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ECONOMIC AND MONETARY UNION: SOME UNRESOLVED ISSUES

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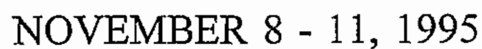

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Economic and Monetary Union: Some Unresolved Issues

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THE POLITICAL ECONOMY OF THE DEBATE

(a) The General Position

There is no doubt that EMU is regarded with less enthusiasm than it was five years ago, and in retrospect the Maastricht treaty may have been the high point of European integration. Most people take the impetus behind EMU to be political rather than economic, their evaluation being that the net economic benefits over costs would be small and rather uncertain - a view which is consistent with the official estimates made in Brussels.* This is in contrast to the single market programme where significant gains are expected from freer market access, increased competitiveness and scale economies etc. Consequently the debate has been more influenced by risk aversion and the political costs of adjustment than by the positive aspects of the EMU programme. How do you book the gains of the single market programme without risking the uncertain benefits of EMU? That is, how do you do this without incurring unacceptable adjustment costs in the transition to EMU, without restricting "locational competitiveness" via the social chapter or via explicit industrial or protectionist

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* 1%-1½% of GNP in "One Market, One Money" (EEC, 1990).

policies, and all of this without being excluded from EU decision making by triggering a "cabal" of inner core countries?

(b) Conservatism and Business Interests

The result of this debate is to make many on the right of the political spectrum into outright sceptics, or into reluctant supporters of EMU as a necessary condition for preserving market access and a degree of influence over decision making. Their attachment to free competition and flexible markets makes them more sensitive to the erosion of sovereignty (in terms of making ones own decisions vs. "interference" from Brussels). Hence the issue for them is really a question of maintaining free market access and free market competition, without the additional restrictions of EMU or an industrial and social policy, but also without losing influence over EU decision making by sitting on the side-lines. This reluctance has certainly damaged the influence of these groups on official European policy making. And it is by no means certain that they will achieve their limited aims. On the other hand they may not care if they don't. In the last analysis market access and free trade are probably their first priority. So if they lose influence over decision making, they will rest on the sidelines with their à la carte approach to integration. Certainly business and finance have drawn their own conclusions, having found membership of the single market to be much more favourable since the ERM was loosened or abandoned in 1992-1993. Their widely held view is that excessive market regulation and/or the use of subsidy schemes, plus inappropriately tight monetary conditions, are rather more damaging than moderate or infrequent exchange rate adjustments.

(c) Popular Interests

Those on the social democratic (or centre-left) of the political spectrum typically favour EMU because they have less attachment to sovereignty. But they are acutely aware that they cannot manage the economy alone or in isolation. The interdependence of monetary and fiscal policy is well understood, and the Mitterand experiment is a painful memory. They would therefore welcome any locomotive power from concerted action across the EU, which helped them towards their objectives. But, much more important, their track record in economic management - and inflation control in particular - is usually not good. Credibility in any new economic programme offered by the social democrats would therefore depend on binding policies into the framework of European policies as a whole, in order to remove any doubts (in financial and business circles) over design faults, market friendliness, or suspicions of backsliding on monetary discipline. In fact inflation control, for parties predisposed to "borrow and spend", might only be possible if monetary policy could be seen to be controlled by an independent central bank. Although EMU is not strictly necessary for an independent central bank, it is surely the most effective way of gaining credibility and justifying unpopular policies.

On the other hand, those on the left dislike EMU because it provides no framework for achieving their most cherished objectives. In fact it arguably neglects a good number of them altogether. The main problem is that fiscal conservatism and competitiveness pressures threaten their social objectives. More specifically EMU appears to pay scant regard to the real side of the economy and to the importance of reducing Europe's unemployment levels in particular. This is an important article of faith for the socialist parties, and any failure to help the unemployed and produce growth would certainly damage them both internally and electorally. It doesn't matter that growth is said to be an objective under EMU; practical

experience so far suggests something quite different, and the rhetoric of policy and the justifications usually given for EMU also say otherwise. Many socialist parties therefore want changes in the balance of objectives and in the use of policies (or level of interventionism) to achieve this.

The second problem is the lack of any attention to redistribution objectives, both across the income distribution and across regions. This might be seen as part of a desire for a stronger fiscal policy framework, but it also implies a greater readiness to sign up to the social chapter if (and may be only if) this can be done in a way that does not restrict competitiveness, increase unemployment or increase labour market rigidities. Given the levels of unemployment and the high unit labour costs in Europe, this may turn out to be a significant restriction. It also implies that social democratic/socialist governments would favour a wider use of fiscal policies. In particular they would be against any limits on fiscal interventions imposed by the convergence criteria. They would reject not being able to achieve their preferred targets with their preferred instrument by arbitrary limits imposed from the centre, just as much as they would resent missing those targets through the selfish and uncoordinated use of fiscal policies by others. Hence their third wish is for some arrangements to allow a more active (and coordinated) use of fiscal policy.

(d) On Britain Specifically

The British Government's position is that, as things stand, the single market and greater free trade are the items of greatest value in the integration programme. If there is "linkage", it is that EMU might be necessary to secure free access to a single, deregulated European market (the Conservative position); or to secure credibility in national monetary policy

making while limiting the competitiveness pressures on employment (the Labour position). Beyond that, EMU is thought to be of very limited value to Britain. The general issue is therefore one of incentives; of ensuring that there are some worthwhile benefits for all participants (including Britain), rather than just benefits on average. That element appears to have been missing from the debate, but is especially important because of the asymmetries which distinguish the British economy from its main EU partners. Those asymmetries are especially marked in Britain's trade structure (still more orientated to non-EU partners); the British preference for creating growth and employment rather than price stability; the greater degree of deregulated markets and competition - and hence market responsiveness - in Britain, especially in the labour markets; and a greater fiscal discipline made possible by the emphasis on growth. So it is not just a question of Britain's vulnerability to asymmetric shocks, although that is important too. There is a perception that Britain's economic structure and preferences are different, so that even symmetric shocks and common policy changes would have asymmetric effects. That would imply significant costs in adjusting to and maintaining a regime designed for other circumstances or structures.

THE ERM EXPERIENCE

- A major difficulty with the priorities underlying EMU is the apparent concentration on price stability to the exclusion of growth and real targets. Many people would argue that overconcentration on price stability merely exaggerates output instability and extends unemployment, and that the later ERM period produced a return to the old "stop-go" cycles. Instability of that kind would lower the overall growth rate and may lead to a build up in unemployment.

- A more even handed approach would be preferred, and to that end some argue that interest rate policy should focus on the management of <u>real</u> rather than nominal interest rates. Certainly the real interest rate consequences of a tough and successful price stability policy can be savagely deflationary. Real interest rates in the OECD area have in fact risen from an average of 2.9% in the 1960s, and 0.8% in the 1970s, to 4.1% in the 1980s and 1990s; and have seen reductions in growth to match.

- Stronger preferences for growth and employment than elsewhere would cause problems for many countries because those relative priorities would not be reflected in the policies of a European central bank. Indeed Article 103 (1) of the Maastricht treaty specifies an economic policy based on the definition of common objectives. This may explain some of the reluctance of the British to commit themselves, for example.

- In Britain, the ERM experience was not good and, at present, there is no serious constituency for a return to that regime. It may well have been that Britain joined at too high a parity. But the main criticism has actually focused on the inability to realign, and the savage interest rate hikes that were necessary as a result. The real interest costs of that scheme proved very deflationary and, in the long run, much more costly than the political sensitivity to high nominal interest rates. This argues that convergence in real as well as nominal terms should be a necessary condition for EMU.

- In this Britain appears to be different from its partners in that its economy appears to be more sensitive to interest rate changes than others. This difference stems from the fact that the household sector borrows almost exclusively with short term variable interest rate contracts (90% of the loans to households) and remarkably little with long term fixed rate contracts (10% of loans). The corresponding figures for Germany are 36% vs. 64%, and France 13% vs. 87% (Borio, 1995). Financial asset ownership is also rather more

widespread than elsewhere in the EU. The upshot is consumption expenditure is more sensitive to nominal interest rate hikes, or to falls in inflation caused by tight money. At the same time business also seems to borrow more at short term interest rates than in Germany (48% of loans are of that type, compared to 40% in Germany; Borio, 1995) which implies a sensitivity in investment expenditures not found elsewhere. All these factors show interest rates and asset effects will have a much greater influence than elsewhere, and that tight monetary policies will generate the corresponding political pressures to correct the real side of the economy more rapidly.

- Public opinion accepts that the ERM stabilised financial variables, but feels that that was achieved at the cost of lower growth and employment. Certainly that view has been sustained since the devaluations of 1992, where there have been no increases in inflation or financial instability while things improved markedly on the real side. Britain and Italy, at least, have experienced gains in growth, the trade balance, and unemployment that were not matched anywhere else, but without higher inflation or greater monetary instability. That appears to turn the original arguments for the ERM on their head.

- Such gains could not have been made simply by estimating speculative pressures on the ERM currencies. In any case the literature shows that attempts to suppress speculative flows are unlikely to work. Instead free capital flows are seen as an important rational for the single market, and to restrict them would defeat the purpose of having a single market.

- In the event Britain's economic performance improved very rapidly on leaving the ERM in September 1992. The expected inflation did not materialise. In fact inflation remained at 2-3% for the next 2 or 3 years. Moreover output grew at 4%, unemployment fell, interest rates halved, and fiscal balances have improved. This has been the best economic performance for 40 years and has, in the view of most commentators, fully justified

the governments decision to abandon the ERM. Naturally these positive benefits has called for a reevaluation of the benefits of EMU - especially as the benefits of leaving the ERM appear to have been predictable in advance (see Hughes Hallett and Wren-Lewis, 1995) while the projected costs of staying in the ERM without realignments would probably have been very costly (Hughes Hallett and Ma, 1994). Evidently the fears of being left out of ERM might, *ex ante*, may seem very serious before you leave; but once you have taken the plunge it actually goes very well. Similarly the possible losses of being left out of EMU may seem very serious ex ante; but once you admit that it doesn't suit your preferences or that you don't fit in, economic prospects may appear just as good outside.

FISCAL ISSUES

- It is always difficult to establish exact figures for the exact fiscal position of a country because of the varying definitions used in different statistical sources. For example in 1993 the UK fiscal deficit was 7.9% of GNP, of which 3.8% of GNP was interest charges. The 1994 figure was 6.9% of GNP, so that position is improving with the recovery and is projected to return within the convergence criteria within 3 years (UK Treasury figures in 1994). In this the UK's fiscal balance is similar to Belgium, Germany (the consolidated balance), Denmark, the Netherlands; but a little worse than France and Spain.
- The UK's gross debt to GNP ratio was estimated at 48% in 1993, 50% for 1994, and is projected to remain at 51% thereafter. That improves on Germany's position of 58%, and on other countries which are now all beyond 60%.

- It is hard to find consensus on the exact (quantitative) implications of forcing any country to meet these fiscal criteria in the near future - or indeed what would happen if the

criteria were abandoned altogether. However, there is a fairly wide understanding of the qualitative impacts - and they are generally perceived as unfavourable since they are likely to be strongly deflationary. The main points are:

(a) All issues of fiscal solvency relate to the debt level. Similarly the spillover effects from excessive use of fiscal instruments (i.e. crowding out, pressure for bail outs, default risk premia and contagion, servicing costs) are all driven by the level of debt rather than by deficits. Moreover excessive debt, being the accumulation of past deficits, is going to be a much more difficult thing to get within a required limit - both in terms of political unpopularity and in terms of deflation costs - than a deficit which should in principle be regarded as a transient or cyclical phenomenon.

(b) Unfortunately the policy debate has switched to the deficit criterion while ignoring the debt criterion. The evidence is in recent statements by a number of policy makers, and most prominently in considering Belgium and Ireland for membership of the core on the grounds of improving deficits. But the real worry is the obvious incentive which policy makers have to make such a switch, given the political costs of achieving significant debt deflations and the accounting opportunities for shifting elements of the deficit "off budget". Debt, by contrast, has to be funded somehow and is therefore quite transparent. Thus the switch to deficit ratios can be perceived as a significant risk. For example, due to a special system of accounting, Germany is not required to account for her entire deficit in order to satisfy the Maastricht criteria. The narrow definition of the deficit gives a ratio of about 2.1% in 1995, instead of about 8%. As a result Germany's debt ratio will rise from 50% to 58% of GNP in 1995, while the deficit ratio is falling from 2.5% to 2.1% at the same time. No other country appears to have arrangements of this kind, although some have allowed certain items

to go "off budget". Consequently it is the changes in the debt ratio which are the real indicators of the true budgetary position.

(c) Debt reductions however, would be unusually deflationary because they are defined as ratios. Any fiscal contractions, to reduce the level of debt, will reduce national income at the same time. Hence the rate at which such a ratio falls will be much smaller than the rate at which the amount of debt itself falls. Indeed the ratio might even rise if the short run fiscal multipliers are greater than one (i.e. a unit reduction in fiscal stance has a more than proportional impact on income) as most empirical estimates suggest.

(d) The financial markets also fear that the costs of fiscal indiscipline, in the form of default risk premia and contagion through imperfect information about the consequences of default or the rules covering no bail outs, would add to the costs of excessive fiscal expansion while also making it more difficult for governments to face the political and deflation costs of debt reduction. Moreover, in EMU these extra costs would have to be born by the low debt countries, damaging economic performance in the union as a whole.

(e) And here we have an irony. Rapid debt reductions are likely to be regarded as more successful in this context precisely because the target is defined as a ratio. Indeed if a rapid reduction is required then too savage a fiscal contraction will not be helpful since it will initially cut national income and hence prevent the ratio falling or may even make it rise. A gradual reduction, on the other hand, will not penalise income falls provided that they fall slower than the quantity of debt itself. That will prove more painful and perhaps less sustainable.

- To understand the difference between debt and deficit reductions, consider the case of a country with a fiscal deficit of 6% of GNP:

(i) Suppose, to meet the Maastricht criteria, it decides to impose expenditure cuts (or tax increases) worth 3% of GNP over a period of time. If the fiscal multipliers are unity, the budget deficit would be 3 units in 97 or 3.1% of GNP at the end of the exercise. But if the multipliers are 1½ say, the deficit will finish at 3.2% of GNP. And so on. The Maastricht target is missed, but by very little. These are sizeable fiscal contractions, but they do the trick if the political cost can be accepted.

(ii) Now consider the equivalent debt reduction case. The country has a debt ratio of 70% say, and imposes fiscal cuts worth 3% of GNP. With multipliers of unity, the debt ratio will become 67 units in 97 at the end of the exercise: a ratio of 69% and a very slow reduction indeed. If the multipliers are 1½, the ratio will finish up at 70.2% - that is a rise in the ratio! The reason that this happens is the deficit reduction is accompanied by a similar fall in GNP, with the result that the deficit ratio doesn't change much. But, although that means a subtraction from absolute debt level, the smaller GNP is also dividing into the old stock of debt - raising the overall ratio. In a high debt country that stock of old debt will be very large, and the increase in its ratio can easily be larger than the subtracted element from the new deficit ratio. This is just the difference between a debt stock and a deficit flow, both expressed as ratios.

- Note also that a debt reduction, unlike a deficit reduction, involves running an overall budget surplus, not just a primary surplus or a reduced primary deficit.* That is much more restrictive, and underlines the extreme political cost of debt reductions even when the

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* Note that all EU countries would in fact have to run primary surpluses even to reduce their deficit ratios let alone their debt ratios, since a debt burden of 60% costs 3% of GNP in service payments alone at interest rates of 5%. No EU country can claim lower figures (Luxembourg excepted) at present.

multipliers are not such that the ratio starts to rise again. Indeed deficit and debt ratios can (as in the example above) move in opposite directions, so that the satisfaction of one does not automatically imply the satisfaction of the other.

- From this one can see the political pressures to ignore the debt criteria will be extreme. And here we have the dilemma. If no action is taken for political reasons, the market will assume that either a monetary bail out or a default will have to follow. Interest rates will therefore rise, either as an inflation risk premium or as a default risk premium. As this is an endogenous market reaction there is not much the policy makers can do to offset it. The alternative strategy would be fiscal contraction (to reduce the debt itself) combined with monetary expansion (offsetting the contraction to preserve national output). But that would trigger a currency depreciation, and hence the extra inflation and financial instability that that implies. So either the targets of output growth, or those of low inflation and currency stability, would have to be sacrificed.

- A popular but contrasting view is that debt/deficit contractions can actually be expansionary. While it is true that there are expansionary elements in fiscal contractions, one must be careful not to assume that they will necessarily be large enough to outweigh the contractionary effects of cutting expenditures. Expenditure contractions will certainly have "crowding in" effects which will be expansionary. Similarly they will potentially have expenditure increasing effects by reverse Ricardian equivalence - consumers will fear tax rises in the future (to pay off the deficit) less, if their rate of the discount is not too high. And if monetary policy is to be run by an independent European central bank, instead of a national central bank subject to government influence, then the credibility effect will lead to lower interest rates since the inflation/devaluation risk has been reduced. On the other hand, the

increased sensitivity of fiscal deficits to the economic cycle, and the greater load placed on fiscal instruments with the removal of individual monetary policies and the overexpansion bias, mean that a default risk premium may well appear to replace the inflation risk premium - and the credibility gain will be lost. National governments will no longer be issuers of the currency of the loans and, *in extremis*, will have to default if the common central bank doesn't bail them out. That is to say that there is a default risk if bail outs are not possible, or an inflation risk if they are possible - but either way a risk premium will remain.

Having said that, if interest rates do fall with the increased credibility of the common monetary policy, they will fall only to the current ECU rate (given unchanged policies). That is a small fall for the highly indebted countries like Italy (perhaps 1%-2%), and a rise for others such as Belgium, Holland, Germany or France. So one shouldn't expect too much from this expansionary effect. In fact it reflects a monetary loosening for the core countries, and in order to generate the low inflation that they are used to monetary tightening and higher ECU interest rates will be required. On balance, therefore, it seems that the expansionary effects of fiscal consolidation would not be very large, except perhaps in the most extreme cases of indebtedness.

- In summary, the lack of a clear fiscal regime - or at least an operational set of rules defining how fiscal policy would be run after EMU - constitutes a significant problem for EMU. On the other hand the costs of failing to impose the fiscal convergence criteria on high debt countries, or equally the costs of imposing only the part that doesn't matter, will imply significant costs for low debt countries. Hence the attraction of a "two speed" regime: this would have the political advantage of allowing EMU to proceed, and the economic advantage of removing any threats to those in EMU from indiscipline from outside.

SOME POLITICAL ECONOMY ISSUES IN FISCAL POLICY

- Fiscal restraints are important because insufficiently coordinated policies would produce excessive expansions since in EMU the costs of fiscal expansion on the individual are reduced. With a single currency, the adverse consequences of a large fiscal expansion by one country (when all have reasonable debt levels) will be spread over all countries. Hence the disciplinary cost on the expander will be that much smaller, unless all expand equally. Monetary union therefore alters the marginal rate of substitution between political benefits of lower taxes or higher spending, and the costs in terms of higher interest rates, service charges, crowding out etc. which are now passed on to other countries. Thus countries face a bias towards overexpansion in a fiscally noncooperative world. The result will be a new bias to excessive debt.

- Others have argued that monetary union may lead to fiscal expansionism because, by Ricardian equivalence, the new taxes which will have to be paid (at some future date) to reduce a current deficit will be spread over all countries to the extent that there are revenues from "the centre". Against that it may be that, by increasing the credibility of monetary policies, EMU will lead to lax fiscal policies since the authorities will have to worry less that their fiscal expansionism will add something to the inflationary potential (or lack of credibility) of national monetary policies. A third argument is the simplest: with the removal of national monetary policies, fiscal policies will have to be more vigorous to replace the differences in those policies if individual economies are to retain the same overall performance. That will require larger deficits on occasion and therefore on average.

- However, the real incentive for fiscal retrenchment is that large deficits, including service payments on past debt, restrict the freedom of manoeuvre for subsequent fiscal policies. If the deficits/debt built up in a cyclical downturn are not removed in the upturn, then all the cost associated with excessive fiscal expansion will appear but with much greater effect when fiscal interventions are needed again in the following downturn. If this is repeated, then the costs start to mount, as do the funding difficulties and the default (or monetisation) risks perceived by the markets. This has already become only too clear in Italy and Sweden: and the UK has clearly seen the danger of getting "boxed in" without an effective fiscal policy. That is why British policy has focused on growth and recovery, rather than on inflation control or preserving the ERM. The idea was that revenues, being a nonlinear function of activity levels, would rise more rapidly with recovery than expenditures (largely precommitted, and proportional to activity through unemployment expenditures) would fall. This strategy makes fiscal adjustments by raising revenues through higher growth and therefore deals with the ratio problem. In other words, the choice is between growing out of debt, or contracting out of debt. The political economy of the situation suggests the former is far more likely to be more successful.

ASYMMETRIC SHOCKS: GERMAN UNIFICATION AND THE BREAK UP OF THE ERM

- European policymakers agree that the income and trade effects of Germany's unilateral expansion were positive. But the monetary consequences, in the form of high <u>real</u> interest rates transmitted by the ERM system and sustained by a monetary policy aimed at heading any inflationary pressure off at any cost, were severely negative. The large negative

monetary spillovers outweighed the small positive spillovers, to produce a significant recession elsewhere. The lesson drawn from this episode was only partly that this could be the kind of outcome one gets from a monetary union with uncoordinated fiscal policies. The main concern now is that there appears to be nothing within the current EMU programme to ensure the necessary fiscal coordination.

- The more general point is our vulnerability to asymmetric shocks of this kind. German unification is only one example. North Sea oil and the sensitivity of the Pound to movements in the world price of oil are two others. This was important in the 1980s. A third example is the differential impacts of the capital flows triggered by the Mexican liquidity crisis in 1995, and policy makers are aware that asymmetric shocks can impose big costs. A fourth will be the accession of Central and East European countries, with their claims on the common agricultural and structural funds, and with their potential supply of migrants or cheap manufacturing facilities.

- Asymmetric shocks themselves, however, may not be the critical factor. Asymmetric responses to common shocks may be a good deal more important in practice because they are more frequent. In this case the asymmetries come from differences in economic structure - more flexible labour markets, lower non-wage (social security) costs, fewer subsidies and more competitive markets, more trade and financial flows outside the EU, and so on.

CREDIBILITY: REAL vs. NOMINAL CRITERIA

The break-up of the ERM was precipitated, in part, by divergences in real variables, especially between Germany and other countries. These differences became so great that markets took the view that interest rates would have to be decoupled from the German standard, and when this did not happen (and policy makers signalled they were not going to

let it happen) pressures in the foreign exchange markets grew to unsustainable levels. Although similar pressures in the foreign exchange markets cannot take place within a monetary union, continuous real divergences can lead to political pressures either to abandon the Union during recessions, or to impose additional fiscal measures to aid adjustment of economies in recession. The former would signal the end of monetary union; the latter is off the political agenda, might violate the convergence criteria, and might well lead to unsustainable fiscal deficits.

Nevertheless, there is now a widespread view among French policy makers,and those outside the "core", that policy must address the real side of the economy and that this is something which EMU will fail to do. In particular policy must be seen to be credible on the real side. Consumers and investors are, after all, no less forward looking than agents in financial markets; consumers because they base their expenditures (in part) on asset holdings whose value depends on future earnings and interest rates, and investors because their expenditures depend on the current market values of firms (i.e. on expected earnings and interest rates again). If consumers and investors see policy makers harden their monetary policies to preserve the exchange rate system in a recession or when exchange rates become misaligned, they will anticipate higher interest rates and falling earnings and will either reduce current expenditures or transfer them elsewhere - despite the extra monetary credibility being signalled. The result would be further downward pressure on the exchange rate and earnings, and upward pressure on interest rates. Moreover interest charges on debt will rise at the same time, widening existing deficits yet further. All these facts raise the costs on the real side without relieving the exchange rate or improving monetary credibility. In other words there is an issue of credibility on the real side, just as there is in the usual arguments for the importance of monetary credibility on the nominal side. Not only will the real targets of

economic policy be missed by a regime which pays little attention to them, greater oscillations will be generated in the real variables as well. The poor performance of the labour markets during the period of fixed exchange rates, where price stability was the priority, is a case in point. Nevertheless, the importance of credibility on the real side will obviously vary with the relative priorities placed on real (output) vs. nominal (inflation) performance.

UNEMPLOYMENT AND THE LABOUR MARKETS

Comparing the performance of the labour markets in Europe to their counterparts in the US and Japan gives a clear indication of the likely costs of an EMS (or EMU) regime that does not pay attention to the real side. It is true that maintaining social cohesion with heavily regulated labour markets and generous welfare provisions in a period of slow growth cannot have helped solve the growing unemployment problem. The European performance must partly have been the result of the particular political choices made. But, at the same time, the progress towards greater and greater price stability has eliminated the use of monetary policy as an instrument of adjustment. And greater price stability in itself means less relative price flexibility - so that channel of adjustment has also become blocked. A comparison between unemployment rates in Europe and those in her competitors (the US and Japan) shows the burden born by the real side in this regime.

- UK unemployment now stands at 8.3% of the labour force (down from 9.8% a year ago). This compares with 9.3% in Germany, 12.6% in France, 12.2% in Italy, 14.4% in Belgium, 24% in Spain and 7.3% in Holland - but 5.4% in the US and 3.2% in Japan. In contrast to the rest of the EU countries, where unemployment has risen over the past year even if it has now stabilised, unemployment has been falling for two years in the US and the

UK. Moreover, the effect on the labour markets has not only been in levels but also in the term structure of unemployment: 40% of European unemployed have been out of work for more than a year, but only 10% in the US. This does great damage to the skill base and re-employment opportunities.

- This difference between the UK and the rest of the EU has probably been made possible, if not encouraged, by changes in the organisation and structure of the British labour market. The old collective bargaining structures withered with legislation of the Thatcher era, designed to limit the power of the Trade Unions, and with the large loss of membership in those Unions which followed. Both decentralised wage bargaining and sharper locational competition have had a significant moderating effect on British wage rises - and this has been underpinned by the government's attempts to foster labour market flexibility and reduce nonwage costs (see table 1). These are important changes, which may not have been matched elsewhere.

- Regional mobility, which by European standards has traditionally been highest in the UK and Italy, remains significantly lower than within the US. Eichengreen's evidence would suggest that at most 1% of the labour force migrates between regions each year (and net migrations will be much less than that 1% figure), compared to 2%-3% in the US. Similarly relative wage flexibility between regions is small. Relative wage differentials exist between regions, and have done for many years, with differentials of perhaps 10% or so above and below the average for comparable occupations in rich and poor regions. Again this is smaller than in the US where there were wage differentials of up to 35% in 1992. So neither migration nor wage flexibility are significant adjustment channels at present.

- Once you move to considering countries as "regions" within the Community, the picture looks significantly worse. First, unemployment disparities across Europe are enormous. This is illustrated by the differences between the variances of regional unemployment rates shown in figures 1 and 2. The average unemployment rates in the UK and EU, and their dispersion, don't show the same pattern: in the UK (outside the EMS to 1990 and from 1992) they rise and fall with the cycle. In the rest of the EU they just rise and then flatten out. Mobility between countries is low for cultural and linguistic reasons. That produces a problem of the second best: high mobility in the single market for goods and capital, but low mobility in the "single" labour market, means that all markets must be off their optimal (equilibrium) reaction curves and the resulting partial equilibria may be very inferior. Our estimates are that the inefficiencies caused, allowing for the fact that labour market segmentation will allow leading sectors to transfer wage rises from elsewhere but that capital mobility provides locational competition in the opposite direction, is equivalent to 1½% on the average inflation rate or 1.7 million on the unemployment level.

A TWO-SPEED EUROPE?

- The ERM crises have clearly demonstrated that countries have heterogenous performances and that any policies applied need to sustain real side as well as monetary stability. As a result, discussions of monetary union since 1992 have rested on the assumption that a small group of countries with credible policies will adopt a single currency; the remainder will maintain national policies and currencies until sufficient convergence and credibility (real and nominal) has been attained.

- In economic terms this two-speed arrangement might be justified as follows. The theory of optimal currency areas (OCAs) suggests that a single currency may be adopted if

four conditions are met: the participants should be open to mutual trade, they should enjoy full mobility of capital and labour, and they should not be subject to asymmetric shocks or asymmetric effects of common shocks. However, the empirical evidence does not support these propositions in Europe. In fact it shows that the US doesn't function as an OCA and that Europe does so even less. The reason is that Europe is characterised by very little labour mobility which makes it very difficult to eliminate structural differences. At the same time Europe is vulnerable to asymmetric shocks which also inhibits convergence. Despite these differences however, the case has been found to improve substantially (Bayoumi and Eichengreen 1993) when one looks at a 'core' of European countries consisting of Germany, Benelux, France and Denmark[*]. But even then, the empirical support for a monetary union is not conclusive one way or the other. For example, the choice of countries to join the first speed is based on nominal criteria, whereas a very different core group would be obtained if unemployment was the defining criteria; an other one, if growth rates were used, and yet another, if fiscal balances were used (Davies 1994). This reflects therefore, one particular set of policy priorities and could not be said to be generally applicable. Second, the evidence clearly favours a core union on the supply side but not on the demand side of these economies - so it would not be without costs even for the core. Third, and most important, the evidence for a core union is that convergence is greater than among periphery countries, <u>not</u> that the degree of convergence is large enough in any absolute sense. On the other hand the evidence does not say that the degree of convergence is too small either. So the only way to proceed is to do a cost-benefit analysis to determine if a core union is close enough to satisfying the

[*] Evidence also appears in the similarities and differences between national money demand behaviour, (Artis *et al* 1993) and in national wage bargaining behaviour, Demertzis and Hughes Hallett (1995).

conditions for an OCA to be sustainable or beneficial, or whether it is far enough away as to make such an arrangement undesirable.

Despite the weakness of the case, last year's open letter from the governing parties in Germany (CDU 1995) has raised the idea of a "2-speed Europe", from a defacto configuration of the European economies, to a formal proposal for European integration. This transforms the debate from theoretic speculation to strategic pragmatism. Many commentators had already taken the view that the collapse of the exchange rate mechanism (ERM) in 1992-3, and the increasingly divergent employment and fiscal developments since 1990, had made some kind of "2-speed" arrangement inevitable. If that comes to pass, then the European Union will have voted for the German financial model of strict monetary control, independent central bank, and regulated markets and inflation aversion at the expense of output growth, employment and cost flexibility in the core countries.

The periphery will then be those countries which prefer the Anglo-Saxon model of deregulated markets, demand management, free exchange rates and maintaining high growth as well as low inflation. That "2-speed" regime,e therefore constitutes a natural "default" solution to the problem of how to manage a currency bloc containing two different financial models. The difficulty is that it would also mean an institutionalisation of those differences such that the periphery would find it much more difficult to catch up and join the core. Indeed the periphery might never catch up if it is to be judged on the nominal and fiscal convergence criteria now being applied. Moreover the increasing German insistence that these criteria be rigorously applied, plus the increasing realisation that monetary union without Germany - that is a monetary union not on German terms - is no monetary union at all, shows

that a 2-speed regime is both inevitable and likely to be a long run state of affairs. And here we have the real dilemma. A regime that was intended (in good faith) to be an easier way of getting to monetary union, given the existing differences between economies, may in fact turn out to be a semi-permanent arrangement because it allows participants to maintain different financial systems within one currency bloc according to taste, and because it accommodates the incentives of the core to maintain themselves as an exclusive club and the periphery to preserve their room for manoeuvre. Whether that improves welfare or not is a moot point. But what it does mean is that a 2-speed regime is likely to delay further integration and to eliminate some of the expected gains from lower transactions costs and exchange rate stability. In other words, in an effort to reduce short run transition costs, it threatens to create greater long run running costs.

- The costs and benefits of this 2-speed proposition deserve to be investigated. German political objectives aside, it is an important issue because, by somehow managing to make a virtue out of necessity, the policy makers have got by without making any assessment of the economic case for such a move. For example, will it be beneficial for Europe as a whole, as well as for the countries in the core and periphery individually? Will it be divisive (because the convergence of the periphery becomes more difficult) or conducive (because convergence is accelerated? What should the institutional and policy relationships between the core and periphery be? Yet there is plenty of evidence that poorly designed integration measures can lead to unsustainable policies and a very fragile union. Unfortunately the economics literature is a poor guide to these questions. It contains some analysis on the incentives for firms to invest and locate under a 2-speed regime (Martin 1995a); two papers on the political economy of expanding the core (Alesina and Grilli 1993, Martin 1995b); and one paper on who might

reasonably form a core from the point of view of monetary stability (Cassard *et al* 1994). But no work has been conducted on the strategic interactions; and none on competitiveness, policy design, or the macroeconomic performance aspects of this regime.

- The specific issues that require immediate attention are:

(a) The likely impact of a 2-speed regime on the economic performance of the core, the periphery, and Europe as a whole. In each case, costs as well as benefits need to be examined.

(b) How many "speeds" would be desirable, and which countries should belong to each speed?

(c) Are there inherent conflicts in that countries which would benefit from belonging to one speed on one criterion, would damage themselves [or others] if they are not allocated to another speed on a different criterion?

(d) How should the relations between core and periphery be managed? An interbloc ERM, floating, or explicit coordination without an explicit ERM framework? Should the periphery cooperate among themselves, or act as a competitive fringe?

(e) What institutional arrangements need to be made? For example, neither the European Central Bank nor the ECU currency (as currently constituted) could function if the core were separated from the periphery.

(f) Is there a conflict between the desire for a 2-speed regime as an easier/faster route to economic integration, and the self-interest of the core to sustain its leading position? Does the existence of a 2-speed regime make it easier or harder for periphery countries to catch up and join the core?

(g) How leading should the leader be? It is important to know how far the leading position of the core should be allowed to set the agenda both for the core countries and for the aspiring periphery members. What system will show the periphery how it should join the core? Should the leaders be required to help in this process?

- In the absence of answers to such questions, there is bound to be a great deal of uncertainty. For example:

(i) The Maastricht Treaty clearly indicates the 1st of January 1999 (originally 1997) as the first date for the adoption of a single currency. But will this actually occur, given the markets' perception that many countries (even some of the ones that traditionally form part of the core) will not have the economic structure needed to maintain it?

(ii) Which countries will actually participate? Those countries that perhaps satisfy the Maastricht criteria and can therefore form part of the first speed, need to know what the implications will be for not participating. On the other hand those countries that are not allowed to proceed need to know what time scale they need to consider in their economic planning for these criteria to be fulfilled and how they should best conduct their policies to maintain stability and to catch up.

(iii) What institutions are required to support such an arrangement? The European Central Bank (ECB) for example is immediately affected by a two-speed framework. Thus, although its original statute requires representatives from all countries in the Union to carry out one single monetary policy, its activities will have to be limited to the monetary policy for the core decided by the core representatives. This implies that remaining countries will not be able to influence the decision process: in that respect policy makers of the peripheral countries will be left to their own devices to manage their monetary instrument. In fact Martin (1995b)

highlights this split of the carrying out of monetary policy and suggests that with no explicit rules to either restrain their monetary policies or direct them towards the monetary objectives of the core countries, the periphery will manage to free-ride by competitively devaluing their own currencies. But Alesina and Grilli (1993) suggest the opposite: the core, by acting as a coalition will be able to appropriate a larger share of the gains than they could as members of a full monetary union, and will therefore prefer to remain an exclusive group.
This of course has a self-reinforcing aspect because of what it implies for voting rights, the conditions to be imposed on new members etc.

- Some think a 2-speed regime unnecessary and divisive: "...once the requisite convergence has been attained, not only in our economic policies, but also in the economic and monetary conditions prevailing in our various countries, the degree of convergence will be sufficient to enable the non-monetary instruments of economic policy to bear the weight of the adjustments which will always be necessary, without giving rise to intolerable economic and social tensions" [V. Giscard d'Estaing in 1994]. But recent events appear to demonstrate the opposite. As a result, Jacques Santer has recently argued that the British were not to have an "a la carte" choice among issues, while at the same time arguing that a "multiple-speed" selection among countries would actually encourage (and may be the only practical way to) monetary union. No consistency of views here.

- There may be a political element in this which, if it becomes part of EMU's design, may threaten the stability of a genuine monetary union for all. Examples would be the inclusion of Belgium or Ireland despite their official debt ratios, curtailing structural/cohesion funds before new members join, tightening the convergence criteria after the Treaty was

agreed, or redefining what counts in the budget or what counts as "normal" fluctuation bands or what counts as "sufficient progress" back towards the official criteria. It is very important that the decisions taken are both incentive compatible and acceptable to all, for the Union is unlikely to survive otherwise.

THE EXTERNAL DIMENSION

Until now there has been very little discussion of the environment in which EMU will have to operate, or of the potential interactions between Europe and third countries. How should we expect a monetary union on this scale to affect and be affected by events in the outside world? There are two main issues:

a) the international role of the ECU and its effect on the stability of the foreign exchange markets,

b) how will the changing policy mix in Europe affect policy coordination and exchange rate management internationally?

A. The ECU and the foreign exchange markets As soon as currencies are locked, there will be no need to deal in any of the national currencies, and the costs associated with these transactions will be eliminated. However, although there will be no incentive for traders to move between EU currencies, they will still maintain their operations with third currencies, switching between European and other internationally traded money. Alogoskoufis and Portes (1992) claim that the ECU will therefore be widely held as a reserve asset *via* asset switching on the day it is introduced. Indeed, if the European Central Bank is as tough as the Bundesbank and there are no problems of excessive debt (two very big 'ifs'), the ECU should be no less attractive than the deutsche mark and more attractive than any other european

currency. This suggests a rapidly increasing demand for the ECU. However, there are a number of reasons why that extra demand may not in fact materialise. First, the developing countries have diversified their portfolios after the collapse of the Bretton Woods in the early 1970s and have maintained very constant shares of currencies thereafter. Hence, unless the ECU operations lead to changes in the pricing of some major commodities such as oil, their currency shares are most likely to remain stable. In anv case, those countries which are closely linked to the EU do not account for a large share of the currency reserves held by developing countries. They are not likely therefore to increase their ECU holdings further than what is required to replace their current EU currency reserves.

Second, the EU countries themselves, obviously hold large amounts of both ECU and national currency reserves. The former will turn into dollars and gold on the first day of Stage Three, whereas the latter will become domestic currency claims on the central bank. Any French Francs (FF) held in the Bank of England for example, will become ECU claims on the European Central Bank. However, these FF reserves were previously used to stabilise the now redundant bilateral FF/£ exchange rate. Such reserves are therefore now in excess of the amount required for interventions in the international financial markets and the lack of any need to hold cash balances in other EU currencies causes a once-and-for-all reduction in the demand of money. The authorities can then do one of three things. They could:

i) change the excess reserves into ECUs and allow them to circulate in the markets. But that would increase supply of money and hence inflation.

ii) sterilise those reserves through open market operations by issuing bonds, but this would push the interest rates up and would lead to recession.

iii) change them into (say) dollars and keep them in the ECB's reserves. But the purchase of these dollars would push the ECU rate down and cause inflation.

All three options therefore cause financial instability. And that instability could be substantial since these reserves amount to about 4% of the European GDP, that is equal to the deficits of all the EU governments combined, (Kenen 1995).

Third, the non- EU countries will obviously also have their current EU reserves swapped for ECU which they will add to their present holdings and use to prevent undesirable currency movements. However, they will not be inclined to buy more ECUs than are actually necessary because if Monetary Union is to provide the credibility it advocates, then its currency is more likely to be strong than weak and hence relatively expensive.

Fourth, as european currencies are withdrawn from circulation, risk averse investors will seek to maintain a stable degree of diversification which will require the holding of a variety of currencies. As the number of european currencies available is minimised, switching to non-european monies is required and then larger flows in and out of the ECU thereafter.

B. EMU and International Policy Coordination

- In transition, unlimited intervention has to be guaranteed by the ECB in order to maintain the parities agreed upon on the 1st of Jan. 1999 to enforce the commitment to Monetary Union. Money supply will subsequently adjust to the needs of the markets. Suppose now that the FF is subjected to heavy speculation and falls. The ECB will then sell DM and buy FF to counter-balance those movements. The national monetary authorities will, at this stage, no longer have the opportunity to renege on the principle of ECB's unlimited intervention. However, the individual that holds any of the currencies concerned will remain uncertain of the eventual completion of Monetary Union, of the ability to maintain the agreed parities, or the credibility of the monetary policies to follow. These individuals will switch from the currencies within Monetary Union to third currencies (witness the 200 million DM

that were transferred from German to Swiss Banks last year, without any particular trigger). This illustrates how currencies can be put under pressure, not only by speculators but also by ordinary citizens who are simply risk averse. Under such circumstances, the ECU will be forced to adjust in relation to third currencies and that will in turn put a lot of pressure on the ECB's ability to pursue pre-assigned monetary objectives.

- Similar pressures on the value of the ECU *vis-à-vis* the rest of the world currencies will appear with the uncoordinated fiscal behaviour of members who choose to overexpand and avoid the necessary fiscal discipline required to achieve monetary stability. Since EMU evidently increases the incentive to overexpand and provides only weak sanctions on those who fail to abide by the convergence criteria after admission to EMU, indebtedness and a lack of coordination are likely outcomes. To remove that indebtedness will require both fiscal contractions and ECU devaluations.

C. Commercial Policy The third external component is trade and competition policy. With the advent of the single market, internal barriers to trade should be reduced. Some of the largest gains will come from reducing the degree of imperfect competition in European markets. This, to the extent it happens, should strengthen the Union but will have little effect on third countries (Hughes Hallett and Ma, 1995). Trade policy, that is the extent to which external barriers are likely to come down at the same time, is an other matter. Hughes Hallett and Braga (1994) note that Europe has some reasons to remain relatively closed, and that any large trading bloc will face the incentive of maintaining those barriers in order to exploit its power in the market. This doesn't improve world welfare, but will increase local gains.

CONCLUDING REMARKS

This review of monetary union has been unable to avoid emphasising the problem of the asymmetries between the main EU countries. They are not all exclusive, but they are especially marked in the trade structure, in the preference for growth and employment rather than price stability, in market structures and market responsiveness, in the vulnerability to asymmetric shocks, and not least in the terms and form in which the political debate is conducted.

If there are any lessons to be drawn from the above, they would be that any revisions of the Maastricht Treaty should give emphasis to the importance of real side credibility for both the achievement of monetary stability and the achievement of monetary union. The key discussion must revolve around the choice of fiscal policy regime and its execution or coordination in a multi-country context. For example, how will European fiscal policy be arranged in relation to the tougher and more clearly specified objectives of monetary policy? How will growth and consequently unemployment respond to a fairly anti-inflationary policy?

Given the existing asymmetries, and their importance in the eyes of national policy makers, it is hardly surprising that there is no enthusiasm for rejoining a weakened post-1993 ERM. Hence the importance now attached to introducing real (as well as nominal) convergence criteria as essential pre-conditions for monetary union to take place. Without such criteria, EMU might be regarded as a very risky business.

TABLE 1

Relative Unit Wage Costs in Britain and Germany

	Germany	UK	Ratio (UK to Germany)
January 1990	97.11	81.25	0.84
January 1991	99.72	86.74	0.87
January 1992	104.56	89.16	0.85
January 1993	113.74	87.75	0.77
January 1994	110.58	87.68	0.79
January 1995	103.88	88.73	0.85

Source: Bank of England. Index Numbers, 1990 = 100 and converted to purchasing power parity at that date.

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Figure 1

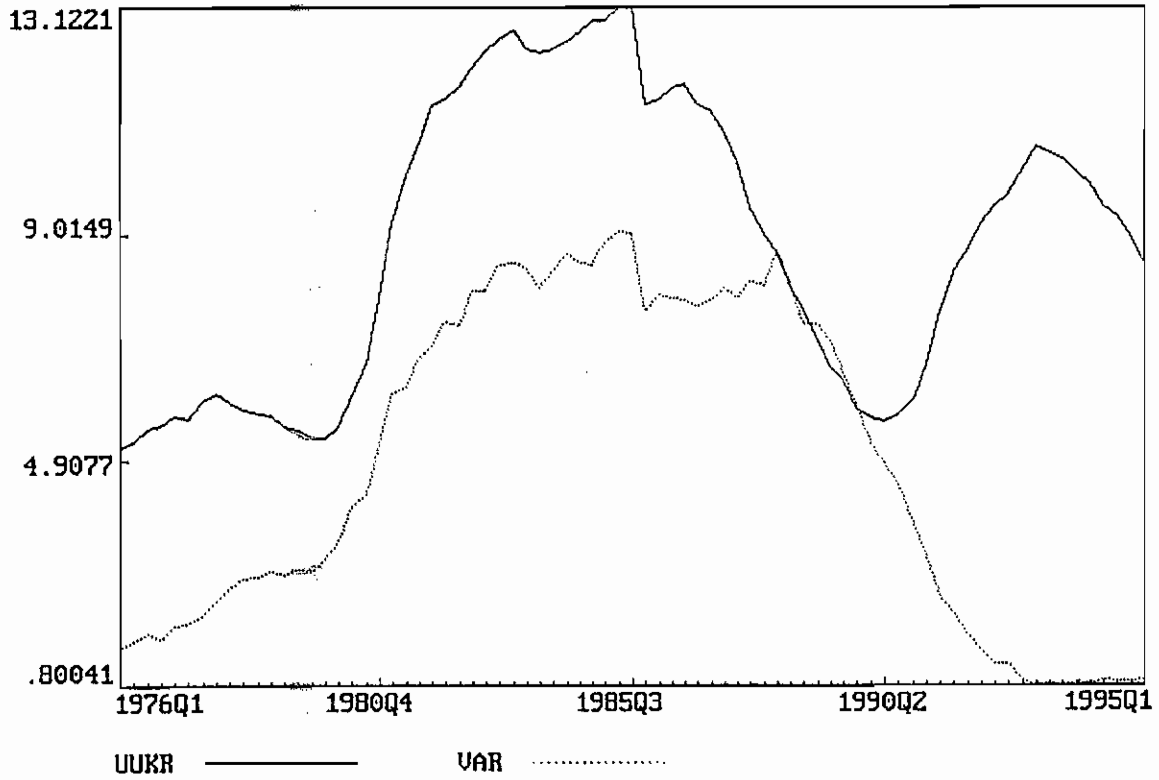

Figure 2