The European Monetary Union: A Political Time Bomb

Lorenzo Bernaldo de Quiros

On January 1, 1999, the exchange rate parities for the countries forming the European Monetary Union were irrevocably fixed. That was the start of the final phase of a process initially aimed at introducing a single currency in Europe, but that now has the final goal of creating a United States of Europe. What are the benefits and potential costs of the European Monetary Union? And will the long transition process between the irrevocable setting of exchange rate parities on January 1, 1999, and the replacement of the various national currencies by the euro in 2002 be a period filled with uncertainty?

Benefits of the European Monetary Union

The texts that the European Commission itself produced provide a good starting point to analyze the advantages of the European Monetary Union. In "One Market, One Money," the Commission (1990) made a considerable effort to quantify the benefits deriving from the conversion of the European Union (EU) into a single currency area. The "clearest" of those benefits is the reduction in transaction costs associated with the uncertainty on foreign exchange and money markets, representing between 0.3 percent and 0.4 percent of the gross domestic product of the European Union. In fact, that gain would be almost totally derived from the reduction in the risk premium on the price of financial instruments. That reasoning is not completely sound, however. Innovations and changes in the financial world over the last 15 years have allowed those transaction costs to be reduced to very low levels.

Cato Journal, Vol. 19, No. 1 (Spring/Summer 1999). Copyright © Cato Institute. All rights reserved.

Lorenzo Bernaldo de Quiros is President of Freemarket International Consulting and Director of Economic Studies at the Círculo de Empresarios in Madrid, Spain.

In addition, the single currency is expected to generate other significant benefits: a low inflation rate, more disciplined public finances, and, as a result, increased macroeconomic stability. Those benefits, however, are also far from clear.

The achievement of a low inflation rate is not a direct consequence of a fixed exchange rate regime or of a single currency, but rather of a monetary policy aimed at achieving that objective. In fact, the United States, Japan, and Switzerland have achieved low inflation rates with flexible exchange rates while countries immersed in a fixed exchange rate regime—Great Britain and Spain between 1989 and 1992, for instance—recorded higher inflation rates than those achieved prior to fixing their exchange rate parities. If one wishes to have an external anchor to keep prices under control, the best thing to do is to introduce a currency board and the worst is to resort to an adjustable fixed exchange rate such as the European Monetary System (EMS) in its version prior to the 1992 crisis.

Advocates of the European Monetary Union usually assume that there will be an automatic transfer of credibility from the Bundesbank to the new European Central Bank (ECB). That hypothesis seems a little misplaced if one takes into account the numerous shadows floating over the ECB:

1. Within the monetary union, exchange rate powers will not lie with the ECB but with the European Council. That means that any conflict between exchange rate policy and price stability need not be resolved in favor of the latter.
2. The federal structure of Europe's issuing bank does not guarantee that the ECB will have such a strong anti-inflationary commitment as, for instance, the Bundesbank. The six members of the ECB's Executive Commission will have to face 11 national governments, 11 central banks, the European Commission, and the European Parliament. Monetary policy for the European Monetary Union as a whole may converge toward a higher inflation rate than that desired by the Bundesbank or by the countries currently forming part of the EU's hard core.
3. There are considerable lacunae about how the ECB's monetary policy is going to operate in practice. There are no series of historical data allowing analysts to know with any precision the behavior of the monetary aggregates on a European scale nor is the harmonized Consumer Price Index particularly precise. The CPIs of the EU countries each assign very different weights to the various elements they contain, reflecting in turn the differences in consumer habits for those countries. This implies that,

even if the changes in the prices of each type of good were always the same, the inflation rates in the member states might not be. In addition, variations in the interest rates do not affect the member states in the same way. As a result, even if inflationary pressures were identical throughout the European Union, the effects of monetary policy on the various countries need not be. That means that Europe's monetary policy will be shrouded in uncertainty for some considerable time. Finally, one must not forget that price stability is not the ECB's only goal. It also has to support other European policies, which may lead, as in the case of the exchange rate, to many problems.

4. Finally, the same monetary policy for all countries in the European Monetary Union could have very destabilizing effects on some members of that union. For instance, a booming economy with inflationary pressures may have to accept interest rates that are too low for its situation and that would contribute to those pressures. Similarly, a stagnating economy could be forced to accept interest rates that are too high for its cyclical situation, which would aggravate its recessionary trend.

At the 1996 Dublin Summit, EU member states signed the so-called stability pact. Under that agreement, the public deficits of the states in the monetary union will not be able to exceed 3 percent of GDP, except in cases of recession with annual output drops of 2 percent. The severity of that clause is tempered by the toleration of public finance imbalances above the 3 percent ceiling if there are "exceptional circumstances"—that is, drops in output of less than 2 percent but greater than 0.5 percent. Anyone breaking those limits will be fined. That measure was necessary to convince Germans that they were not going to swap their Deutschmarks for *spaghetti euros*.[1]

The stability pact is an attempt to convince markets that the monetary union being created is a solid one. The European Monetary Union will not survive if it does not balance the shaky public finances of its member states. But the application of the pact will impose very considerable budgetary constraints on member states over a very long

[1]The Maastricht criteria for the European Monetary Union require that (1) the public deficit be no more than 3 percent of GDP; (2) the public debt not exceed 60 percent of GDP, although exceptions can be made if the debt has a decreasing trend; (3) the rate of inflation be no more than 1.5 percentage points higher than the average of the three lowest inflation rates of member countries; (4) long-term interest rates be no more than 2 percentage points higher than the average rate for the countries with the three lowest inflation rates; and (5) no devaluations take place in the two years prior to entry in the European Monetary Union.

period of time, and the social and political consequences of that are unforeseeable.

As designed at Maastricht, the *nonmonetization of deficits* clause does not offer a solid guarantee for a sensible fiscal policy. It seems unlikely that the European Union, guided by financial orthodoxy, will be prepared to allow an EU member state to reach a state of bankruptcy as a result of an irresponsible budgetary strategy. The political costs for the EU of tolerating that kind of situation would be very great. There are good reasons to think that the EU would bail out a country on the verge of a crash, thus making the fiscal requirements established at Maastricht less than a guarantee that one or more member states will not foster excessive deficits or unsustainable levels of debt.

It is also uncertain that the European Monetary Union will foster trade and investment as a result of greater exchange rate stability. Since the collapse of the Bretton Woods system, trade flows have not stopped growing and the investment-to-GDP ratios have not been substantially modified. Exchange rate stability does not depend on the exchange regime adopted but on the economic conditions that determine the exchange rate. If the economies forming part of the European Monetary Union do not enjoy solid macro- and microeconomic bases, the incentives for launching speculative attacks against the euro may be very high, making exchange rate stability in the area very low. In that sense, the recent experience of the EMS is quite illustrative. The destabilizing movements would no longer affect the franc, the peseta, or the lira, but the euro. In addition, the country risk premium would not disappear as markets could push up the long-term interest rates of those countries with less solid fundamentals.

Economic theory has not succeeded in demonstrating the existence of any connection, whether positive or negative, between exchange rate volatility and trade flows. The Commission (1990: 73) itself has acknowledged that: "Since empirical research has not shown a robust relationship between trade and exchange rate variability, it is not possible to estimate the increase in intra-community trade potentially deriving from the irrevocable fixing of the exchange rate." Nevertheless, there is empirical evidence that the volatility of exchange rates has declined over time, thanks in part to the proliferation of (cheap) financial instruments to cover the exchange rate risk (see Bernaldo de Quiros 1999:80).

A single market does not need a single currency. The North America Free Trade Agreement, the largest common market in the world, operates effectively with a flexible exchange rate mechanism. The EU has been a clear example for decades of a single market operating successfully without a single currency. In fact, flexible exchange rates provide the most appropriate mechanism for a common economic space with economies of some size and considerable differences, as those exchange rates allow each country to achieve its special niches in a market that is open to competition from other countries and to gradually adapt to external competitive shocks. On the other hand, deregulation of energy, telecommunications, and labor markets and the elimination of both explicit and implicit assistance to public and private companies in the EU are more urgent and important tasks than the single currency for the correct operation of a common market.

Another argument in favor of a tight relationship between the single market and the single currency is the one that says the countries remaining outside the European Monetary Union may resort to competitive devaluations. Competitive devaluations are incompatible with a regime of floating exchange rates as the economic authorities, central banks mostly, do not manipulate the market-determined price of the currency. In addition, that kind of practice is not feasible in economies with high degrees of trade integration, such as those in Europe, and in a scenario of free capital flows. Within that framework, the value of the currency is not determined by the government or the monetary authority but by the market.

In short, in the best-case scenario—that is, accepting the forecasts of the European Commission—savings equivalent to 0.4 percent of GDP are extraordinarily small for the economies of Europe if compared, as shall be seen below, with the potential costs arising out of the setting up of a single currency area as foreseen in the Maastricht Treaty.

Theoretical Bases for the European Monetary Union

The decision to restrict the convergence criteria to a series of macroeconomic goals is equivalent to assuming that the European Monetary Union only affects nominal variables. The effects of demand-side policies on real economic activity are neutral in the long term and only affect the price level. Some economists—real-cycle theorists, for instance—go even further and deny that short-term movements can be affected by monetary actions. Most economists accept that there is no connection between monetary factors and real factors in the long term, and increasingly they also accept that short-term real effects are weak.

That consensus of opinion has considerable implications: divergences between the unemployment rates in the EU cannot be eliminated by expansive monetary or fiscal actions accompanied by exchange rate adjustments. Economic theory and experience have shown that that tradeoff is illusory and only leads to higher inflation in the long run, greater public sector indebtedness, and lower rates of growth and employment. In a globalized economy with free circulation of capital, people, goods, and services, EU member states, including France and Germany, are small open economies incapable of effectively pursuing expansive monetary and fiscal actions. In short, the traditional Keynesian multiplier does not apply and leads to inflation or to a *crowding-out* effect much faster than before.

In addition, increased market integration makes it very difficult to isolate one country from all others. As a result, the use of exchange rate policy has to a large extent lost its efficacy in dampening the shocks faced by productive activity and in hiding the behavior of real variables. In Europe, prices and wages are very rigid, but devaluations do not work as a corrective mechanism beyond the very short term. The indexation of wages to prices, automatic in almost all EU states, prevents devaluations from achieving the necessary erosion of real wages to restore the balance. To achieve that goal, it is necessary to accompany the drop in the currency's value with a monetary contraction in order to avoid inflation. That measure has, however, a negative effect on output and employment, which is precisely what the reduction in the external value of the currency was supposed to avoid.

With the use of monetary or exchange rate instruments, the room to avoid the impact of real phenomena (costs increasing more than productivity) is very small and the time to do it very short. In the best possible case, their use can only delay or soften the adjustments, which must be inevitably carried out. If market rigidities that impose wage increases higher than increases in productivity lead to price increases that artificially make inputs more expensive, or generate inflationary pressures, the solution is not to resort to the exchange rate policy, but to eliminate instead the factors contributing to those rigidities.

From a theoretical standpoint, the position given above is not incompatible with another position whereby exchange rate flexibility need not delay adjustments in wages and prices but merely softens the transition from a rigid economy to a more flexible one. Exchange rate depreciation can be used, then, as an instrument for short-term dynamic adjustment. That approach is consistent with the consideration that growth and employment depend in the long term only on real variables, but it takes into account that structural reforms are more likely to succeed if the initial lack of downward flexibility in real wages and prices does not produce very intense recessive tensions.

Initially, the most positive aspect of the theoretical approach underlying the European Monetary Union is the rejection of the basic core of Keynesian theories (activism) and its return to pre-Keynesian financial and monetary orthodoxy (rules). Nonetheless, a strong currency and balanced budgets are necessary, although not sufficient, to grow and generate employment. To achieve that requires truly open markets, which will emerge only if the numerous restrictions on competition currently in place in the EU member states and the Commission's obstacles are eliminated.

Is Nominal Convergence Enough to Create a Stable Monetary Union?

As has been shown, restricting the convergence criteria to a series of macroeconomic goals (inflation, interest and exchange rates, level of debt) assumes that the European Monetary Union only affects nominal variables and, therefore, that the effects of monetary policy on real economic activity are neutral in the long term. That approach is correct. At this stage, it is very difficult to maintain that the divergence between the unemployment rates in the EU can be eliminated by monetary actions accompanied by exchange rate adjustments. It is, however, useful to conduct a simple theoretical exercise to clarify the preceding point and to show the usefulness of exchange rate flexibility as an instrument for dynamic adjustment in the short term.

It is perfectly possible to imagine a situation in which the levels of unemployment in each of the member states are equal to their nonaccelerating inflation rate of unemployment (NAIRU). The inflation rates may converge because monetary policy for the whole of the EU has the same effect on all the member states in the area, even if the unemployment rates are different because of cyclical reasons. That does not imply that it is possible to ignore the real convergence criteria without consequences.

Let us suppose that the economies with high structural unemployment decide to introduce reforms into the labor market institutions and social security to reduce the NAIRU to the EU average. In this case, the adjustment of the labor market can operate in two ways: (1) wait for wages and prices to drop in relation to those in force in other EU countries, which will happen slowly, if it happens at all; or (2) modify the exchange rate, which is a faster method. As Milton Friedman (1953: 180-82) has pointed out, in situations such as the one described, it is easier to adjust a single price, the exchange rate, than the entire structure of relative prices in the economy.

It is clear that the second route is not feasible within the European Monetary Union. The persistence of a large volume of unemployment over a long period of time increases the risks of generating severe tensions within the European Monetary Union in favor of a more expansive policy, even if the differences in the employment situation are structural in nature. Under the European Monetary Union it is impossible to respond to that political pressure by relaxing monetary policy and it is more difficult to do so with fiscal policy.

The combination of the factors indicated above may give rise to two deeply negative consequences:

1. The countries with very high unemployment may be forced to leave the European Monetary Union in order to obtain greater flexibility in their economic policy. Although that seems illogical or unlikely, it is not impossible and may trigger speculative movements against the monetary union itself. The attacks against the EMS in the 1992–93 crisis were clearly motivated by the fact that the markets felt that countries such as Great Britain did not have the political will to keep interest rates high and maintain their monetary policies in line with the Bundesbank.
2. The pressure in favor of greater transfers of income toward the economies with high unemployment may increase, on the grounds that the European Monetary Union has caused it. Again, that attitude may make little economic sense, but it is politically very powerful. The reunification of Germany is a palpable demonstration of the fiscal costs produced by a monetary union of two very different economies.

The Loss of Exchange Rate Flexibility

The main cost of the European Monetary Union is the loss of the exchange rate as a mechanism to dampen supply and demand shocks that the European economy might have to face. Those costs can be understood with a very simple example. In a monetary union, all members of that union are obliged to deploy the same monetary and fiscal policies, which requires an assumption of *symmetry* in the disturbances in supply and demand—that is, all members of the union are affected in the same way and with the same intensity. When that does not happen, however, the *asymmetry* can be handled much faster and more efficiently by adjusting the exchange rate to stabilize an open economy than by adjusting domestic wages and prices.

The literature on "optimal monetary areas" clearly illustrates this point (see Mundell 1961, Kenen 1969). For the adoption of a common currency not to produce a decline in welfare, it is necessary for the economies in the union to comply with a series of requirements posited by the theory of optimal monetary areas: flexible prices and wages and similar economic structures. In the absence of those two elements, labor force mobility and the existence of a centralized fiscal policy are the two alternative mechanisms for adjustment to prevent the monetary union from having too high a cost in terms of employment and output.

The advantages of having exchange rate flexibility for European countries are not, however, Keynesian in nature (the monetary policy response to cyclical changes in the unemployment rate). On the one hand, when a country is facing a demand-side shock, the market automatically sets off two types of response: a drop in interest rates (the demand for money and credit decreases) and a depreciation in the value of the currency. On the other hand, it is possible to use currency devaluations (or revaluations) to adjust for *permanent* modifications in the terms of trade or in real exchange rates, at a lower social cost than through short, sharp drops in real wages and production costs or through the mobility of the production factors, particularly labor. Currency devaluations are of no use if they become a common practice, but they can be effective if accompanied by measures aimed at making the markets more flexible and tidying up public finance.

Numerous econometric studies show the impact of supply and demand shocks on the EU economies. Tamim Bayoumi and Barry Eichengreen (1992) sum up the position of the greater part of the literature on the subject: shocks affect countries in the hard core of the European Union (Germany, Belgium, Austria, Holland, Denmark, and France) in a very similar way, while the countries on the periphery of the Union (Great Britain, Italy, Portugal, Greece, Sweden, Finland, and Spain) are affected very differently.

The countries in the hard core have supply-side shocks with average deviations ranging between 1 percent and 2 percent per year. The deviations recorded on the periphery, on the other hand, range from 2 percent to 2.5 percent per year. That implies that there may be solid arguments for a monetary union among the countries of the hard core but not for the economies on the periphery. Moreover, that divergent response to shocks by the core and the periphery of the EU does not seem to have declined over time.

The Dangers of Harmonization

The Maastricht Treaty not only contains a project for monetary union but also establishes the groundwork for establishing greater uniformity in social and economic legislation throughout the continent.

Since the end of the 1980s, the European Commission has adopted increasingly interventionist policies, imposing new regulations or attempting to harmonize the legislation of member states under the pretext that free competition is otherwise inefficient. There has been and there still is a flood of new EU regulations without any consideration for their economic consequences.[2] Far from eliminating existing distortions, the Commission's policies are creating new ones that are reducing competitiveness. That is a very serious concern for those economies that have passed reforms to reduce interventionism or are in the course of doing so. There is a risk of consolidating an inefficient status quo.

Harmonization is not interpreted as the elimination of the barriers to competition but as a means of bureaucratic control of the market and an instrument to consolidate interventionism in Europe. There is a desire to force convergence toward similar tax schemes and identical regulations. In that way, competition between the various types of social and economic orders in the different countries making up the EU is eliminated. The differences between a top-down *imposed harmonization* and a bottom-up harmonization achieved through the fair play of competition have important practical implications. In the first case, the tax and regulatory models which are consolidated are at the root of the loss of vitality in the economies of Europe; in the second case, through the free circulation of goods, services, people, and capital, market forces will tend to establish a *spontaneous* harmonization of the economic and social institutions of the member states. Those countries with lower taxes, smaller social security costs, and freer markets would attract business away from countries with more burdensome tax and regulatory structures. The inefficient countries would be obliged to turn toward the free market or continue to lose ground.

That process works, as Jacques Delors, former President of the European Commission, was forced to acknowledge on the occasion of Great Britain's refusal to sign the European Social Charter. He regretted that by doing so Britain would become a "paradise for Japanese companies seeking to avoid EC social legislation" (Delors 1991).

Regulations existing in the EU are a clear obstacle for the incorporation and development of new companies, for the survival of existing companies, and for the competitiveness of the continent's economy both in the domestic market and abroad.

[2]According to the Adam Smith Institute (1995: 16), the EU's bureaucracy produces around 18,000 resolutions, regulations, and directives per year.

If the Commission's interventionist policies are not reversed, a paradox might arise whereby a government—the Spanish government, for instance—decides to deregulate its markets to develop the country's full growth potential, improve its competitive position, and keep price increases under control, but might find its efforts cancelled out by the EU's harmonization strategy.

European Monetary Union: A Political Project

There are no well-founded reasons or at least no indisputable reasons to initiate a process of monetary integration such as the one set out in the Maastricht Treaty. The real motives behind that project have to be sought in the political terrain, basically in the interests of the French and German political classes. The process of economic and monetary integration is one step on the road toward a more ambitious goal: the construction of a falsely federal European political structure.

In the political sphere, one of the most powerful arguments brought forward by proponents of the European Monetary Union has been its identification with peace in Europe. That thesis was propounded explicitly by former German Chancellor Helmut Kohl in a lecture given in Louvain in February 1996, and reflects well the thinking of a large part of the political class of postwar Germany.[3] Those politicians see in a monetary union a solid anchor for Germany in a democratic Europe, which would allow it to expel the family devils that have so stirred up the land of Goethe throughout the 20th century. The European Monetary Union would achieve that goal, but it would also ensure Germany's peaceful hegemony within Europe. In terms of population, its economic power and its strategic position in the center of Europe, Germany would become the heart of a United States of Europe.

France's wager in favor of the European Monetary Union is also a political gamble. The creation of a single currency allows France to shake off the tutelage of the Bundesbank and influence the decisions on Europe's monetary policy from the management Committee of the ECB. It must not be forgotten that, in two years' time, the next president of the ECB will be a Frenchman if the tacit agreement reached for the institution of Europe's issuing bank's administrative structure is respected. The French elites believe that the countries in the south of Europe could be their allies in favor of a more "political"

[3]There is no solid connection between the European Monetary Union and peace. Since the end of World War II, Europe has lived through the most peaceful period of its recent history without having needed a single currency.

monetary strategy versus the orthodoxy of the Germans. Thus, France would also manage to have a dominant role in the European political and economic arena, a role that has been notably curtailed since the reunification of Germany.

Apart from other reasons (the conviction that the European Monetary Union is a means to impose economic discipline and the identification of Europe with progress), the backing of the southern European countries for monetary union stems from the belief that their interests will be better protected within the Union than outside it. That is a flimsy argument. Sooner or later, the European Monetary Union will be enlarged eastward and the former centrally planned economies will enter. From that point on, it will be harder to drum up a sufficient minority to block projects considered harmful to national interests. On the other hand, a large part of the social, cohesion, and structural funds currently received by countries in the south of Europe would no longer be admissible because other EU states would have considerably lower levels of development.

In some countries (Spain and Italy), monetary union is also seen as a mechanism to restrain the secessionist movements within their national boundaries. That approach is also highly debatable. Internationalization weakens the structure of national states from the top down through the transfer of areas of sovereignty to supranational institutions, and from the bottom up by facilitating specific centrifugal movements within states. The internationalization of the economy allows for viable territorial structures that would be unthinkable without the free circulation of goods, services, people, and capital. As soon as the market is global or an open trading area such as the EU, the size of the domestic market is no longer the basic variable constraining the political feasibility of a region. For that reason, the integration of Europe may stimulate instead of weaken those centrifugal impulses of the nationalist movements, and perhaps that is why nationalist parties are so enthusiastic about the European Monetary Union.

From a political standpoint, the European Monetary Union can entail considerable risks for the stability of Europe. To begin with, the "federal" design encouraged by France and Germany is federal in name only, as there is a growing concentration of power in the hands of a bureaucratic elite without democratic legitimacy. Indeed, the European Commission—and the bureaucratic structure at its command—is one of the last remnants of "enlightened despotism" in existence in the western world. The principle of subsidiarity included in the Maastricht Treaty, whereby European-level institutions are involved only in what cannot be done at the national level, is never applied. In practice, things are the other way around. The powers of the nation-states are being transferred to EU institutions in a way that is far from transparent. That phenomenon may strengthen, not weaken, the nationalist movements within the member states of the European Monetary Union and create great tension within Europe.

1999–2002: A Transition Filled with Uncertainty

The process of European Monetary Union designed at Maastricht is, as Bernard Connolly (1996) put it, "out of place, out of time." The enormous transformations suffered by the world's economies over the last 15 years (free movement of capitals, technological revolution, and a drastic reduction of the tariff barriers) are going to lead to a succession of real and in many cases asymmetric shocks in the EU countries. In that scenario, the loss of exchange rate flexibility, with all its limitations, entails certain risks and costs that are not cyclical in nature but structural.

In any case, between 1999 and 2002 (date of the arrival of the euro and the disappearance of the national currencies), there is an interregnum filled with uncertainties. The irrevocable setting of exchange rates between national currencies that continue to remain in force in their respective countries creates a credibility gap regarding the real stability of the exchange rates. If the internal economic policies on an intertemporal horizon are not compatible with a sustained exchange rate parity, interest rates for those currencies with devaluation potential will increase,[4] and there will be many incentives to launch speculative attacks against those currencies. As a result, exchange rate stability in the region may be low.

The long-term interest-rate differentials may vary substantially within the European Monetary Union. The intense reduction in interest rates which has taken place over the last year and a half lies partly in an improvement in the fundamental macroeconomic variables (inflation and deficit) and partly in the market's confidence that the European Monetary Union would occur and that the bulk of EU member states would participate in it. That represents the granting of what one might term a *convergence premium* to those countries destined to form part of the first stage of the Monetary Union. Once those countries are confirmed as members, that premium will disappear, as markets, aware that the efforts of some EU member states to meet the Maastricht Treaty criteria were not based on a true correction of their imbalances, start to look again at economic fundamentals.

[4]Although short-term rates will be the same throughout the European Monetary Union, there is no reason for long-term rates to be the same.

In that case, maintaining market confidence will require very strict economic policies. In the past, markets have attacked currencies from countries with better inflation results than those of Germany. If good behavior in the past and present is not enough to gain recognition as a stable currency, then a tradition of inflation and systematic disregard for budgetary constraints—as is the case with some European countries—makes it mandatory to have a much stricter fiscal policy than that of those countries with a more respectable reputation. In other words, the public deficit within the European Monetary Union must fall below 3 percent of GDP and remain at those low levels for a long time.

Market confidence in the sustainability of rigorous macroeconomic policies consistent with a fixed exchange rate requires the adoption of measures aimed at reducing unemployment. Otherwise, current levels of unemployment or even an increase of those levels will cause such pressure on economic policies that it might lead to the abandonment of monetary and financial rigor. Without greater flexibility in the labor market, financial markets will come to the conclusion that governments will sooner or later embark on lax fiscal and monetary policies. Financial-market conviction that certain countries were incapable of maintaining a very restrictive monetary policy aimed at propping up exchange rate parity in the face of growing unemployment rates was one of the decisive factors leading to the EMS crisis.

Many of the countries that have made it through to the third stage of the European Monetary Union applied some *creative accounting* to comply with the Maastricht goal on the public deficit. Almost all of the EU states drew up one-of-a-kind budgets to meet the convergence criteria. Financial markets treated those "fudged" budgetary policies leniently because they were in favor of a wide European Monetary Union. Now that it is set up, however, they will demand the correction of the structural factors in the deficit. In other words, the reduction in long-term differentials vis-a-vis the German bond is a transitory affair for the peripheral countries and does not correspond to a change in fundamentals of the EU's peripheral economies. If the factors determining the structural public deficit, in particular expenditures on the welfare state, are not tackled within the European Monetary Union, the markets will impose a higher risk premium and will attack the new fixed and irrevocable parities, thus forcing devaluations. Will those countries be capable of reforming those politically extremely sensitive items of the budget? So far the answer has been no, but perhaps the stability pact will give governments the courage they have been lacking until now.

The situation is even worse for countries with high levels of debt, such as Belgium and Italy. Belgium's public debt-to-GDP ratio is 130 percent. To reach the Maastricht goal of debt-to-GDP ratio of 60 percent would take Belgium 30 years and it would also force the Belgian government to have primary surpluses (balance of the budget without the burden of debt interest) of around 5.2 percent of GDP (optimistically assuming 4 percent annual GDP growth and long-term interest rates of 5 percent). Using the same assumption and with a primary surplus of 3.2 percent of GDP, Italy would take 20 years to reach the Maastricht figure. Is such an effort sustainable over decades from a social and political viewpoint?

The situation becomes even more complicated if one takes into account a factor that is often overlooked. When countries lose their monetary sovereignty, the cost of indebtedness increases. The United States provides a good example of this. The individual states usually have lower levels of indebtedness-to-GDP ratios than the federal government, and their financial solidity is guaranteed by constitutional provisions (49 of 50 U.S. states cannot generate current account deficits or are obliged to balance their budgets). Despite this, interest rates for state bonds are higher than for those of the federal government. The reason is very simple: the excess debt cannot be reduced by monetization and there is therefore no risk of bankruptcy if one of the members of the monetary union cannot meet its debts.

In the European Monetary Union, those features of the U.S. system will be highlighted, among other things, by the absence of a central government and by the prohibition imposed by the Maastricht Treaty on the European System of Central Banks from allowing national governments access to credit. The combination of both factors has two consequences: (1) long-term interest rates in the peripheral countries of the European Monetary Union will, in any case, be higher than rates in the core countries; and (2) countries with excessive debt, namely Italy, will be forced to generate constant and large primary surpluses, as interest rates will provide no help and perhaps some hindrance.

The irrevocable setting of exchange rates, even if accompanied by the establishment of a central reserve aimed at maintaining parities in cases of tension, is still not enough to armor plate the European Monetary Union against potential attacks by financial markets. That mechanism of concerted action by the central banks to avoid exchange rate crises has very low levels of effectiveness nowadays. That kind of intervention cannot stand up against the strength of market actions based on a negative opinion of the fundamentals of the economy suffering tensions in its currency when the foreign exchange market is moving 20 billion European Currency Units every day, an amount that is about double the total reserves of all industrialized countries. Recent experience has shown the failure of that kind of action (see Frankel and Dominguez 1993). Capital flows are fatal for any system of fixed exchange rates. In this case, there is a high risk associated with introducing capital controls to eliminate "speculative" movements.

Finally, whether the convergence conditions are made more flexible *de jure* or *de facto*, there will be exchange rate tensions and markets may revoke the idea of upholding fixed exchange rates. That possibility is accentuated by changes that have recently taken place on the European political scene, particularly in Germany. The socialist governments of Europe are backing economic philosophies that are scarcely compatible with the monetary and financial stability criteria enshrined at Maastricht. In fact, they have already pointed out the need to make a freer interpretation of the principles underlying the stability pact and have recalled that the ECB does not have the sole goal of price stability but must also support European policies. That hypothesis has already been confirmed by the decision of the Council of Economy and Finance Ministers of the European Union to allow Italy to ignore the public deficit criteria established in the Maastricht Treaty and the stability pact. In this case, the conflict between the political and economic targets pursued by some European governments and the need to have sound fiscal and monetary bases for the European Monetary Union may turn out to be insoluble.

The European Monetary Union and the Global Economy

The weight of Europe's economy on the world stage is similar to that of the United States. The European Union accounts for 31 percent of world GDP and approximately 20 percent of world trade. It is possible that (1) the euro will become an alternative to the dollar as a reserve currency and as an instrument for international transactions and (2) the role of Europe's economy on the international scene will become more prominent. Some authors have predicted a speedy reorganization of international portfolios with a strong shift from dollar-denominated instruments toward euro-denominated ones (see Bergsten 1997).

For a currency to play an important role on the world stage, a series of conditions must be met: considerable clout in the world's economy and trade, independence from external restrictions, absence of exchange controls, extensive and liquid capital markets, and the strength and stability of the economy and its foreign trade position.

The EU would be large enough for its currency to take on a world role. At the same time, Euroland is a relatively closed economy, making it less vulnerable to external shocks and giving a certain freedom for capital flows. Of the five requirements needed for the euro to attain the status of an international currency, it clearly meets three. The other two, however, have not yet been met. European capital markets are neither as deep nor as liquid as their North American equivalents. The U.S. securities market is twice the size of all its equivalents in Europe taken together, and customary practice differs greatly in the various European capital markets. Except for Great Britain, the operation of capital markets in Europe is much less liberal than in the United States.

But perhaps the least clear issue when speculating about the euro becoming a competitor for the dollar is the question of the European economy's strength and stability. In the short term, the euro will fluctuate significantly with respect to the dollar because of the different cyclical positions of the two economies, but in the medium and long term the values of the two currencies will reflect the underlying strengths of their economies. In that sense, the euro will have to earn its spurs as a solid and stable currency, something that will not happen overnight but will require some considerable time. For many years, the pound enjoyed a degree of international importance that was no longer justified by the strength of the British economy. From this standpoint, the euro's credibility will, to a large extent, depend on the policy applied by the ECB and on that score, as has been shown, there is more than a reasonable doubt.

On the other hand, the strength of the euro will also depend on the strength of the economy in Europe. The EU is currently an area with little dynamism, with severe and as yet unresolved structural problems, and without clear solutions in the offing. With a very high tax pressure, excessive market intervention, an aging population, considerable unemployment, and the expensive burden of social protection systems, the economy of continental Europe has severe problems in adapting to the requirements of an open and competitive economic order. The U.S. economy, on the other hand, has carried through the necessary adjustments, at least the most essential, to be able to operate in the new international economic order.

In short, the euro may become an important international currency but it is difficult to believe that it can displace the dollar or represent strong competition to it in the short term.

Conclusion

On the positive side, the European Monetary Union represents the consolidation of a culture of macroeconomic stability that is very important, in particular, for countries such as Spain and Italy that have lacked that for so long. Nonetheless, the establishment of a single currency area entails a risk if its member countries decide to implement protectionist barriers and capital controls as a substitute for the tax adjustments and appropriate reforms in the labor market institutions necessary to maintain fiscal balance and reduce unemployment. Those dangers have become more acute with the political changes in Germany. The new government shows much less financial and monetary orthodoxy than its predecessor, thus increasing the doubts that Euroland will enjoy high levels of stability.

References

Adam Smith Institute (1995) *Europe at Risk*. London: Adam Smith Institute.

Bayoumi, T., and Eichengreen, B.J. (1992) "Is There a Conflict between EC Enlargement and European Monetary Unification?" Centre for Economic Policy Research Discussion Paper No. 646, 30 May.

Bergsten, C.F. (1997) "The Dollar and the Euro." *Foreign Affairs* (July/August): 83–95.

Bernaldo de Quiros, L. (1999) "Crisis ¿Que Crisis?" *La Ilustracion Liberal* 1(1): 69–87.

Commission of the European Communities (1990) "One Market, One Money." *European Economy*, No. 44 (October).

Connolly, B. (1996) "EMU: Out of Place, Out of Time." *Economic Affairs* 16(3): 33–35.

Delors, J. (1991) "EC Summit." Agence France Presse, 10 December.

Frankel, J., and Dominguez, K.M. (1993) *Does Foreign Exchange Intervention Work?* Washington: Institute for International Economics.

Friedman, M. (1953) "The Case for Flexible Exchange Rates." *Essays in Positive Economics*, 157–203. Chicago: University of Chicago Press.

Kenen, P. (1969) "The Theory of Optimum Currency Areas: An Eclectic View." In R. Mundell and A. Swobodaa (eds.) *Monetary Problems of International Economics.* Chicago: University of Chicago Press.

Mundell, R. (1961) "A Theory of Optimum Currency Areas." *American Economic Review* 51 (September): 657–65.