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Άρθρα - Articles

The European Monetary Union: Success or Failure?*

by
Willi Semmler

1. Introduction

The European Monetary Union (EMU) has set new monetary and fiscal rules for Europe for the next century to come. In May 1998 11 countries have formed the EMU and on January 1, 1999, with introduction of the Euro, the last stage of the EMU is near completion. New members of the EMU are about to be included. Greece will be included soon and for Denmark there is an important referendum in September 2000. Sweden is still outside and Great Britain is still waiting and watching which way the EMU goes. Will the EMU be a crisis-ridden currency union or will it be a prosperous currency region? There are still some doubts of how the EMU will work in in the long run. Before the birth of the Euro there were three views on the EMU.

American economists (Dornbusch 1996, Feldstein 1997) were very skeptical about the EMU before the EMU was introduced. Some of them (Feldstein 1997) predicted (and still predicts) it to be a failure. He predicts stronger business cycles and "lower standard of living" (Feldstein 1997) for Europe. The economic problems might lead to political instability in Europe and, possibly, to a rising conflict between the US and Europe (and the Euro and the US dollar).

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Many European economists and politicians were rather optimistic. Public optimism was displayed in particular by the conservative parties who have initiated this project. Business leaders and the financial sector have supported the last step toward the European economic unification. Large firms and banks were, from early on actively pursuing mergers and acquisitions in order to position themselves in the new Europe. The mergers and acquisitions have been undertaken with increasing speed after January 1999.

There is a third position which is represented by the center-left parties in Europe. Many representatives of this camp have felt themselves trapped in the preparation for the Euro. The EMU has been initiated by the conservative parties in Europe and when the center-left parties, were in power in 1999 in most of the European countries, they had no other choice than to continue the project. The preparation of the Euro had been costly for a large section of the population. The restricted monetary and fiscal policies have prolonged unemployment in Europe. With the new parties in power in Europe, however, the EMU had undergone substantial changes.

Overall, the process of the EMU will not be finished in 2002 when the new currency is officially the legal tender. Mistakes will be made and reforms will be needed. Since there are new monetary and fiscal institutions and rules, mostly fixed in the Maastricht Treaty and then amended in the Amsterdam Agreement (1997), we will focus, after a brief discussion on the achieved convergence, on the new fiscal and monetary arrangements that have been agreed upon by the treaties leading the EMU. We will describe the new arrangements and then evaluate the main problem areas.

2. From the European Common Market to the European Monetary Union

2.1. *Reasons for the EMU*

There have been many arguments made concerning the cost and the benefits of the monetary union. The benefits are: First, the EMU eliminates exchange rate uncertainty and reduces transaction cost from currency conversion. This cost was estimated by the Bank of International Settlement as 0.25 and 0.4 percent of the GNP. The EMU also implies reduced accounting and increased transparency in competition. Second, monetary disturbances will be reduced and there will be insulation from the volatility of currencies. Thus, so it is argued, countries, before the EMU needed a high interest rate policy to defend the currency against market attacks (Eichengreen, 1997). Eichengreen points to the experience of September 1992, where some countries (Sweden) had to raise the short term interest rate to 50% to defend the currency. Third, most of the smaller countries want the EMU in order to avoid the dominance of the German Bundesbank in Europe. Since one did not want to go back to the flexible exchange rate system, where each country could use monetary and exchange rate policies to stabilize macroeconomic imbalances, the fixed exchange rate system (EMS) was the only option. Under the EMS, however, the German Bundesbank has set the monetary targets or interest rates and the other countries lost their policy instruments. Thus, many countries have prefered the EMU in order to have a voice in the current policy decisions in Europe.

The EMU was planned in three steps phases. Phase 1: until the end of 1993, ratification of the treaty, decision on the European Monetary Institute (EMI) and capital market liberalization. Phase 2: from 1994 the EMI coordinates the monetary policy of the central banks, technical preparation of the EMU. Phase 3: May 1998 decision on the 11 members and fixing of the exchange rates, EMU January 1, 1999, dual currencies until 2002, then Euro as single currency.

The economic convergence can be seen in a most financial and monetary time series for the EMU countries. There has been, since the middle of the 1970s, a strong convergence in GDP growth, inflation rates, interest rates, interest rates spreads, stock market performance, labor markets, exchange rates and public deficits.

3. The Fiscal Adjustments and Fiscal Rules

3.1. *The Treaties*

According the Maastricht Treaty (1992, ratified by the member states 1993) the following fiscal criteria were required for entry into the Union: 60% debt to GNP ratio and 3% deficit to GNP ratio. Although the 3% deficit rule might be viewed as consistent with the 60% debt rule, many economists in Europe have argued that the Maastricht criteria were too tight and the required fiscal adjustments too restrictive and deflationary (Buiter and de Grauwe). We will discuss this point later. Let me first show what fiscal rules were set-up for the EMU. The Fiscal Stability Pact (Agreement of Dublin 1996, Amsterdam 1997) required the following.

As for the entry into the EMU for the membership in the EMU it is also required: at most a 3% deficit and 60% debt to GNP ratio but the budget should be balanced in the medium run. Deficits should be counteracted by budget surpluses in the subsequent periods, so that the countries aim at a balanced budget and countries with budget deficits exceeding 3% (except if the countries face natural disasters or sudden 2% or more drop in GNP) are subject to a fine. For a deficit between 0.75% and 2% an approval is required. Violations of the above 3% rule (which is very likely to happen in recessions) invoke the Excess Deficit Procedure (EDP): penalty for fiscal violations are imposed; the EDP is declared by the European Council upon a report by the European Commission and a judgement by the Monetary Committee. As penalty is imposed: 0.2% -0.5% of the GNP (the size depending on the excess deficit). This will be a permanent penalty if deficit is not reduced within 2 years. Member states are not liable for the debt of other states and the ECB will not (ex post) bailout member states by monetizing government debt or (ex ante) by low interest rates to lighten the debt service (no bailout clause).

3.2. *A Preliminary Evaluation of the Fiscal Rules:*

Here are some preliminary considerations on the fiscal rules (a consistency check of the new fiscal rules is undertaken in the appendix): The controversies on the fiscal pact are as follows:

It is not quite clear whether the potential candidates for the EMU should be measured by the fixed ratios (of deficit to GNP or debt to GNP ratios) or whether the government debt should be judged as sustainable. Sustainability should be interpreted as solvency condition and the criterion for the entry and membership of countries in the EMU should be, as some argue, the solvency of the government (Wyplosz 1997, Semmler and Sieveking 1997, Greiner and Semmler 1977b). Moreover, 3% deficit in a recession might not be enough and the requirement of a balanced budget (on average over the business cycle) amounts to decreasing the debt-GNP ratio to zero.

Fiscal rules do exist in many countries (Germany 1967, Japan 1995, US

States, Canadian Provinces 1996/1997). Yet, rules that require balanced budgets are really only rules for subcenters (states or provinces). Many economists in Europe (and the French Government) argue that one does not need the fiscal pact and the Excessive Deficit Procedure. It is pointed out that a penalty to fiscal violations will be imposed through the financial market. De Grauwe (1996) for example, argues that the national governments should be left free to engage in countercyclical policy. The capital market will retrench governments. Eichengreen and von Hagen (1997) refer to the US where the States are not constrained by the Federal Government and yet state debt is low. Moreover, national states still control the bulk of Europe's tax. The existence of the taxing capacity of the states (subcentral governments) will make the EDP redundant, since tax raising capacity can help to control the deficit.

The counter-argument (see McKinnon 1997) is, of course, that the initial level of debt of some European member states is too high, risk premia could be high and default, or credit rationing is likely. McKinnon (1997) points out that the existing debt of EU member states is much higher than the US-States. Government bonds are widely held by pension funds and European national governments are "too big to fail". The inability to roll over existing debt becomes likely and a "bailout" will be required.

There is another problem that arises when the penalty for fiscal violations is left to the financial market. It is true that governments might have to pay a default risk on government bonds for excessive deficits. To the extend that markets price risk correctly the demand for public debt could be constrained by the market. However, history suggests skepticism about the ability of the market to impose discipline as argued in theory. In practice, markets are rather volatile and when markets react to "discipline" governments it is often too late and too violent. The market abruptly cuts financing, making it impossible for governments (states or local authority) to borrow further and states must declare insolvency with strong financial and economic consequences. This may then also lead to the situation where the central banks then might feel compelled to monetize part of the debt. Does this, however, require EDP? We will have a further discussion on this problem below.

Finally it is controversial what "public deficits" means: as it was defined in the treaties productive government investments are not considered as part of the deficit (should this be included in the 3% deficit rule? This is an open question, see article 104c of MT). (Also, spending for human capital is not considered as productive government investment). In recent times, however, the definition of the deficit moves into the direction of the German definition: namely to allow deficit only if it used for infrastructure investments.

4. Monetary Rules and Monetary Policy

The monetary convergence criteria required by the Maastricht treaty were: Interest rate not 2% above the three countries with the lowest interest rates. The inflation rate should not be 1.5% above the three lowest inflation rate countries.For the exchange rate should a 2 years membership in the EMS.

4.1. *European Central Bank*

The monetary policy is executed by the independent European Central Bank (governing council of the ECB consists of the Executive Board plus governors of the EMU member banks). Originally the ECB was built according to the model of the German Bundesbank. In fact, the status and the objectives of the ECB originally were designed to remarkably resemble those of the Bundesbank: strong independence, price stability as main objective (yet no mentioning of other stabilization goals as the German Stabilitaetsgesetz, 1967 does): indirect inflation targeting through the control of money supply and no monetization of government debt by the ECB (also the member banks are not permitted to issue treasury bonds for the government; governments instead have to float bonds on the capital markets in order to compete with private borrowers).

4.2. *A Preliminary Evaluation of the Monetary Policy Rules*

Recently, there have been extensive discussions on the objective functions of a monetary authority (see, for example, Gong, Semmler and Flaschel 1999). The discussion focuses mainly on two rules. The monetary authority should:

- target monetary aggregates

$$\hat{M}_t = \Delta M_t / M_t = \hat{p}_t^* + \hat{y}_t^*$$

where $\hat{M}$ = rowth rate of money supply, $\hat{p}^*$ = the targeted inflation rate $\hat{y}^*$ = growth rate of potential output.

Advantage: of this procedure was supposed to be Bundesbank reputation; Disadvantage: is the mobility of the control of money supply and unstable money demand.

- target the inflation rate:

$$r_{t+1} = r_0 + \beta_{r_1}(r_t - r_0) + \beta_{r_2}(\hat{p}_t - \pi_t) + \beta_{r_3}(U_t - \bar{U})$$

where r = short term interest rate, r_0 = target interest rate, $(r_t - r_0)$ = interest gap, $(\hat{p}_t - \pi_t)$ = inflation gap and $(U_t - \bar{U})$ = output gap.

The advantage is: direct inflation control, transparency and accountability of the ECB; Disadvantage: is the adequate inflation measure in the different member state (half of the member states pursue this concept of inflation control; for example, UK, Finland, Italy, Spain).

The Bundesbank wanted the first concept to be adopted for the ECB. It argues that the first concept has gained credibility over the last 40 years and this credibility will carry over to the European Central Bank (ECB). In its view, the control of monetary aggregates have been successful to control inflation. The most critical points are, however, the "measure of money" and the assumption of a stable relation between money, income and interest rate. If the money demand is unstable a shift in money demand parameters will make interest rates moving around a lot. The Bundesbank quotes numerous studies that are supposed to show a stable money demand function in Germany (Luetgepohl and Wolters 1997). The Bundesbank, admits, however, that even if it had been stable in the past in Germany, this might not be so for the entire Europe. Although the Maastricht Treaty contains no explicit guidelines and gives the ECB complete freedom in implementing its policy, the Bundesbank was defending its concept of controlling inflation:

> "The prepatory work undertaken by the EMI has reduced the possible alternatives to just two strategies, that is monetary targeting and inflation

> targeting... There is a good chance that... monetary targeting will fulfil the prerequisites." Yet, the "initial phase of the monetary union will be burdened by a number of imponderables... this will have an impact on the growth of money stock. It is thus advisable by including some elements of inflation targeting." (Issing, January 1998).

Recently, the ECB has also admitted that the concept of direct inflation targeting may be more useful in Europe. The ECB seems to realize what has worked for Germany (the money supply rule) might not work for Europe. Direct inflation targeting would give rise to more transparency and accountability of the ECB. The ECB has recently more and more adopted the inflation targeting rule, however, always with some escape clause. The inflation target is based on an official European cost of living index.

4.3. *Exchange Rates and Exchange Rate Policy*

The Maastricht Treaty required exchange rate stability before the entry. A two-years membership in the EMS was required for the members of the EMU. For the conversion rate between the Euro and the currencies of the EMU members the actual exchange rates of December 31, 1998 were taken. The exchange rate with respect to other currencies and the ("outs") is under control of the European Council, but the Council has to support the aim of price stability. Yet, the main question, is how an exchange rate is sustained without coordination with the monetary policy. In fact in practice the ECB tried to counteract the sliding down of the Euro vis-a-vis the dollar when the Euro fell by almost 20% against the dollar. This fall of the Euro was not surprising. The Euro was over valued when it was introduced in January 1999. Since, however, Euroland is the richest region of the world in terms of current account surplus and net foreign assets (see Semmler and Sieveking (1999)), in the long run, the Euro will again rise against the dollar. Moreover, as the perspective of economic growth in Euroland rises again it becomes an attractive asset market for international investors. Thus the Euro will recover its loss the long run, although it will be volatile as other currencies in the flexible exchange rate systems.

5. Potential Problem Areas

5.1. *Is the Primary Goal of Controlling the Inflation Rate Justified?*

In order to sell the EMU to its German constituency the previous (conservative) German government had pushed for the inflation rate to be the major target of the ECB. Yet, there was already a low inflationary environment of the 1990s in Europe (and also in the US) which was quite favorable for achieving inflation targets.

The inflation rates were low because of high interest rate policies by central banks in the 1980s, the German anti-inflationary policy after 1992 (which raised interest rates to a record high in order to break the spending boom after the unification), the reasonable wage bargaining of the Trade Unions in recent years and low expected inflation in commodity and financial markets. Moreover, there is now in Europe strong external pressure and competition from abroad so that inflation remains low.

All the markets where one can extract information from on future inflation rates did not signal high inflationary expectations (labor market, product markets, financial market and commodity market). The inflationary expectations are low and so monetary policy faces nowadays a lower expected rate of price change then in the 1970s and 1980s. In other words the Phillips curve, although still convex, has become flatter[1]. Moreover, the NAIRU is estimated in the U.S. to be around 5.5%. In Europe the NAIRU cannot be 9.5%.

In addition the fall out of the Asian financial crisis (and Russian exchange rate and financial crises) created a pressure of cheap imports and low commodity (future) prices. The annual inflation rate, for the current year, is roughly 2%. With those inflation rates modern economies can live.

One should also mention that, according to the fiscal theory of the price level, the independence of the ECB by itself is no guarantee for low inflation rates, also fiscal policy matters, see Woodford (1996) and Sims (1997).

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1. Moreover, one can say that there were substantial losses for recipients of welfare expenditures and social security and low income groups in the preparation stage of the Euro. One is almost tempted to say that they lost more income before the creation of the Euro than they will lose under the Euro through inflation rates.

5.2. *Were the Fiscal Austerity and Retrenchments Useful and Successful?*

The fiscal arrangements before the entry into the EMU required a restrictive fiscal policy even when unemployment was high and growth low. The EMU is supposed continue this policy. But does such fiscal retrenchment work? In recent years, numerous studies have explored the effects of fiscal austerity and retrenchment since the 1980s. The question has been explored of whether deficit reduction (under the condition of high unemployment rates) will in fact be lasting.

There are two theoretical positions on this matter. The Keynesian position argues that spending reduction will reduce effective demand and thus decrease output and employment whereas the rational expectations position is that spending reduction will decrease expected long term interest rate and thus increase private spending (this is the position, for example of John Taylor in the U.S.). In fact, a realistic position is that of the debt is low Keynesian (expensionary) effects prevail, if debt is high contractionary effects may hold (see Gong, Greiner and Semmler 2000).

According to detailed empirical studies such as by Alesina and Perotti (1996) and others some conuntries (Ireland and Denmark) could successfully reduce their deficit. The studies show, however, that deficit reduction through tax increase and reduction of public investment will not be lasting but deficit reduction through reducing transfers and public consumption will be lasting. There is a strong composition effect[2] and it is by now recognized that those countries where successful in the deficit reduction where fiscal policy adjustments where accompanied by other policies such as monetary policy (to reduce interest rates), exchange rate and wage policies. This appears to explain the success of Ireland and Denmark. Other countries were less successful and the policy was contractionary. Fiscal policy did not reduce the deficit.

Now given those experiences what does the EDP imply? The EDP may not do much harm if regional shocks occur and there are sufficient transfers from the center. (Note, however, that there no agreements on such transfers yet). The EDP might be failure when the EMU countries face a common shock or a business cycle downturn. Some countries might face the EDP and

2. See also Greiner and Semmler (1998, 2000).

other countries, in order to avoid the EDP, may pursue a contractionary fiscal policy. Yet, a joint fiscal retrenchment in a contraction is neither a reasonable procedure nor can one cite any historical experience where it has been unambiguously successful. Moreover, the balanced budget requirement amounts to decrease the debt to GNP ratio to zero.

One could, however, imagine fiscal rules such as the German constitution provides which says that in normal times deficit is permitted only for public investment, a further increase of the deficit is permitted solely in the case of severe macroeconomic imbalances[3]. The consequences of such a rule for long run growth have been discussed in Greiner and Semmler (1999, 2000). One could also require commitments of the governments to reduce deficits in an orderly and planned manner, for example requiring a time period for the reduction of the excess deficit, say five to seven years (as has been discussed in the U.S. in the 1990's).

5.3. *The Wrong Policy Mix: High Cost for the Labor Market?*

In preparation for the EMU the labor market has been affected most in the core countries (except U.K.). The tight monetary policy aiming at inflation and the restricted fiscal policy have helped to create a low growth climate in Europe in the 1990s with an overall unemployment rate of 10% and no net job creation.

There was a wrong mix of fiscal and monetary policies in Europe. In the U.S. the restrictive fiscal policy sind 1990 was accompanied by a less restrictive monetary policy. In Europe since 1990, the restrictive fiscal policy and the falling growth rate of output was accompanied by a high real interest rate policy. In the U.S. the restrictive fiscal policy was counteracted by monetary ease the public deficit could thus be reduced and growth rates increase. In Europe for the EU 11 countries the restrictive fiscal policy was not successful. The deficit and debt until recently instead increased as growth rates became low and unemployment rose. This wrong policy mix is partly still built into the EMU arrangements.

The current labor market situation is a follows. We can see countries with low and high unemployment rates:

3. See Stabilitäts-und Wachstumsgesetz, in Germany 1967.

Low Unemployment Countries (January 1998)

Lux	Aust	Neth	Den	Portug	UK
2.2	3.4	2.9	4.8	4.2	5.5

High Unemployment Countries (January 1998)

Swed	Belg	Irel	Germ	Fran	Finl	Spain	Euro
9.2	9.3	9.8	10.8	12.5	12.7	20.8	10.6

Source: Data from Eurostat, News Release, July 2000.

The central bankers in Europe (at least the Bundesbank) have always had stressed that the problem for the EMU are the labor market rigidities in Europe (and those should be solved first before monetary ease could be pursued). Often the high mobility of labor and more flexible labor market institutions of the U.S. are quoted as a good examples for an (optimal) currency union. In Europe the presence of strong (and in some countries highly centralized) labor unions wage rigidities and the welfare state are quoted as facts working against the currency union. (Yet, one should mention that the U.S. was not an optimal currency union in the 19th century either.) Politically enforced labor market flexibility and labor mobility in Europe might, however, become a political liability. There have already been undertaken some labor markets reforms in Europe (Netherland, Denmark) with some success in increasing employment.

Some core countries (France Germany) do appear to have some structural problems causing in particular long term unemployment. As shown Gong, Semmler and Flaschel (1999) labor market institutions and high social welfare standards are only part of the problem. There is not more wage rigidity in Germany than there is in the U.S. (may be even more wage flexibility in Germany). The unit wage cost (product wage) in the last 10 years rose faster in the U.S. than in Germany (Germany experienced strong productivity increase and an export boom, not indicating excessively high wages). The change from the traditional industries to the new knowledged based industries has not gone fast enough in Germany and bottle necks for employees with high technology skills are already appearing. Therefore, Germany seems to have lost on the product market (in some industries) and has not been moving so fast into IT (information technology) areas as the

U.S. The German unemployment problem seems to be also caused –beside by in the above mentioned restrictive monetary and fiscal policies– by a lack of success in the product market and the founding of small scale venture firms (start up firms).

How helpful will be the new monetary and fiscal arrangements overcome unemployment? It is a cost of the currency union that individual regions forgo the ability to use monetary and exchange rate policies to respond to region specific shocks: region specific imbalances, unemployment rates or region specific inflation rates. A single currency region may exacerbate unemployment by eliminating the possibility of national differences in interest rates and of changes in the exchange rates. This may increase the cyclical instability of the economies. With the current fiscal arrangement, however, fiscal policy cannot flexibly close the gap when monetary policy has no region specific effects. Decreasing the interest rate as has been pursued in 1999 by French and German governments was a viable policy. Although there is no current inflationary environment, there are, however, some countries with some inflationary pressure (Portugal, Ireland, Netherland, Denmark, UK). On the other hand countries like Germany and France, as the core countries of European integration, still show a high rate of unemployment and need a low interest rate. For some countries the interest rate is too low for some countries too high and with no fiscal policy tools some countries might be trapped in an upward pressure of prices and some countries face an upward pressure in unemployment.

5.4. *The Euro and the Financial Market*

A further major issue is whether the Euro can establish itself as a stable currency on the international financial market in the long run(this at a time of a financially unstable world economy).

The Euro is a challenge to the dollar and might replace the dollar centered world that has prevailed most of this century. The global economic role of Europe and the US will almost be identical (GNP per capita, share of world trade). Yet, it has been conjectured that the Euro will be a rival to the dollar as the world's leading currency.

There has been certainly a new self-confidence in Europe arising. As it is expressed by Issing: as reserve, investment, transaction and anchor currency the Euro "will... finally give Europe its due weight in the concert of world powers" (Issing 1998). The EU 11 countries may now soon better represented in the IMF and World Bank. The Euro is seen as a device for a stronger role of European politics in the long run. Although the creation of the Euro is bound to affect the international monetary relations, it is visible that the creation of a new currency with the above functions will be a very slow process and the dollar will still be the leading currency for the years to come. But during this process the ECB is likely to attempt to stabilize the Euro by restricted monetary policy and so the interest rates might be kept unreasonably high (which again might adversely affect employment).

There is likely to be in the short run volatility in the exchange rate market, but in the long run the Euro might become stronger. There are large currency reserves in Europe (mainly due to the German trade surplus in the past), there is no short run foreign debt build-up exceeding foreign reserves, there are better reserve requirements in Europe and better bank supervisions or regulations, than, for example in Asia (although the external sector might be vulnerable due to the increase of exports to regions which are vulnerable to financial instability). In other words there is currently no major credit risk and exchange rate risk due to overborrowing from abroad.

Also the financial market in Europe is currently stable and the Euro has passed its first test. The Asian, Russian, and Latin American financial crises did not have a big impact on Europe. The ECB tends to respond less to stock price decline and declining of growth rates than the US Fed. The ECB, in 1999, resisted lowering the interest rates to provide more liquidity to the banking sector (as the Fed did). The ECB is prepared neither to act nor has it any instruments to counteract financial instability if it occurs (there is for example, a lack of bank supervision and regulation). In fact, as many economists in Europe now argue, interest rate raises were not necessary but cooperation with the US and Japan is needed to reduce the expected volatility between the major three currencies: the dollar, the Euro and the yen. In fact, there are challenges in the time to come and in the global economy and other cooperations will be important.

5.5. *The Lack of Political Union and Fiscal Centralism: The Politics of the Union*

The last important issue is the lack of political union and fiscal centralism. In the post-war period the completion of the European Union was driven by the idea to unify European countries so that Europe would not suffer again from nationalism or disastrous wars. Particularly the Germans seem to have pursued the idea that the monetary union is necessary to complete the customs union and political union (see Hoffmann 1997). The customs union has been completed since 1992. Is the European currency union necessary for a politically unified Europe? Can the economic losses (Feldstein 1997) be weighted against the political gain of a unified Europe? The arguments are as follows:

On the economic front, it was argued that swings in the exchange rates of the currencies of the customs union members inflict costs on the EU. Cooperative exchange rate management, the EMS, was not enough to secure the customs union; commercial integration may not be feasible in the long run without monetary integration.

Is the EMU necessary for the political union of Europe? The EMU seems to be viewed as a necessary step to achieve this. But it appears only as a necessary step. Competition and conflicts of regions over employment and other issues like imigration may still be a source of political instability. Also ethnic and social conflicts and different types of governments may still be there as a source of instability (or, as Europeans have pointed out, Yugoslavia had a single currency).

There is also a problem of a monetary union without political unification. Since there is no common policy for the subcenters, monetary policy will become an insufficient tool to solve conflicts. There will be diverse political pressures on the monetary policy which monetary policy by itself will not be able to resolve.

While the central monetary and exchange rate policies cannot be region specific and the fiscal policy is constrained by the EDC, on the other hand, there is also no central fiscal authority which, through tax and transfer policies might mitigate regional shocks. One can also, due to the existence of the federation of states, anticipate a considerable, tax competition across states. The only mechanism against regional shocks would in fact be transfers from the center (or some kind of insurance scheme), but there is currently a strong resistance against tax raising and spending power of the EU (particularly by the Germans). A stronger centralization of tax revenue and expenditure decisions is not on the agenda.

The lack of political unification will produce some inertia in the decision making process. The weak center and the strong national interests will impact the decision making of the two major councils, the European Council and the governing council of the ECB. The decision making process in the European Council (for entry into EMU and the decision on the stability pact, a qualified majority vote is needed: at least 62 out of 87) considering the total of votes composed of a large number of different countries one can imagine simple voting coalitions that block decisions or force decisions.

The council of the ECB has 11 representatives of the national central banks and, furthermore, six independent executive board members. (In 2000 the decision was made to include Greece which will be then also on the council). National interests will be strong and there will be some inertia in policy formation (in particular if fast policy action are required to avoid financial instability).

6. Outlook and Conclusion

It appears almost certain that separate national currencies and currency fluctuations would have given rise to repeated competitive devaluations and exchange dumping as well as to political responses in the form of protectionism that severely hinder the single market and the customs union in Europe. Fixing the exchange rates in the preparation period of the EMU had certainly already a stabilizing effect on the financial sector in Europe. So far the Euro did well and a number of years with higher growth rates in Europe are expected.

The arguments made mostly by American economists, that the member states of the Euro do not constitute an optimal currency union, as the US supposedly does, poses the wrong choice between the EMU and a perfect market (a perfect currency union). The EMU is likely to improve the previous situation. The previous choice was between the flexible exchange rate system (whereby the customs union is hard to maintain) and the fixed rate EMS which was very vulnerably and would have transmitted more strongly financial crises (such as the Asian and Russian financial crises) into Europe.

The EMU has been initiated by conservative parties. Both the restrictive fiscal and monetary policies in the 1990s have prolonged European unemployment with high cost on the population. There have been considerable adjustments made in the welfare state and the labor markets and the Maastricht criteria have been used as a disciplining device (McKinnon 1997, Sutherland 1997). The debate over the usefulness of the fiscal stability criteria, and the restrictive fiscal and monetary policies will be taken up again and the solely inflation oriented European Central Bank policy will questioned. Some other conflicts concern the relation between the European Council and the ECB on the one side and the European Parliament on the other. It is clear that the ECB has to be more accountable to the European citizens (to the European Parliament). The relationship between the ECB and the European Parliament has already become a topic in the European Parliament and it is arranged now that the Governor of the ECB should, as the Governor of the Fed, regularly testify in front of the European Parliament. Moreover, a discussion on a European constitutions and European bill of rights have started to bring about stronger European institutions.

The next years will still be difficult but the Euro survived already an unstable period in the international financial market. The growth rate for Europe have been revised upward this year and the labor market will slowly improve . Yet, there is still high level of unemployment in the core countries (Germany and France). Under the pressure of actual economic and political events (such as the right-wing government in Austria) the EMU will change and it is easy to guess that the process of EMU will not be finished in 2002 but rather the structure of the monetary regulation the fiscal operation of Europe's monetary union as well as the institutional arrangements will continue to evolve for the years to come.

Appendix: A quick consistency check:

Employing a simple textbook approach (Blanchard 1997) the primary deficit or surplus can be shown to depend on the interest rate, r, and the growth rate, g and b= B/Y (where B is public debt, Y the GNP and G and T public expenditure and tax revenue respectively):

$$\frac{B_t}{Y_t}-\frac{B_{t-1}}{Y_{t-1}}=(r-g)\frac{B_{t-1}}{Y_{t-1}}+\frac{G_t-T_t}{Y_t}$$

$$\dot{b}=(r-g)b+d \Rightarrow$$

$$0=(r-g)b+d \Rightarrow$$

$$b=-\frac{d}{r-g}$$

Case 1: r > g, then d = surplus, take b = 0.6

$$0.6=+\frac{0.012}{0.05-0.03}$$

Case 2: r < g, then d = deficit

$$0.6=-\frac{0.012}{0.03-0.05}$$

But given b=B/Y for each country:

Case 1 (Germany):

$$0.03=(r-g)b+d;\ r-g=0.03,\ b=0.6$$

$$\Rightarrow\ 0.03=0.03\times 0.6+0.012$$

Case 2 (Italy):

$$0.03=(r-g)b+d;\ r-g=0.04,\ b=1.2$$

$\Rightarrow\ 0.03=0.04\times 1.2-d;$ needs a big primary surplus (of roughly 2%)

Thus, for some countries, for example Belgium and Italy, it will particularly be difficult to fulfill the criteria of the Stability Pact in the long run.

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