions insofar as it allows a diversification of portfolios. [Back.](#)

Note 152: Portes and Rey calculate that this increase in the growth rate is likely to be as high as 0.5 percentage point *per annum*. In contrast, the United States could see its growth rate reduced by perhaps 0.2 per cent a year. *Op. cit.* [Back.](#)

Note 153: R. Dornbusch has argued that capital markets are like trade: "If Europe grows, that is a substantial benefit. It's absurd to say that the U.S. will lose anything". *International Herald Tribune*, 20 April 1998. [Back.](#)

Note 154: C. Randall Henning, *op.cit.* Some might even argue that this would be a blessing in disguise. Still, the emergence of the euro will force US policy-makers to pursue (domestic) policies which lend a higher priority to the external value of the dollar (a tendency which might already be taking hold as a result of an increasing awareness of the role played, from the US economy's standpoint, by international investors' willingness to invest in the dollar). [Back.](#)

Note 155: *Ibid.* The example underlying this case is that of 1987 when private finance for the US current account deficit dried up and the European central banks, among others, intervened to buy dollars, fearful of the effects of the dollar's depreciation on the competitiveness of the European economies. [Back.](#)