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Class B

The EMU

Quoted References:

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Introduction

One of the most critical issues on the political agenda of today's governments of the European Union is the question of whether to join or not to join the European Monetary Union (EMU), thereby creating a Europe-wide single currency. Governments' power has hinged upon their decision in this matter[1] and remaining undecided about the topic has led to equally unfavourable reactions from the public.

In this essay I would like to contrast the benefits and the costs of such a monetary union, stressing the economic arguments and how they are linked to the theory of Optimum Currency Areas.

In the second part I shall take a look at the Maastricht Treaty of 1991 and discuss how it relates to the economic theory, and what the economic consequences of the treaty have been and may turn out to be, thereby elucidating some serious flaws in the approach the treaty takes.

In the last section I shall take a look at monetary policy's counterpart, namely fiscal policy, and I will discuss the form fiscal policy might have to take in a monetary union scenario.

Benefits versus Costs of EMU

In analysing the benefits that may arise from a monetary union, it is necessary to distinguish between *direct* benefits and *indirect* benefits arising from such a union.

The direct benefits arising from a monetary union are said to be the following (Tsoukalis 1997:180):

- Savings in Currency Conversion
- Risk reduction through elimination of exchange rate variability and uncertainty
- Price stability

[1]eg France, where Alain Juppé's policy of enduring economic hardship in order to participate in the EMU led to the dramatic change to a socialist government under Lionel Jospin

The savings in currency conversion arise from banks no longer being able to accrue a commission every time an exchange from one currency to another takes place. This commission is clearly a deadweight loss and its abolition presents an increase in social benefit. (de Grauwe 1997:53)

The fact that risks are reduced in a monetary union is only beneficial if the average European citizen is seen to be risk-averse. Monetary Union may indeed remove certain risks, but through doing so it also diminishes average expected utility, so this outcome does not necessarily present an a priori benef. (de Grauwe 1997:55)

The issue of price stability is the most crucial one and serves as an explanans for almost all the indirect benefits associated with a monetary union. Price stability is said to come about in a monetary union because all decisions in monetary policy will lie in the hands of the European Central Bank (ECB). What is a fact is that through the political shift (in terms of monetary policy) away from national governments towards a centralised institution, governments can no longer entertain a policy of high or increasing inflation in order to overcome other macro-economic problems. The question is, however, if this political shift will actually lead to lower inflation and increased price stability, since the ECB could also apply policies that don't necessarily reduce inflation. This problem will form a large part of the following discussion.

In order to analyse the costs of a monetary union, it is helpful to take a closer look at the benefits of maintaining a national currency and hence the exchange rate as an economic instrument.

The benefit of the exchange rate instrument is, put very simply, that when a country experiences a situation of a severe *asymmetric*[2] demand shock, it can regain its lost competitiveness by employing a devaluation of its own currency (de Grauwe 1997:29).

However, it is clear that such a devaluation does not happen without a cost involved: an improved equilibrium through devaluation cannot be sustained because the prices of imports rise through a devaluation, decreasing the purchasing power of the people in the devaluating country. This will cause wages and prices to shift upwards in order to increase purchasing power, which in turn causes a shift in the supply schedule: the long-run outcome of a devaluation is that prices have gone up, whereas real income has remained at its depressed level. (de Grauwe 1997:29)

[2]ie, other countries don't suffer the same shock, or even a shock in the opposite direction

This is exactly the *monetarist* argument that implies that an exchange rate instrument is, in effect, no instrument at all, since it merely changes *nominal* values and not *real* ones. (de Grauwe 1997:30)

The monetarist argument would thus imply that there is no cost involved in giving up the exchange rate instrument and thus a monetary union bears no real costs.

There is, however, a Keynesian counterargument, namely that prices and wages are so *rigid* in some cases that it is worthwhile for some countries to keep the exchange rate instrument, since it can have positive real effects. Indeed, "Only a small minority of economists would go as far as arguing the complete ineffectiveness of the exchange rate as an instrument of adjustment". (Tsoukalis 1997:181)

It can therefore be purported that a monetary union is beneficial for some countries, and costly for others. But which ones, and why? Enter *Optimum Currency Areas.*

The theory of Optimum Currency Areas states that the benefits a country can gain are directly linked to the degree of *flexibility* and *mobility* a country demonstrates in its *prices, wages, and labour markets* respectively. Thus, the more flexible the labour market institutions and the more mobile labour, the more worth while it is for a country to join a monetary union. (de Grauwe 1997:73)[3]

The question is whether all EU countries form an optimum currency area. The answer is a definite *no*. Some countries would still need to aquire more labour mobility and wage flexibility in order to be within an optimum currency area.[4] Most economists agree that roughly eight to ten EU countries would form such an optimum, but hardline monetarists purport that it would still be worth it for the other countries to join, since this would force

[3]This principle can be demonstrated in the case of the 70s recessions of Belgium and Michigan: both regions gradually got out of the recession, but whereas in Michigan this was mainly due to workers migrating to other states, in Belgium the recovery was helped by a devaluation of the Belgian Franc. Had Belgium not had the possibility to devalue its currency, it would have found itself in a very critical situation, since it could not rely on workers migrating to other parts of Europe. (de Grauwe 1997:77)

[4]at this point it may be interesting to point out a comment made by de Grauwe that it might actually be beneficial for some nations to split their regions into different monetary areas, thereby creating a few optimum currency areas in the same country.

them to change their labour market institutions and degrees of mobility, thus creating a self-fulfilling prophesy.

Macro Treaty vs Micro Theory

In December 1991 the heads of state of the European Union met up in Maastricht to sign a treaty that lay down the agenda of creating a monetary union through the principles of *gradualism* and *convergence* (de Grauwe 1997:127). Three stages were laid out for the monetary union to take effect[5] which span roughly a decade (gradualism) and convergence criteria[6] were laid down for countries to achieve in order to participate in monetary union (convergence).

One astounding fact was the arbitrary nature of the convergence criteria relating to government budgets. This is where it is important to take into account Germany's position in the monetary union. It could be easily argued that Germany doesn't have any economic interests in joining such a union, since it is teaming up with countries that have lower inflation performances. However, as Tsoukalis points out, Germany's decision to join rests on strong political motives[7]. "A monetary union without Germany makes no sense; and Germany will not have a monetay union unless on its own tems" (Tsoukalis 1997:171)

Thus Germany's main concern was that the new ECB should follow strict policies of low inflation, and that this would be made more difficult if countries with high inflation would join. These might put pressure on the ECB to employ policies of higher inflation and already the fact that governments with a bad inflationary reputation join the union would make the ECB less credible to begin with, thereby making lower inflation even more difficult (de Grauwe 1997:130ff)

Germany therefore wanted to be very sure that the countries joining the union would be in an economic position that would let the ECB follow a low-inflation route: high inflation would raise aggregate inflation (or, at least, the possible demand for it), and high budget debt and deficits would lead to governments possibly wanting to revert to higher-inflation politics.

De Grauwe (1997:136) points out that there might be a "self-defeating aspect" of the criteria[8]. He argues that some of the criteria, especially the ones concerning the budget deficits, are too harsh for countries to attain and that they even act as causes for some countries to get even further away from the criteria.

De Grauwe points out the big difference between the proposals made by the economic theory mentioned above and the convergence criteria laid down in the treaty: the treaty lays down rules in the conduct of *macroeconomic* factors, whereas the theory advances proposals to make major changes in *microeconomic* factors, namely labour mobility and wage flexibility.

The question arises, as to why not to have a faster transition, thereby not giving time for economies to deteriorate even more and letting them converge *after* the transition[9]. One problem with this (more monetarist) argument, however, is that initial inflation differentials and price and wage inertia may lead to unsustainable differences between countries within a union.

The economical argument supporting the Germans, however, still remains strong: the risks involved in letting too many countries with a bad history of inflation join the union are too high for Germany, so that the criteria must be seen more as a way to let *less* countries join the union to begin with, rather than enforcing a low-inflation regime on those countries that might be threatening.

However, if countries do reach the targets, there is still no guarantee that they will not revert to high-inflation politics once they're in. For this reason Germany has proposed the

[5]The three stages are:
1. Stage: EMS countries abolish all remaining capital controls
2. Stage: EMI is created as precursor to ECB, functioning to srengthen monetary co-operation between national and central banks.
3. Stage: Exchange rates between national currencies are irrevocably fixed. Euro becomes legal tender. ECB starts its operations.

[6] These convergence criteria are the following:
1. The inflation rate is no higher than 1.5% points above that of the three countries with the lowest inflation.
2. The long-term interest rate is to be no higher than 2% above that of the three countries with the lowest rate.
3. No devaluation of the national currency is to take place in the three years preceding the entrance into EMU.
4. The government budget deficit is to be no higher than 3% of GDP.
5. The government debt is to be no higher than 60% of GDP.

[7]Helmut Kohl said that economic and monetary integration was a matter of 'war and peace in the 21st century' (Tsoukalis 1997:170)

[8]"A striking fact is that during the 1990s economic growth in the group of countries that have declared their intention to follow the Maastricht transition strategy has been low compared to the previous decade and compared to the industrial countries not involved in the Maastricht strategy."

[9]This, after all, is what happened with the unification of the two Germanys

implemenation of a 'Stability pact', that ensures that governments don't overshoot their deficits, through the threat of heavy sanctions if they do.

The discussion of the stability pact leads us directly to a very important question: what will fiscal policy have to look like in the event of an EMU?

Fiscal Policy in EMU

A national government loses two very important economic tools when joining the EMU: that of money creation and that of the exchange rate.

In other words, the only macroeconomic tool left to governments now is that of *fiscal poicy*. However, there are some strings attached, even to this instrument.

Ideally, in the case of asymmetric demand shocks, a country should be able to rely on either a centralised European Budget or a very flexible internal budget. If we compare Michigan and Belgium again, we can see that Michigan managed to smooth its recession through receiving direct purchasing power from the Federal budget. In other words, the other states subsidised Michigan's recession. Belgium, on the other hand, could not rely on a central European budget that supplied purchasing power, so it had to use other fiscal tools, namely that of enlarging its government debt, thus making the consumption-smoothing inter-generational rather than inter-regional (de Grauwe 1997:80).

The problem with the EU countries today, however, is that they cannot make use of either tool of fiscal stabilization. The central European budget is not large enough to accomodate asymmetric shocks, and the stability pact, with its harsh rules, does not allow for much budgetary flexibility.

The argument for the stability pact is that it prevents countries declaring outright default on their debt, since they cannot accumulate such debt to begin with, and that it is a further guarantee that some countries don't have to bail other countries out in problematic times[10]. The stability pact thus aims to enforce fiscal discipline on the countries participating in the EMU.

[10]This is further enforced with the no-bailout clause in the treaty.

However, this strictness may lead some countries to unsustainable situations of economic hardship, which will only create further disunity between the countries within the EMU, which is exactly what was to be avoided *through* the creation of the EMU in the first place. The risk of disunity is probably bigger in the case of strict enforcement of the stability pact than the risk of outright default or bailouts in its absence (de Grauwe 1997:207).

Thus, it seems that a centralised European budget is the only really safe fiscal system in which a monetary union would work.[11] There aren't, however, any great plans to create such a central budget as yet. The question is if such a centralised budget will come about as an automatic consequence of an EMU. Some argue that the political unity created through an EMU will accelerate the creation of such a budget. If, however, an EMU without a central budget is given enough time to create tensions between nations, then the political unity proclaimed by everyone will not be there to see a central budget through, and we would be left standing with a very detrimental monetary union.

[11]C. Allsop and D. Vines argue, however, that a centralised budget is not the only solution, and that it is just as good, even necessary, to enforce a global cut in interest rates, thus ensuring a sustained rise in private sector investment and growth which is needed for the success of an EU economy.