This is a revised version of a paper prepared for the Inter-American Development Bank, Integration and Regional Programs Department, Institute for the Integration of Latin America and the Caribbean (INTAL). The earlier version was presented at the IADB/CEBRI conference on ‘Macroeconomic Policy Coordination and Monetary Cooperation in Mercosur’, Rio de Janeiro, 9 October 2000 and is to appear in Integration and Trade No. 13.
This paper begins with a discussion of the relation between economics and politics in the construction of EMU. It briefly considers how the structural characteristics of the European economies relate to the Single Market programme, and how this initiative of the late 1980s both built the foundations for and led the way to EMU. It then considers in more detail the justification for monetary union and the process by which it was achieved. The analysis turns to instabilities that arise from the ‘domino effect’ in regional integration and how those relate to EMU. A discussion of the problems of fiscal consolidation in a monetary union and the ‘Stability Pact’ then leads to an enumeration of a range of problems that still face EMU. We conclude that both the integration of the real economy embodied in the Single Market programme and the political commitment – however imperfect and limited – of the European Union are necessary conditions for the success of monetary union.

Keywords: monetary union, single currency, economic integration, EMU

JEL numbers: F15, F33, F36
1. Alternative perspectives on monetary union

The European Commission’s original study of the costs and benefits of economic and monetary union (EMU) focused on the economics:

‘The likely impact of EMU is:
(1) Microeconomic efficiency: sure advantages, as a single currency and economic union complement the single market…One market needs one money...
(2) Macroeconomic stability: sure advantages as regards better overall price stability (i.e. both very low inflation on average, and low variability)…and probably some gain also in terms of the stability of the real economy.
(3) Equity as between countries and regions…The least-favoured regions have a real opportunity for rapid catch-up. EMU, like 1992, is a positive-sum game.’


But Tommaso Padoa-Schioppa, rapporteur to the Delors Committee, which launched the project with its report to the Council of Ministers in 1989 (see Section 6), saw it as part of a political project in Europe:

‘…The task of setting the sovereignty of Europe’s nation-states within a common, legally constituted order is the legacy of two world wars…This order cannot be achieved without institutions empowered to address and solve common problems…In the economic sphere, a single market requires monetary union and both require firm institutional foundations.’


After EMU was realised, Jürgen Stark, Vice-President of the Bundesbank, expressed a similar vision in a global context:

‘A monetary union is more than a technical federation for the management of the single currency. A monetary union must be based on a joint political commitment on the part of the countries participating in it…The basis for extending the international role of the euro can only be laid by making further advances in integration on the way towards a political union.
...[so as to] convince market players that the euro is not merely the result of a technical exchange rate arrangement but also is an expression of the willingness and determination to achieve further integration.'

Stark (2000), pp. 19, 22

And a senior journalist who writes on international affairs gave EMU and the euro a key role in the competition – as he saw it – between the European and American economic and social 'models':

'The new European currency has been established to protect the European social model, and European industrial and technological sovereignty, against American competitive pressures...[The conflict is] solidarity - health and pension systems, worker representation, and activist government... [against the] stockholder-beholden, downsized, low-security, high-mobility American corporate model.'


These very different perspectives on economic and monetary union in Europe demonstrate how wide is the range of issues that one must cover in analysing how EMU came to pass. The need for a comprehensive view is all the greater if we are asking what lessons can be drawn from the European experience for other regional initiatives that might lead to a common currency or lesser forms of economic integration (see Portes and Vines, 1998). The first step is to map out the historical sequence that led to EMU. A schematic version appears below.

This paper begins with a discussion of the relation between economics and politics in the construction of EMU. It briefly considers how the structural characteristics of the European economies relate to the Single Market programme, and how this initiative of the late 1980s both built the foundations for and led the way to EMU. It then considers in more detail the justification for monetary union and the process by which it was achieved. The analysis turns to instabilities that arise from the 'domino effect' in regional integration and how those relate to EMU. A discussion of the problems of fiscal consolidation in a monetary union and the 'Stability Pact' then leads to an enumeration of a range of problems that still face EMU. We conclude that both the integration of the real economy embodied in the Single Market programme and the political commitment – however imperfect and limited – of the European Union are necessary conditions for the success of monetary union.
The Process of European Integration

1950 - European Payments Union (EPU)
1951 - European Coal and Steel Community (F, D, I, B, N, L)
1957 - Treaty of Rome - the 6 (EEC, EAEC)
1958 - Monetary Committee established to review macroeconomic conditions
1966 - ‘Luxembourg compromise’ - the role of the veto
1968 - Internal tariffs and quotas gone, Common External Tariff in place
1970 - Werner Report on Monetary Union
1972 - Currency ‘snake’ established
1973 - Accession of UK, Ireland, Denmark
1979 - European Monetary System (the 6 plus Denmark and Ireland)
1981 - Accession of Greece
1986 - Accession of Spain and Portugal
1987 - Basle-Nyborg Agreement (‘new EMS’)
1988 - Delors Committee established to launch MU process
1989-92 - Peseta, pound sterling and escudo join EMS
1990 - Abolition of capital controls
1990 - German reunification
1991 - Maastricht Treaty (EMU, home affairs, foreign affairs)
1992/3 - ERM crises
1994 - European Monetary Institute established
1995 - Accession of Austria, Finland, Sweden
1996 - Intergovernmental Conference (IGC), leading to Amsterdam Treaty (1997)

1997 - Stability and Growth Pact

1998 - Beginning of accession negotiations with five East European countries and Cyprus

1998 - Decisions on EMU member states, creation of European Central Bank

1999 - Monetary Union

1999 - Beginning of accession negotiations with a further five East European countries and Malta

2002 - Abolition of ‘national’ currencies
2. The process of European integration: the relationship between politics and economics

Monetary union in Europe is the latest, perhaps the biggest step in a process that spans five decades. The steps set out in the box are a sequence with an internal dynamic. The architects of European unification often refer to ‘ever closer union’, but the sequence is not monotonic – there have been many ‘backward’ steps, from Charles de Gaulle’s veto on UK entry in 1963 and his assertion of the right of national veto in 1966, to the inability to implement the 1970 Werner Report on monetary unification, to the breakdown of the ‘new EMS’ in 1992-93 (Portes, 1993). Nevertheless, it is an ongoing process of interaction between politics and ideology, on the one hand, and economic costs and benefits on the other.

This dynamic process is for the most part internal to Europe itself. But it is not independent of the United States, which has for the most part supported moves towards closer European integration. There have been American concerns about ‘fortress Europe’ and specific disagreements with various EU economic and trade policies. From the outset, however, the US has been broadly supportive. For example, the European Payments Union of 1950 could be viewed as an extreme form of capital controls and a Keynesian, interventionist measure to deal with Europe’s ‘dollar shortage’ by favouring internal European trade over trade with the US. But the United States did not oppose the EPU, despite clear American preferences for convertibility and a laissez-faire approach. Similarly, the European Coal and Steel Community was clearly a form of ‘economic planning’ at a supranational level, and again the US accepted it.

In regard to monetary union, the US attitude has been to affirm that what is good for Europe is good for the US - but that Europe must reform (be like the US) to make EMU work. There has been widespread scepticism in the American academic and policy community about the desirability and feasibility of monetary union for a large, diverse continent like Europe. The US might also not be an ‘optimal currency area’, but at least it has substantial labour mobility and fiscal transfers across states. So the common American view is that the Europeans will have a tough task (see the negative evaluation of EMU by Feldstein (1997), with a contrasting European view from Wyplosz (1997)). If it goes well, then the euro may become a more important international currency, but this is nothing the US need fear:

‘If...Europe deliver[s] a successful, credible EMU backed by strong policy fundamentals, a more integrated capital market, and a more dynamic economy, then EMU would probably be associated with some gradual increase in the euro’s role in the [international monetary] system...’

Tim Geithner, Assistant Secretary of the Treasury for International Affairs, 7 May 1998

Although the integration process has come a long way towards ‘closer union’, the internal logic is still not well understood. That is partly because the relative
importance of the forces promoting integration changes over time. There is a ‘Jeffersonian’ element that moves from the elimination of barriers to market integration, which then requires the creation of institutions to manage it; and a ‘Bismarckian’ element, starting with the establishment of institutions which then proceed to implement integration.

The Maastricht Treaty is an example of the ‘Bismarckian’ tendency in European affairs. It provided explicitly for the creation (at a specified date) of the European Monetary Institute, precursor of the ECB. The EMI was essential in preparing the ground for the successful introduction of EMU: the payments system, money market operations, indeed the ability to move seamlessly from 31 December 1998, with 11 separate monetary policies and supporting financial systems, to 4 January 1999 with a single monetary policy. These preparations took five years – the ECB existed for only the last six months of that period. Monetary integration had to be preceded and prepared by the EMI.

There are recurring tensions. Some have been resolved – since the mid-1980s, there can be no doubt that the underlying economic model is that of a single, unified market, rather than just a free trade area or even a customs union. Others are still the issues of today: the relationship between and relative importance of the ‘economic project’ and the ‘political project’; federalism or confederation; technocracy vs. democracy. And it is fair to say that in most dimensions, the impetus has come from the political and bureaucratic elite, so that there is an acknowledged ‘democratic deficit’ in the functioning of the European Union.

3. Structural characteristics of the European economy

The process of European integration, real and monetary, has been determined in part by the characteristics and needs of the European economy. It is therefore useful to summarise these briefly here, without referring to detailed data.

Relative to the United States, the countries of the European Union have high population densities and limited natural resources. Although they are individually highly open to trade, their domestic markets have been small and diffused; this was the fundamental motivation behind the Single Market programme (see below). Moreover, they are not specialised ‘regionally’ – i.e., across countries. There are considerable differences across regions and countries, typically between the ‘core’ (often thought of as the London-Hamburg-Milan triangle) and the ‘periphery’, in terms of per capita GDP and the synchronisation of business cycles. Despite (or because of) the differences, intra-EU trade is now high, and consequently the EU as a whole is a relatively ‘closed’ economy; its trade participation ratios with the rest of the world (i.e., excluding intra-EU trade) are very similar to those of the US and Japan.
‘Continental’ capitalism is often contrasted with the ‘Anglo-Saxon’ version. The former has been more bank-oriented than securities-based, with repressed and segmented capital markets; strong welfare state elements; and highly regulated markets, especially the labour market.

These factors help to explain why European policy-makers came to put such strong emphasis on product and factor market integration by the 1980s, as expressed in the Single Market programme. Subsequently, one of the key justifications for monetary union is the powerful effect the single currency is already having on the opening up and development of financial markets in the euro area. This is expected to stimulate investment and growth.

4. From the Treaty of Rome to the EMS

The Treaty of Rome that established the European Community (as it was until 1992) already marked an important move away from the diriisme of the early postwar period towards a more free-market approach. It created a customs union (internal free trade and a common external tariff), and in addition to free movement of goods, it proposed free movement of persons, services and capital. A further ‘liberal’ feature was a Community-wide competition policy, with restrictions on state subsidies to firms. There were no industrial or regional policies (although the Treaty did create the European Investment Bank), nor any common macroeconomic policies, nor any redistributional measures across countries. But the Common Agricultural Policy did have some redistributional consequences, with its price supports, import restrictions and export subsidies.

External critics, particularly from the Asia-Pacific region, have come to regard the kind of customs union embodied in the Treaty of Rome as an old-fashioned form of liberalisation. Trade theory, so they argue, teaches that unilateral most favoured nation (MFN) liberalisation is in a country’s interests. Certainly a customs union leads to trade creation. But it also leads to trade diversion. This has real resource costs, both for the countries within the region and for those excluded. By contrast, these critics argue, unilateral liberalisation does not lead to trade diversion, because exporters in the rest of the world and importers within the region are on a ‘level playing field’ in supplying imports to the liberalised markets.

Much has been written about trade creation and trade diversion in Europe. Winters (1996) surveys this evidence. The central thrust of this literature has been to argue that, apart from agriculture, trade creation has dominated trade diversion. The European Commission published in 1996 an economic evaluation of the Single Market program. There were forty background studies for this report, including one on trade creation and trade diversion and two others on external access to the European market. All of these studies concluded that there had been little diversion.
It took a decade to implement the customs union fully. Then attention turned to monetary issues. By this time, France was complaining that the United States was abusing its power as the hegemon of the international financial system, running current account deficits and at the same time using dollars to buy up European firms. Germany was equally upset about the way in which a loose American fiscal policy (unwillingness to raise taxes to finance the Vietnam war), accommodated by monetary policy, was exporting inflationary pressures to Europe. So they requested a blueprint for monetary union from a group headed by Pierre Werner.

The proposals in the Werner Report were in fact more ambitious and ‘federalist’ than those of the Delors Committee twenty years later. But the timing could not have been worse. Partly because of American macroeconomic policies, the Bretton Woods exchange rate system broke down not long after the report was delivered. Far from progressing towards monetary union, the subsequent European attempts just to maintain parities among their own currencies in the ‘snake’ did not succeed.

In 1978, however, the German Chancellor, the French President, and the British President of the European Commission jointly conceived and carried through the project for pegged exchange rates in Europe. This was the European Monetary System with its Exchange Rate Mechanism. From its beginning in March 1979 until 1987, especially in the early years, these pegs were adjusted fairly frequently. The turning point towards a fixed exchange rate regime came when France rejected its ‘Keynesianism in one country’ expansionary fiscal policies of 1981-83 in favour of macroeconomic orthodoxy. This was the first example of how currency stability was to take precedence over macroeconomic policy autonomy in Europe.

5. The Single European Act

Even a rock-solid EMS, however, could not have led to monetary union without the Single European Act. This finally launched the European Union on the road to a truly integrated market for goods, services, capital and labour, almost 30 years after these were formally included as objectives of the Treaty of Rome. It was a response to several pressures: a noticeable deceleration of intra-EC trade growth after 1972; increasing protectionism in the form of national non-tariff barriers; the relentless growth of spending on the Common Agricultural Policy, which dominated the EC budget; and the ideological shift towards deregulation and ‘supply-side’ measures.

This new treaty included essential provisions for qualified majority voting, effectively abolishing the national veto on ‘Single Market’ issues. It emphasised mutual recognition of national product standards, rather than far-reaching harmonisation. It set a target for abolition of capital controls within the European Union by 1990 – and it was quickly recognised that this would force the pace towards monetary union. And it created the ‘structural funds’, a system of large-scale redistributive grants intended to reduce disparities across countries. The weaker (‘peripheral’) economies demanded these as
compensation for full opening of their markets to the stronger ‘core’ economies.

A common view of the European Union’s underlying purpose takes it to be a fundamentally political initiative. In that perspective, the supra-national institutions of the Single European Market and the customs union should be understood as the core part of the European project. Thus the only way in which Europe could go from where it is now to an ‘open regionalism’ would be if the European project were to break down.

The creation of this single European market has led to the elimination of a large number of formal national trade barriers, the elimination of customs formalities at national borders and the replacement of these national trade controls by Community-level instruments. It has led to a form of Europe-wide competition policy and the passing of trade policy competence almost entirely to the European level (although not in services).

Before the internal market program, the European market was characterised by a proliferation of standards and technical regulations that had the effect of segmenting markets. This was a barrier to access into national markets both of products from outside the European Union and from other member states. This has given way to a Europe-wide process of standardisation. That has required the construction of a Europe-wide apparatus of notification, mutual recognition directives, harmonisation and certification.

The Single Market has also established freedom of trade in services as well as goods. Since such service provision is highly regulated, this has required the establishment of Europe-wide regulatory structures; examples are finance and transport services. The Single Market is also removing internal barriers to public procurement, the enforcement of which requires regulatory discipline.

There has been a Europe-wide competition policy since 1958. In 1990 this was extended to merger policy, where the extraterritorial reach of EU policy has sharply defined a European role in this key aspect of globalisation. In addition, the opening of the internal market in regulated network industries (in particular, telecommunications and energy) is leading to the establishment of Europe-wide regulatory structures in these industries too (see Bergman et al., 1998). Thus the creation of a genuine single market has required the establishment of supra-national structures: both standard-setting and regulatory apparatus. This has been embedded in a supra-national system of law making and the administration of justice.

6. Why monetary union?

Soon after the Single European Act, the Basle-Nyborg Agreement ratified the transformation of the EMS into a (virtually) fixed exchange rate system, with supposedly unlimited intervention available to maintain the parities. The EMS was originally intended to operate symmetrically as between member
countries. In practice, it had become dominated by Germany and the Bundesbank.

Initially, currency realignments were depreciations against the Deutschemark. Then the other countries came around to fixing against the DM, ‘borrowing German monetary credibility’ in the 1980s fight against inflation and accepting the Bundesbank’s leadership in interest-rate policy (see Begg and Wyplosz, 1993). Neither France nor Germany saw that as a sustainable long-run position, so in 1988 the governments set up a committee chaired by Jacques Delors, with all 12 central bank governors and five outside experts, to draw up proposals for full monetary union.

The Committee’s unanimous report a year later set in motion the intergovernmental conference that led to the Maastricht Treaty, which specified the details of monetary union and the transition to it. How was it possible to get all the central bank governors to agree to surrender their authority over monetary policy and to achieve the accord of all twelve governments (with a British and then a Danish ‘opt-out’ provision)?

There was, to be sure, the continuing political desire among many leaders of the process for further progress towards ‘ever closer union’. Pooling monetary sovereignty in a supranational institution, the European Central Bank, would be a major step in this direction. The reunification of Germany in 1990 awakened fears both inside and outside the country of German political dominance in Europe. The German political elite at that time saw federalist political corollaries to monetary union that would moderate any such undesirable tendencies.

There were equally important economic motives. It was argued that a truly integrated market for goods, services and capital required a single currency to reduce transactions costs and bring price transparency. This point has since been reinforced by strong evidence of price dispersion ‘border effects’ (Engle and Rogers, 1996) and of a powerful stimulus of currency union to trade (Rose, 2000). A single currency would promote the unification of financial markets, and capital market integration would promote corporate restructuring, investment and growth. And this single currency could weaken the dominance of the dollar in the international financial system, with both economic and political benefits for Europe (see Portes and Rey, 1998, and Cohen, 2000).

The intellectual environment had shifted dramatically away from the Phillips Curve and ‘fine tuning’ macroeconomic policies of the 1960s and early 1970s, as well as the optimism of that period regarding the supposed monetary autonomy offered by floating exchange rates. The new orthodoxy adopted price stability as the only legitimate objective for monetary policy and central bank independence as a prerequisite for a stability-oriented monetary policy. And floating exchange rates outside the EMS had shown high volatility and substantial, persistent misalignments; the advantages of permanently fixed rates seemed very strong, despite the reservations suggested by the ‘optimal currency area’ literature.
There was also dissatisfaction with the de facto asymmetry of the EMS. If French monetary policy was to be set in Frankfurt, the French wanted a seat at the table when interest rate decisions were taken. And the earlier advantages of giving up monetary autonomy to borrow German anti-inflation credibility were reduced when Germany suffered the inflationary shock consequent upon reunification. The DM ‘anchor’ of the system actually moved, and sharing German monetary policy authority with other countries that had demonstrated their sound monetary credentials became more plausible.

I would argue, however, that the single most important factor necessitating EMU was the move to full capital mobility specified as part of the Single Market programme. Tommaso Padoa-Schioppa (1988) had argued, correctly, that fixed exchange rates, independent monetary policies and full capital mobility were incompatible. The EMS had been able to establish exchange-rate stability only by virtue of some sacrifice of monetary autonomy plus the help of capital controls in delaying and moderating pressures for realignments. And the ‘new’ EMS did in fact break down in 1992-93 under the pressure of uncontrolled speculative capital flows; then the only way to go was back to floating or capital controls, or forward to full monetary union (Portes, 1993).

7. Onwards to EMU

Put that way, there was no choice. It had to be forward, or otherwise shake the member states’ commitment to the Single Market, which had become the keystone of the EU – so that going back would endanger the very integrity of the Union. One major obstacle remained: German concerns that lax fiscal policies in some EMU member countries could generate harmful spillovers on others, make it impossible to conduct an appropriate monetary policy for the monetary union, and thereby lead to a breakup.

The Maastricht Treaty had specified ‘convergence criteria’ for eligibility for entry into monetary union, among which were numerical limits on the ratio of public debt and of the public sector deficit to GDP. The ‘Growth and Stability Pact’ continued the latter restriction into the monetary union period and added serious sanctions on any country violating it. That was enough to bring Germany to accept the ‘Club Med’ – Italy, Spain and Portugal – as members of the monetary union despite their relatively short history of macroeconomic stability (they had legally satisfied the ‘Maastricht criteria’, but their anti-inflationary credentials were still in doubt).

Thus monetary union in Europe commenced on 1 January 1999 with 11 countries; only Denmark, Greece, Sweden and the United Kingdom remained outside (Greece subsequently joined on 1 January 2001). This is not a fixed exchange rate system – not even ‘irrevocably’ fixed exchange rates. The exchange rates are now only conversion rates among units of the same (single) currency, accounting conventions required because the national
currencies (notes and coins) will not be replaced until early 2002. The Delors Committee and the Maastricht Treaty took a ‘fundamentalist’ approach (Padoa-Schioppa, 1994): monetary union is not a rule for international cooperation, not an international agreement for policy coordination, but rather a monetary constitution for a supranational monetary system.

This is run by the European Central Bank, whose formal independence from political pressure is greater even than that of the Bundesbank itself. Its mandate specifies only that its monetary policies should ensure price stability, leaving the ECB to define what that means. Its Council includes the central bank governors of all the participating countries and a six-member Executive Board appointed by the member states, of whom one is the President, with an eight-year term. Member countries are bound to respect the Growth and Stability Pact and to carry out regular mutual surveillance of their economic policies. The ECB may not buy member government securities in the primary market, nor may it ‘bail out’ any government with monetary financing of its deficits or debt repayments.

8. A structural flaw

The most important difficulty associated with customs union and then complete goods and capital market integration is the instability of the ‘domino effect’ which it induces, with particularly awkward consequences.

A developing customs union is attractive for others around its borders to join, in order to gain access to the market within the union. Baldwin (1995) has called this a domino effect and argues that it is driven by ‘jealousy’. ‘In business, what matters is relative competitiveness. A firm’s profits and sales are lowered by anything that lowers its rival’s costs.’ This is his explanation for the pressures that impel those around the edges of the European Union to become a part of the Union, a process which has seen membership grow from 6 to 9 to 12 to 15 members.

Thus, in the early 1960s, as barriers within the European Community (EC) customs union began to fall, political economy pressures grew from producers outside the union for access to it, particularly within the European Free Trade Association (EFTA: Denmark, Finland, Ireland, Iceland, Norway, and the United Kingdom). This pressure resulted in defection from the EFTA to the European Community by the United Kingdom, Denmark and Ireland in the early 1970s. Then, in the 1980s, three new southern members were added (Greece, Portugal and Spain), all of whom saw integration within the European Community as a route to prosperity and growth as they emerged from periods of authoritarian government.

More recently, three northern Europeans (Austria, Finland and Sweden) have joined, again for generically similar reasons. Those remaining in EFTA after the earlier defections decided that they must react, and they sought and obtained the European Economic Area (EEA), which was negotiated in the late 1980s. The purpose of that arrangement was essentially to give those in
EFTA access to the market of the European Community. What emerged, however, was an extraordinary and unstable arrangement. In fact, virtually none of the EFTAns was prepared to live with the EEA as it was negotiated. Even before the negotiations were completed, Austria, Finland, Norway, Sweden and Switzerland had applied for membership of the European Union itself.

The awkward consequences which flow from this domino process are as follows. First, the newly joining members essentially have to adapt themselves to the incentives and cost structures of the EU core (since at each stage they are relatively small, so their joining has relatively little effect on this overall cost structure). This structure may not be an appropriate one for the joining country's best integration into the world economy and may give rise to incentives for trade diversion.

The negotiations to bring in the newcomers can give rise to extensive side-payments. Adding three new southern members in the 1980s (Greece, Spain and Portugal) meant the construction of a new grouping, the ‘poor four’ (Ireland, Greece, Portugal and Spain). All these countries had large agricultural sectors whose output was competitive with that of the existing beneficiaries of the CAP. To limit opposition from incumbent farmers, and also from workers in sensitive areas, the European Community insisted on long transition periods. For example, quotas on Iberian iron and steel were in place for seven years, and Spanish fruits, vegetables and vegetable fats obtained free access to the EU market only in 1996. Migration rights were restricted for five years.

‘The increased structural spending served an important ... purpose. While the Iberians received second-class treatment in terms of market access and the labour market, they were offered better than first class treatment on the Structural Funds. This balanced the impression that Spain and Portugal were joining as second class members’ (Baldwin 1994: 201). As a result, in 1992, nearly a third of the EU budget (31.6 per cent) was devoted to structural funds, in addition to the 53.7 per cent devoted to the CAP (Baldwin, 1994 p.162). This spending then increased further. A special ‘cohesion fund’ was agreed by heads of state at the Maastricht meeting at which the Treaty on European Union was agreed. It was established to fund projects exclusively in the four poorest EU states. This agreement again seems to have been unrelated to generally perceived need, but rather to a requirement to get acceptance of the European agenda as part of the Maastricht process.

These developments turned the European system into one with several key features: not just agricultural support, a customs union, and a single market, but also redistributive spending, and now monetary union. Furthermore, the increasingly wide membership of the customs union (which, for reasons touched on above, is an all-or-nothing membership) puts at risk the negotiation of further liberalisation by the core members of the union. This is a kind of median-voter-theorem problem. Adding more members at the edge of the union involves bringing in countries whose concerns regarding liberalisation are different from those in the core, possibly making it harder to
reach liberalisation decisions. Deadlock can then result because of the inability within the all-or-nothing framework to do liberalisation at variable speeds.

Finally, negotiations to bring in the newcomers may give rise to difficulties for incumbent members, especially now that there is qualified majority voting. The prospect of the dilution of the ability to form blocking coalitions on one or a few key issues can then induce incumbent members to block the membership of peripheral countries. The Nice Treaty sought to deal with the voting problem in order to prepare for enlargement, but the solution adopted was in fact worse than the existing rules (Baldwin, et al., 2001).

Finally, EMU will have an effect on the widening process discussed above. If EMU is not well handled and is deflationary, then this effect will be damaging to the countries around the EU core. It would also be likely to affect negatively negotiations on further liberalisation of trade between these countries and the European Union, and to upset and complicate the timetable for the widening of the European Union.

If EMU is well handled, however, there remain technical issues. At present countries in the 'queue' to join EMU will have to enter a new Exchange Rate Mechanism (ERM II). In our view, it would be preferable if such a requirement were not imposed, but instead fitness were judged according to whether a mix of fiscal and monetary policies had satisfactorily controlled deficits and inflation. Nevertheless, this requirement may prove possible to manage without the kind of speculative crisis which shook the ERM in 1992-93. First, the bands around central parities will be wide (plus or minus 15 per cent). Second, it is less likely that these countries will be burdened with overvalued exchange rates. Their labour costs are low and industrialisation relatively rapid. Such countries are likely to experience rising (not falling) equilibrium real exchange rates, a phenomenon which can be met either with nominal appreciation or with somewhat more rapid inflation (for a discussion of these issues, see Begg et al., 1999).

9. Fiscal consolidation, the Maastricht criteria, and the importance of monetary policy

Public deficits and debt are thought to pose serious problems for monetary union. Through the 1980s and 1990s, budget deficits averaged well above 4 per cent of GDP. In the EU15 the ratio of government debt to GDP rose from 40 per cent in 1979 to about 75 per cent in 1996. Only in one year, the year of unsustainable growth in 1979, did the EU15 budget deficit fall below 3 per cent of GDP. As a result, all countries in Europe have recently moved towards fiscal restraint. But there is a danger that governments underestimate the difficulties of fiscal consolidation in an area as large as Europe and underestimate the complexities of doing this at the same time as forming a monetary union. Success would require a sustained, medium-term rise in private sector investment (or reduced private savings). This is unlikely to
happen through some automatic process of ‘crowding-in’ (but see Giavazzi and Pagano, 1995).

The Maastricht criteria for entry to EMU, which have enforced this consolidation, are usually seen as an imperfect response to the need to guard against a financial crisis within the monetary union resulting from ‘excess deficits’ in one country. The limits on deficits recently imposed in the Stability and Growth Pact have been given similar justification. The conventional rationale is that such a crisis would impose externalities on other countries which would be especially large within a monetary union. The argument rests, in turn, on the view that a no-bail-out rule for the central bank could not remain credible in such circumstances: inevitably, so the argument goes, all European countries might be drawn into the solution of such a crisis, so firm rules are needed to guard against it. But this view overestimates the risk of actual sovereign insolvency in European countries (neither the markets, in government bond spreads, nor the ratings agencies see any significant risk of this kind). If that is so, then arguments for the Maastricht conditions and a 'stability pact' must be found elsewhere.

There are strong rationales for such rules, because the generally shared objective of fiscal restraint and consolidation may require coordinated means within EMU. The problem with carrying out fiscal consolidation within a monetary union is that membership of the union makes consolidation a prisoner's dilemma, which is not the case with floating exchange rates. Even if each country desires fiscal consolidation, a single country acting on its own within a monetary union cannot accompany its own fiscal consolidation with its own tailor-made 'matching' monetary expansion. If the consolidation is Europe-wide, the costs can be avoided. Thus, each country might well prefer 'tight' fiscal policy only if others pursue tight fiscal policy. Consolidation - according to this argument - becomes something which has to be coordinated.

Notice that concerted fiscal restraint alone is not enough; it must be accompanied by sufficient monetary relaxation. In its absence, consolidation might become damaging, and the rules of the stability pact might be quite unsuitable. One country's fiscal consolidation would cause another's output and tax revenue to fall, threatening higher unemployment and maybe even lower investment (so exacerbating the longer-term problem of macro-economic malaise which the stability pact was designed to help solve). To avoid such problems, a pre-emptive cut in interest rates might be necessary.

There are three related risks. First, it is hard to see how a good outcome can be achieved if the ECB sticks to a narrow view of its remit. An ECB committed only to building credibility for an 'inflation first' strategy is unlikely to manage this task in a satisfactory way. Second, even a more 'flexible' ECB might be unwilling to risk the required monetary relaxation if it doubts the credibility of the commitment by European fiscal authorities to consolidation. And, in turn, the fiscal authorities might doubt whether the ECB will allow the required monetary loosening. A non-cooperative game of 'chicken' might then emerge between the fiscal authorities and the ECB, whose outcome was not enough
consolidation, and yet still not enough monetary easing to prevent that consolidation from causing unemployment.

The second issue arises because fiscal policy will actually need to be more actively used for short-term stabilisation in a future EMU common currency area. This is necessary since individual countries will no longer have the freedom to lower interest rates or to devalue in order to counteract recession. Contrary to ‘fiscal federalist’ fears, such stabilisation should not involve centralisation, but can be carried out at the national level. Normally in a recession the ‘automatic stabilisers’ allow tax revenues to fall, supporting income and counteracting the downturn; and individual countries partly offset shocks by the flexible use of budgetary policy. Simply allowing the operation of the stabilisers, and perhaps some limited budgetary flexibility, would do much to stabilise the economies of the countries in EMU.

Nevertheless, there are serious difficulties. Without care, stabilisation of shocks will be prevented by the Growth and Stability Pact. There is only a narrow range of 'exceptional and temporary circumstances' under which a country can escape these penalties if its deficit exceeds three per cent of GDP. This constraint has so far not been a problem, since the euro area has been in a cyclical upswing since the beginning of EMU.

10. Problems facing the ECB and EMU

At this early stage in the life of EMU, it is easy to draw up a list of difficulties which confront the monetary union, but we have little evidence on how serious they are likely to be. The first set of issues are economic:

- trends and cycles may diverge among member countries to the point that a ‘one-size-fits-all’ monetary policy becomes unsustainable
- there are no long time series data for the euro area as such, so it is difficult to assess the behaviour of the aggregate variables
- financial structures differ across countries, hence so do sensitivity to interest rates and the transmission mechanism of monetary policy
- there is as yet no coordination of monetary with aggregate fiscal policy, and indeed the latter may not exist
- there is no clarity in the determination of exchange rate policies (the ECB has undiluted authority over monetary policy, but the Maastricht Treaty gives finance ministers a role in exchange rate policy)
- there is no clarity on lender of last resort responsibility and ‘crisis powers’ (financial supervision and regulation is decentralised to member countries)
- there is a potential free rider problem on national government debt

The political problems are equally daunting:

- the ECB has no history, no reputation to underpin popular support
- its efforts to gain that confidence are hampered by inadequate transparency and accountability – perhaps partly a consequence of the
exceptionally great independence guaranteed for it by the Maastricht Treaty

• without popular support, it will be vulnerable to government efforts to interfere

Yet at the same time, it is important to recognise that the pessimists have so far been proved wrong. They said it could never happen – the project was legally flawed, speculators would break up the system before it got launched, few countries would actually satisfy the Maastricht economic criteria, etc. If there were an attempt to launch it, the payments system would break down, it would be impossible to implement a decentralised but unified monetary policy, and again, the forex markets would attack the intra-EMU parities. None of this has happened, and the ECB’s policy decisions have in general been reasonable, although its communications policies have been clumsy and incoherent, consequently harmful in the foreign exchange markets.

The longer run issues remain, and they will even after the current exchange-rate misalignment (euro undervaluation) is corrected. They are not, however, the issues highlighted in the optimal currency area literature: unsynchronised business cycles, asymmetric shocks, insufficient labour mobility, inadequate fiscal transfer mechanisms. Full financial integration has much reduced the importance of these considerations, and the structural features underlying them are partly endogenous to the monetary regime itself: so monetary union will mitigate them greatly. Rather, the deep problems are the political issues – those set out just above, and the more fundamental ones raised by Tommaso Padoa-Schioppa and Jürgen Stark in the quotations that open this paper.

A single currency, a monetary union, is totally different from a currency board or dollarisation/euroisation. The arguments for and against monetary union are different from those for and against dollarisation/euroisation. The symmetry of monetary union and the consequent requirement to forge a common monetary policy requires a deep basis in economic and political institutions. The single currency was not as desirable, not as necessary, and not as feasible before the Single Market. The Council of the ECB, however independent it is legally, could not achieve unity in decision-making and could not function in its political context if the member countries which it represents did not have the political commitment embodied in the European Union.

Conversely, the greatest force for maintaining monetary union is the knowledge for each member country that if, having been created, EMU were to disintegrate, the very fabric of the European Union and the European historical project would be torn asunder. No country will wish to take on that heavy responsibility for purely economic reasons.

At least that degree of commitment – though not necessarily a political federation – is perhaps essential for the viability of a single currency in a region of diverse countries. So also is the economic integration on the real side that was embodied in the Single Market programme. These are important lessons from the European experience.
References


