*Journal of Economic Perspectives—Volume 11, Number 4—Fall 1997—Pages 23–42*

# The Political Economy of the European Economic and Monetary Union: Political Sources of an Economic Liability

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The introduction of the European economic and monetary union (EMU)[1] could be the most far-reaching European political event of the twentieth century. Its significance would not just be the substituting of a single European currency for the individual national currencies of the member countries, but that doing so could lead, as many of its proponents hope, to a political union that would fundamentally change the politics of Europe and of the world. If, instead, the shift to a single currency were now abandoned, the Maastricht treaty with its explicit provisions for future political union and the coordination of foreign and security policies would be effectively dead.

As I write this essay, it is still uncertain whether the economic and monetary union will begin on schedule in January 1999, will be postponed to a later year, or will be postponed and never occur. What is clear to me is that the decision will not depend on the *economic* advantages and disadvantages of a single currency. The decision of whether or not to form a monetary union will reflect deeply held political views about the appropriate future for Europe and about the political advantages and disadvantages to the individual countries and even to the individual political decisionmakers themselves. Although the decision on whether to go forward will formally be decided by a "qualified majority" of the entire European Council

[1] Although EMU signifies "economic and monetary union," the essential feature is the monetary union; that is, the shift to a single currency and a single European central bank. The EMU should of course be distinguished from the earlier "single market" agreement to eliminate barriers to cross-border trade, investment and employment within the countries of the European Union.

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of Heads of State or Government (that is, by a majority vote in which countries have unequal numbers of votes), the actual decision will depend overwhelmingly on the preferences of the German and French political leaders.

I stress the importance of these political motivations to emphasize that it would be wrong to infer from a European decision to form a monetary union that expert opinion in Europe had concluded that doing so would be economically advantageous. Similarly, if that effort is now abandoned, it would be wrong to infer that the experts had concluded that the economic costs would outweigh the economic benefits.

The shift to a single currency for all of Europe would be an unprecedented event. No sizable country anywhere in the world is without its own currency. A national currency is both a symbol of sovereignty and the key to the pursuit of an independent economic and budget policy. The tentative decision of the European Union member states (with the exceptions of Denmark and the United Kingdom), embodied in the Maastricht treaty, to abandon their national currencies in favor of the euro is therefore a decision of fundamental political significance. Although Europeans debate the extent to which this change will automatically lead to a shift of power from the national governments to a European government (embodied in the European Commission, the European Parliament, the Council of Ministers, and the European Central Bank), there can be no doubt that eliminating individual currencies would be a major psychological and substantive step toward a European central government. For the residents of Europe, substituting the new euros for their own familiar national currencies would be a powerful signal that Europe had become the operative state and that their own countries were now subsidiary political subdivisions.

As economists, we can evaluate the likely effects of monetary union on employment, inflation, trade and overall economic well-being. But we should recognize that the officials who are pursuing monetary union are motivated by political considerations that transcend questions about the likely performance of the European Central Bank and whether the European economy satisfies the Mundell (1961) criteria for an optimal currency area. It is useful to explore these political considerations before looking at the likely consequences of EMU for the economies of Europe and the rest of the world.

My own judgement is that the net economic effect of a European Monetary Union would be negative.[2] The standard of living of the typical European would be lower in the medium term and long term if EMU goes ahead than if Europe continues with its current economic policies of a single market for trade in goods and services, the free flow of capital and labor, adjustable exchange rates within broad bands, and domestic monetary policies aimed at low inflation. But in the end, it should be for the Europeans themselves to decide whether there are net political advantages of EMU that outweigh the net economic disadvantages. Unfor-

[2] For earlier statements of my own views, see Feldstein (1992, 1993).

tunately, the public discussion of EMU in Europe has not focused on this trade-off, because EMU is being marketed as a source of improved economic performance.

## The Politics of European Monetary Union

Although political considerations are dominant in creating a European monetary union, there is no single coherent political case for doing so. The political driving forces that are responsible for EMU are in fact a strange mixture of pro-European internationalism and the pursuit of narrowly defined national self-interest. Although no individual advocates all of these views and the views themselves may be mutually contradictory, taken together they may propel Europe into a monetary union.

### Protecting Peace and Projecting Force

The roots of EMU can be traced back to the years immediately after World War II when Jean Monnet and others dreamed of preventing future European wars by forming a United States of Europe. The first step toward that goal was the European Coal and Steel Community, transformed in 1957 by the Treaty of Rome into the European Common Market. The strategy of gradual evolution led next to the creation of the European Communities in 1967, the European Monetary System (EMS) in 1979, the Single European Market in 1992 and the European Union in 1993, with increases at each stage in the range of coordination and in the centralization of power.

Chancellor Helmut Kohl of Germany, the most important proponent of monetary union, argues that the greater political cohesion that would follow EMU is the best way to prevent a recurrence of war in Europe. As someone who lived through World War II, Chancellor Kohl knows the powerful appeal of such an argument to the people of his own generation. He argues further that Germany's reliability as a peaceful neighbor will be enhanced if it is contained within a strong European confederation. Although the memory of World War II is diminished for the population as a whole after more than 50 years, the history of three major wars involving Germany since the Franco-Prussian war of 1870 makes this belief, if true, a very important reason for welcoming EMU and the political transformation of Europe to which it might contribute.

Assessing the likelihood of future military conflicts under different institutional arrangements is of course extremely difficult.[3] It is certainly not clear that peace in Europe needs (or would even benefit from) the much stronger political ties envisioned in the Maastricht treaty and in the subsequent official discussions among

[3] War may seem unthinkable in the current age of weapons of mass destruction. Unfortunately, such an optimistic view was widely held before both World War I and World War II; see Kagan (1995, especially pp. 1–11).

European leaders. Western Europe has avoided war for half a century with its existing structure of nation-states and military cooperation through NATO. The freedom that individual nations have had to pursue their own economic, social and international policies may create less conflict than would result if a strong political union sought to impose common policies on nations with very different political, religious and historic experiences and potentially very different economic interests. Conflicts could be even greater if an initial core group of EMU members unilaterally imposed conditions on non-EMU members[4] and on future EMU entrants. A long-term split of the European Union into EMU members and those who do not join EMU would create a two-class Europe with the potential for serious economic and political conflicts. Such a long-term division is not unlikely as the European Union expands to the east.

A strong constitutional political union is certainly not a guarantee against a new war among its members, as the devastating civil war between the member states of the United States clearly demonstrated. The ethnic-based struggles in eastern Europe and the former Soviet Union and the splitting of Czechoslovakia into Slovakia and the Czech Republic show that separation may be a more stable peaceful equilibrium than integration.

It is even more difficult to assess how a politically unified and powerful European Union would affect potential conflict with others. Russia, although still a major nuclear power, is now relatively weak and focusing on achieving economic reform and industrial rebuilding. Might a stronger Russia at some time in the future and with a more secure political leadership try to reassert control over the now independent Ukraine? Would a strong unified European Union discourage such action? Would a united Europe be tempted to transform a Russian takeover of Ukraine into a broader conflict, reminiscent of Germany's invasion of Russia in World War I and again in World War II?

Until recently, the threat of attack by the Soviet Union has made Europe militarily dependent on the U.S.-dominated NATO. The existing political structure of Europe has also prevented Europe from developing the capability to pursue independent military policies. This was demonstrated most dramatically and decisively when England and France were forced by the United States to abandon their attack on the Suez Canal in 1956. As Henry Kissinger (1994, ch. 21) has noted, this episode showed the Europeans that they had lost their previous ability to play a major independent role in world affairs and convinced them that a new structure of Europe was needed if they were to regain their earlier power and influence. Kissinger (1994, p. 547, quoting Finer, 1964, p. 467) describes the following revealing episode:

[4] The new European Monetary System rules, agreed to at the December 1996 Dublin European Council meeting, requires all members of the European Union (including those that are not members of the monetary union) to pursue convergence policies with specific targets for budget balance and inflation, a major change from previous EMS rules. (Only the UK is not legally bound to avoid a budget deficit in excess of 3 percent of gross domestic product.) The fact that there is no clear mechanism for enforcing this legal obligation is itself a potential source of conflict.

> Adenauer happened to be in Paris on November 6, the day Eden and Mollet decided they would have to yield to American pressures (to withdraw from Suez). According to the French Foreign Minister Christian Pineau, Adenauer said: "France and England will never be powers comparable to the United States and the Soviet Union. Nor Germany, either. There remains to them only one way of playing a decisive role in the world; that is to unite to make Europe. England is not ripe for it but the affair of Suez will help to prepare her spirits for it. We have no time to waste: Europe will be your revenge."

That was a year before the Treaty of Rome launched the Common Market and two years before Charles de Gaulle, unable to achieve what he regarded as a satisfactory restructuring of NATO, withdrew France from the NATO military alliance and moved to develop an independent French nuclear capability. France and Germany also moved to establish closer ties, leading to their 1963 treaty of friendship and collaboration.

Although the United States and the countries of western Europe have had an extremely close alliance since the end of World War II and continue to coordinate military efforts within the NATO structure, there is no doubt that many Europeans in positions of responsibility see their economic interests and their foreign policy goals differing from those of the United States with respect to many parts of the world, including eastern Europe, the Middle East, Africa and even the Caribbean. A more united Europe would undoubtedly be able to pursue an independent foreign policy more effectively than the current separate nations within the European Union. Indeed, the German government originally emphasized the importance of this by demanding that political union and harmonization of foreign and military policies should precede monetary union (as it did when Prussia united Germany under its leadership in the nineteenth century). Although Germany has now accepted that the order be reversed, with monetary union preceding political union, the Bonn government always emphasizes that monetary union is a prelude to the coordination of these other noneconomic policies.[5] With the U.S. military presence in Europe diminished and the Russian threat in abeyance, a united Europe could build on the existing small Franco-German joint military collaboration to develop the ability to project military force outside Europe and thereby to pursue an independent foreign policy. Indeed, France and Germany announced jointly in March 1997, on the 40th anniversary of the treaty of Rome, their desire to see a merger of the European Union with the European military alliance (the Western

[5] Helmut Schlesinger, former head of the Bundesbank, explained as follows in his John Foster Dulles Lecture at Princeton's Woodrow Wilson School on October 31, 1994 (mimeo, p. 11): "Sometime there was an attempt to draw parallels between German unification and the path to a united Europe. I think only one point is really comparable and that is: the final goal in both cases is a political one in which the economic union is an important vehicle to reach this target. Since 1952, the beginning of the creation of the European Community, the final goal was and is to reach any type of political unification in Europe, a federation of states, an association of states or even a stronger form of union. The political target has been guiding Germany since the beginning and will certainly continue to do so in the future."

European Union) to strengthen military coordination of European nations outside the NATO framework.[6] Whether such developments would be good or bad for long-run world peace cannot be foretold with any certainty. The likely further reductions in the U.S. military presence in Europe would undoubtedly make Europe more vulnerable to some future attack. The weakening of America's global hegemony would undoubtedly complicate international military relationships more generally.

**National Interests**

Although some politicians and bureaucrats may judge the desirability of a stronger and more unified European Union solely in terms of its impact on Europe as a whole, most will focus on what EMU and a more centralized Europe would mean for their own country. Regardless of the formal procedure, it is the French and Germans who will now determine whether or not monetary union will occur and it is likely that each will determine its position in terms of its perception of national self-interest. The other members of the European Union can only decide whether, if there is a monetary union, they wish to join.[7]

France sees EMU and the stronger political union to which EMU will lead as an opportunity for France to be a "co-manager" of Europe as an equal of Germany rather than being dominated by a Germany that has nearly 50 percent more population than France.[8] In the economic sphere, the current domination of European monetary policy by the German Bundesbank would be replaced by the European Central Bank at which Germany and France would sit and vote as equals. With its "natural" Mediterranean allies of Italy and Spain, France may come to have the decisive influence on the evolution of European policies. The center of gravity of Europe would become Brussels or Strasbourg rather than Berlin. The very skillful international French civil servants may come to dominate the administration of the European government. All of this may be wishful thinking in Paris, but it persuades French officials that France is likely to be better off with monetary union and the political evolution that would follow than with a continuation of the current system.

Germany's reason for wanting monetary union and a closer coordination of noneconomic policies is harder to understand. Some German leaders no doubt believe that such a policy increases the prospects for peace and "helps to contain

[6] France has recently indicated a willingness to reenter the NATO military structure but only if it can replace the United States as head of the NATO Southern Command that is responsible for the Mediterranean area, a condition that the United States has rejected.

[7] For an excellent explicit example of such an analysis for Sweden, see Calmfors (1996). The Swedish government has announced that it does not want to join the EMU in January 1999. Although all members of the European Union (other than Denmark and the UK) are in principle required by the Maastricht treaty to join the monetary union, the Swedish experience shows that a country can decide whether it is "ready" to do so.

[8] Compare Kissinger's (1994, p. 606) description of French aspirations at an earlier time: "What de Gaulle had in mind was a Europe organized along the lines of Bismarck's Germany—that is, unified on the basis of states, one of which (France) would play the dominant role . . . Everybody would have some role in de Gaulle's redefinition of Richelieu's pre-eminent France: . . . France to diverting German national aspirations into European unity."

a potentially dangerous Germany within Europe." Other Germans disagree with the French assessment of the consequences of greater economic and political integration. They see Germany as the natural leader within the European Union, because of its economic weight, military capability and central location in a European Union that will soon include Poland, the Czech Republic and Hungary. With the European Central Bank in Frankfurt and its charter designed in the Maastricht treaty to make it function like the Bundesbank, Germany can hope to dominate monetary policy. The "stability pact" demanded by Germany (and accepted at the December 1996 Dublin European Council summit meeting) may provide the fiscal discipline that Germany wants as well. For these Germans, the implicit model may be Bismarck's ability to unify Germany around Prussia. As Chancellor Kohl frequently says, not without ambiguity, "Germany is our fatherland but Europe is our future." The view of a unified Europe dominated by Germany may also reflect a good deal of wishful thinking in Bonn and Frankfurt. It is clear that a French aspiration for equality and a German expectation of hegemony are not compatible. But both visions of the future drive their countrymen to support the pursuit of EMU.

What about the other countries of the European Union? The Italian government's impressive efforts during the past few years to meet the Maastricht treaty's criteria of eligibility to join EMU shows how eager the Italian government is to be part of the first group to join in January 1999.[9] Italy's sense of urgency is no doubt driven by national pride. As one of the original group of six signers of the Treaty of Rome, the Italians do not want to be deprived of first-round entry to the EMU. The Italians also recognize that they do not have France's close working relation with Germany and therefore feel even more strongly than the French that they can influence European policy only within a formal structure. While Italy may welcome the external standards of macroeconomic discipline the European Monetary System system has brought, an outsider may nevertheless wonder why Italy, whose economic growth exceeds that of both France and Germany, wants to conform to new pan-European economic regulations that may lower its economic growth. But the real driving force in Italy is the desire to be part of the political process and the stronger political union that can be imagined to be just over the horizon.

Spain, like Italy, has been making major efforts to be eligible for admission to the EMU. The common reasons given by Spanish officials are to show that Spain has overcome its past history of political and economic isolation during the Franco regime and that Spain desires to be treated as a full member of the European

[9] The Maastricht Treaty specifies that eligibility for admission requires low rates of inflation and low interest rates, a budget deficit of less than 3 percent of GDP and a debt-to-GDP ratio of less than 0.6 or an indication of progress in achieving that goal. Since 1995, Italy has reduced its inflation rate from 5.4 percent to less than 2 percent and its budget deficit from 7.1 percent of GDP to 3.3 percent of GDP. Although some of the deficit reduction reflects creative accounting and temporary measures, the achievement is nevertheless impressive. And while Italy's debt-to-GDP ratio is still far above 0.6, it has been coming down significantly.

Union. The emphasis in Spain is thus not on the possible benefits of being in EMU but rather on the advantage of becoming a member and of being seen to become one.

Advocates of joining the EMU in Spain, Britain, and most of the smaller countries of the European Union also state that their country must be part of the monetary union in order to "have a seat at the table" where the policies are made that will affect them in the future. That table is not at the European Central Bank, since a country that did not join EMU could in principle pursue an independent monetary policy. And all of the members of the European Union are literally "at the table" of the Council of Ministers and the other European decision-making bodies, regardless of whether or not they join EMU. But pro-EMU officials assert that a country must join the EMU to show that it is enthusiastic about the future political development of Europe if it wants to be influential in those decision-making bodies. This route to influence may also be an illusion. As the European Union looks eastward and the number of member countries increases substantially, the smaller countries may well find that membership in the EMU does not guarantee a meaningful voice in policy deliberations. Instead, the combination of qualified majority decision-making (that is, weighted voting) and the inevitability of indirect representation in key decision-making bodies (with only one representative literally at the table from a group of smaller countries) may significantly limit their voice in European affairs.

Countries may join the EMU and participate in the future European political development not because they favor that as such, but because they fear that they will be discriminated against in other European Union activities if they do not join. For example, France has argued that Britain should be denied access to the European bank clearing system if Britain does not join the EMU.

Any country that accepts the future that is implied by the Maastricht treaty must recognize that there will be a substantial loss of national control over its domestic and international affairs. The "stability pact" that was insisted on by Germany and accepted at the December 1996 European Council meeting is designed to limit the fiscal policies of member countries. The European Commission is now actively preparing plans to "harmonize" tax rules, denying countries the opportunity to tailor tax policies to national political views and to experiment with different approaches to raising revenue. The EMU is clearly just the beginning of a rapidly evolving set of rules to which member nations would be irrevocably committed.

The Maastricht treaty's principle of "subsidiarity," which asserts that activities will be assigned to the most appropriate level of government—European, national or local—cannot provide much comfort to anyone who has watched the imposition of economic regulations on national governments by the European Commission.[10]

[10] Even the tenth amendment to the U.S. Constitution, which reserves to the states (or to the people) any powers not delegated to the national government, has not prevented the shift of power to the national government over an enormous range of "local" issues, such as speed limits on local roads and the age at which individuals may drink alcohol.

Many of these are small nuisances, like the regulation of beer standards. But others, like the limit on working hours, can have substantial effects on a domestic economy.

Countries have to recognize that the treaty obligations of EMU members may change in the future and that there is no opportunity provided in the treaty for member countries to opt out of such future provisions or of the original Maastricht treaty obligations if they discover that the net effect of EMU is contrary to their national interest. Indeed, when Danish voters initially rejected EMU and decided against ratifying the Maastricht treaty, Denmark was threatened with losing the free trade benefits of the single market.

The pressure to have common labor legislation and economic regulations, common tax rules and common social benefits would strengthen the control of government relative to the market and would eliminate the competitive process by which different types of government rules can be judged in practice.

**Majority Preferences and Political Elites**

The government leaders of most of the European Union countries have strongly urged their citizens to support European monetary union. They have, moreover, frequently been joined in this effort by the leaders of the opposition parties. Nevertheless, the majority of the public in many countries remains unconvinced. In Germany, polls indicate that as many as two-thirds of the voters oppose German participation in the EMU. In France, a plebiscite approved monetary union with a majority of less than 1 percent despite the strong endorsement of the then President Francois Mitterand and by the leader of the opposition party; a similar vote today might well show a majority opposed to EMU.

It is impossible to know why politicians are disregarding the popular sentiment. They may feel that EMU is really in the public's best interest, but that the issues are too complex for the public to understand. Alternatively, they may believe that public opposition is excessively influenced by the temporary increase in unemployment that has resulted from pursuing the convergence criteria that are required for admission to EMU. More generally, they may believe that although the current generation will be hurt by joining the EMU, the gains to future generations outweigh the losses to the current generation. Or they may be influenced by the way that the decision about EMU will affect themselves personally.

Chancellor Kohl has been the leading politician promoting EMU and the transition to a more politically unified Europe. Success in this arena, coming on top of his leadership in reunifying Germany, would secure his place in German history alongside Bismarck as one of the two greatest German leaders. Other politicians are reluctant to appear anti-European or to challenge the elite consensus. When the speaker of the French National Assembly spoke against EMU, Chancellor Kohl declared publicly that a man with such views could never be fit to be the leader of France. The lesson was undoubtedly not lost on other politicians in France and elsewhere. Even those politicians who doubt the wisdom of EMU and who would not support it if it were beginning today may be reluctant to try to resist EMU's powerful momentum.

For the bureaucrats, the evolution of European institutions and rules provides exciting new challenges and a wider network of colleagues throughout Europe. Those who voice opposition to EMU or to a more centralized European political structure are not likely to be given the opportunities to participate in such activities.

How important each of these factors is in shaping the decision to go forward with European monetary union is impossible to say. But my judgement, as one who has followed the European debate closely and has had the opportunity to discuss these issues with many of the European political participants, is that the decisions that have brought Europe to the current point and that will determine whether EMU occurs are based on the combination of broader political considerations and personal interests rather than on the economic merits of the case. Nevertheless, we as economists can, and indeed have an obligation to, evaluate the likely economic effects of EMU. It is to that task that I now turn.

## The Economics of European Monetary Union

Stripped to its bare essentials, the fundamental economics of evaluating any monetary union is a quite straightforward balancing of potential trade gains against macroeconomic losses. Substituting a single currency for several national currencies reduces the transaction costs of trade within that group of countries. This saves resources directly and may bring further gains by increasing trade among the member countries. Whether the increased trade within the monetary union is a good thing or not depends on the relative importance of trade–creating effects (that is, the increased trade among the member countries) and trade–diverting effects (that is, the diversion of existing imports from countries outside the monetary union to countries inside it).

Balanced against this potentially (but not necessarily) positive trade effect, the shift to a single currency exacerbates unemployment by eliminating the possibility of national differences in interest rates and of changes in nominal exchange rates. The single currency therefore implies not only the government's inability to conduct a national monetary policy but also the absence of autonomous market responses of interest rates and exchange rates to exogenous demand shocks. This increases the cyclical instability of the economy and, more specifically, the average level of cyclical unemployment.

In addition, the substitution of the European Central Bank for the current system of national central banks will affect the prospects for price stability. The new arrangements could also affect broader aspects of economic policy, including protectionist trade policies toward the non-EMU countries and the policies that affect structural unemployment within the EMU area. I will return to these after I discuss the ways in which the conditions within the European Union affect the likely tradeoff between reduced transaction costs and increased macroeconomic instability.

My own judgement is that, on balance, a European monetary union would be an economic liability. The gains from reduced transaction costs would be small and might, when looked at from the global point of view, be negative. At the same time, EMU would increase cyclical instability, raising the cyclical unemployment rate. Although it is less certain, I believe that the EMU would also make it more difficult to reduce structural unemployment and would increase the risk of protectionist policies toward non-EMU countries.[11] I turn now to the reasons for these conclusions.

**Reducing the Cost of Trade Among EMU Countries**

Consider first the effect of EMU on the cost of international trade and therefore on the volume and structure of that trade. There is no doubt that a single currency would reduce the cost of trade among the EMU countries by eliminating the need for purchasing and selling foreign exchange in spot and forward markets. It is difficult to say how much these savings would be, especially since changes in European banking practices and the increasing use of electronic payment mechanisms are already reducing the costs of such transactions. Beyond the actual transactions costs, the existence of a single currency may also reduce currency risks associated with trade and investment among EMU countries and therefore make it more attractive for firms in EMU countries to increase their intra-EMU trade. The importance of this is also diminishing rapidly as long-term forward exchange contracts become cheaper and much more readily available.

It is clear, however, that the European Commission's (1991) claim—in its popular document, *One Market, One Money*—that the integration of product and factor markets in Europe requires a single currency has no basis in either theory or experience. The enormous expansion of trade within Europe and within the global economy more generally during the past several decades has occurred without a single currency or a return to fixed exchange rates. There is, moreover, no clear evidence that the reduced exchange rate volatility that accompanied the introduction of the European Monetary System of exchange rate targets has increased the volume of trade and cross-border investments among the participating countries relative to the trade and investment relations with other countries. Harmonization of tax rules and other legal structures would probably have a more fundamental effect than greater exchange rate stability. The North American Free Trade Agreement, although different in many ways from the European "single market" agreement, has stimulated trade and investment without any movement toward a single North American currency or even toward exchange rate stability within North America.

It is important, moreover, to bear in mind that although a European monetary

[11] In this evaluation I focus on the longer-term consequences of EMU. It is clear that meeting the Maastricht criteria for EMU membership has led in some countries to substantial short-term increases in unemployment. The final stage of the transition to EMU could impose further dislocations if the initial exchange rate parities at which the countries enter the single currency (to be set by a majority vote of the Economic and Finance Ministers Council, the ECOFIN Council) require downward adjustments in local wages and prices to prevent further increases in unemployment.

union would eliminate currency fluctuations among its member countries, currency fluctuations between the euro and other countries would continue and might increase. Therefore, even if exchange rate stability as such facilitates increased trade, the net impact of the shift to a single currency on the total volume of European trade would be uncertain. Consider, for example, a Dutch firm that exports primarily to Germany where it also competes with Japanese products. Because the exchange rate between the Dutch guilder and the German mark has been very stable under the existing European Monetary System arrangements, the shift to a single currency would have little effect on Dutch-German exchange rate volatility. It is possible, however, that the euro-yen exchange rate would fluctuate more than the exchange rate between the mark and the yen (for example, because euro interest rates are less stable than deutsche mark rates had been or because larger euro-yen fluctuations are required to equilibrate shifts in the trade balance with other European Union members.) If so, the shift to the EMU would increase the Dutch firm's risk in trading in Germany and would therefore reduce the attractiveness of such intra-EMU trade. The trade between Germany and Japan would also become more risky, thereby reducing trade between an EMU country and a non-EMU country. As this example illustrates, the shift to a single currency has an ambiguous effect on the volume of trade both among the EMU countries and between the EMU countries and the non-EMU countries.[12]

**Effects of Monetary Union on Cyclical Unemployment**

When a country with its own currency experiences a decline in the demand for some of its exports, the value of its currency naturally declines. This automatic market response increases other exports and reduces imports, thereby damping the rise in unemployment that accompanies the initial loss of exports.

More generally, when a country experiences any kind of a decrease in aggregate demand, two countervailing financial market responses will occur automatically: real interest rates will temporarily decline (in response to the decline in the demand for money and credit) and the real value of the currency will decline. Neither of these stabilizing responses is possible if the country does not have its own currency. A country that is part of a monetary union must have the same interest rates and the same exchange rate as the other monetary union members; its interest rate and currency value can only adjust to the extent that the other countries in the monetary union also experience a decline in demand.

[12] Even if it were clear that the shift to a single currency would increase trade among the EMU countries, the effect of that development on economic welfare would be theoretically ambiguous. The European Union countries now have essentially zero tariffs for trade among the member countries but continue to have tariffs on imports from the rest of the world. Although the absence of internal tariffs increases welfare to the extent that it increases trade among member countries, the combination of free trade within the European Union and external tariffs for nonmembers may cause a net loss of economic welfare by diverting production from lower-cost nonmember countries to higher-cost member countries. To the extent that a single currency further reduces the barriers to trade among the EMU countries, the trade-diversion welfare loss would be increased.

In addition to the helpful automatic market responses of interest rates and the exchange rate, a country with its own currency can use discretionary monetary policy to reduce the adverse unemployment effects of negative demand shocks. While monetary easing may sometimes be counterproductive, producing higher prices and no real effects, there are clearly times when such discretionary changes in interest rates and the exchange rate are effective. A country that is part of a monetary union and lacks its own currency is obviously precluded from using such discretionary policy to reduce cyclical fluctuations in unemployment.[13]

Robert Mundell, who formulated the theory of monetary unions as a trade-off between the reduced costs of trade and the adverse macroeconomic effects of precluding interest rate and exchange rate variations, also identified the primary factors that determine the importance of variable interest rates and exchange rates (Mundell, 1961). The sensitivity of cyclical unemployment to the flexibility of national interest rates and exchange rates depends on four factors: 1) homogeneity of the countries within the monetary union; 2) flexibility of domestic prices and wages; 3) mobility of the labor force; and 4) responsiveness of fiscal transfers. I will explain each of these briefly and comment on their relevance to a European monetary union. Since the move to a single currency for Europe is often compared to the single currency in the United States, I will also comment on the relevant differences between the United States and Europe on these factors.

*Homogeneity:* If the individual countries within a potential monetary union are essentially alike, they will experience the same demand shocks, have the same automatic responses of interest rates and exchange rates, and want the same discretionary monetary policies. Combining these homogeneous countries into a monetary union with a single currency would therefore change nothing since the individual currencies and interest rates would have moved together anyway. In contrast, to the extent that countries actually differ, the automatic market responses and appropriate discretionary policies will also differ.

While some of the European countries are similar to their neighbors, others differ substantially. Because of differences in the composition of GDP and differences in natural trading partners, the demand shocks that affect Germany are likely to be very different from the demand shocks that affect Spain. Similarly, the demand shocks that affect Sweden are likely to be very different from the demand shocks that affect Portugal.[14] Monetary policies aimed at offsetting disturbances for

[13] The inability of interest rates and exchange rates to vary (either automatically or as a result of discretionary policy) may raise the unemployment cost of reducing a national budget deficit (since the adverse demand effects of the fiscal contraction cannot be offset by lower interest rates and a more competitive exchange rate). The increased cost of deficit reduction may cause countries to be willing to tolerate higher budget deficits than they would otherwise accept. The discretionary penalties for fiscal deficits specified in the "stability pact," if actually enforced by the Council of Ministers, might be enough to offset these domestic unemployment costs.

[14] Although some economists have suggested that countries within a monetary union might become more alike over time, it seems more likely that the combination of reduced trade barriers and a fixed exchange rate would encourage more specialization and therefore greater heterogeneity among the countries.

Europe as a whole and automatic changes in euro interest rates and in euro-dollar exchange rates would not be sufficient to deal with demand shocks in individual countries. The adverse unemployment effect of forcing a uniform monetary and exchange rate policy on all EMU countries would therefore depend on the other three factors.

*Flexibility:* If domestic wages and prices are fully flexible, a decrease in demand will cause an immediate adjustment of the level and structure of wages and prices that maintains full employment without the need for a change in the nominal exchange rate or in interest rates. Such a change in the overall level of prices within a country would imply a change in the country's real exchange rate even though its nominal exchange rate is fixed. However, it is clear from the existing level of structural unemployment in Europe, as well as from direct observation, that prices and wages in Europe are quite rigid and cannot be counted on to offset demand shocks. In contrast, wage flexibility in the United States is much greater, reducing the adverse unemployment consequences of having a single currency for the entire U.S. economy.

*Mobility:* Even if wages and prices are not flexible, a decline in demand need not raise unemployment if workers are geographically mobile and move to the places where jobs are available. But although the legal barriers to labor mobility within the European Union have been eliminated, language and custom impede both temporary and long-term movement within Europe. As long as Europeans speak ten different languages, cross-border movement in response to job availability will be far less than movement among American regions. Moreover, the American heritage of immigration and national settlement makes Americans much more willing to move internally than their European counterparts. While Americans don't hesitate to move from Ohio and Massachusetts to Arizona and California, Germans are loathe to leave one part of Germany for another.

*Fiscal transfers:* The contractionary effect of a local decline in demand can be partially offset by a net fiscal transfer from outside the area. In the United States, a decline in demand that causes income to drop in one American state automatically causes a substantial net fiscal transfer from the federal government to the people of that state. The combination of reduced federal income and profits taxes and increased transfer payments (unemployment benefits and welfare) implies that a $1 fall in a state's GDP is counterbalanced by about a 40 cent change in the net flow between the residents of that state and the federal government in Washington. There is no similar cyclical net transfer in Europe, since taxes and benefits are almost exclusively the responsibility of the national governments.

It is clear that the countries of the European Union do not constitute a natural monetary union and that forcing a single currency on the area would raise cyclical unemployment in response to adverse demand shocks.

**EMU, ECB and Inflation**

By shifting to a monetary union, the nations of Europe would transfer responsibility for monetary policy from their own central banks to a new European Central

Bank (ECB). The ECB alone would be responsible for controlling the supply of euros and the short-term euro interest rate. Although some advocates of monetary union argue that this shift of authority would help Europe to achieve and maintain price stability, in my judgement it would be more likely to lead to a higher rate of inflation than the continuation of the current arrangements. While the "convergence" requirements for entry in the EMU have no doubt helped several countries to accept the discipline required to lower inflation to German levels, the overall inflation rate of the EMU area may rise once the ECB is responsible for monetary policy and the Bundesbank anchor is gone.

In assessing the likely future behavior of inflation, it is useful to start with the fact that Europe has had a remarkably good record of declining inflation during the past decade. Inflation in the European Union as a whole has come down from more than 10 percent in 1976 to less than 4 percent in 1986 and less than 3 percent in 1996. Even in Italy, the inflation rate has come down from 6 percent a decade ago to less than 2 percent over the past year. This common decline in inflation has occurred despite the fact that each country controls its own money supply and therefore its own inflation rate. In practice, many of the European Union countries have followed the Bundesbank's lead to keep their exchange rate with the mark within relatively narrow limits. But even those countries that left the exchange rate mechanism and devalued their exchange rates in 1993—namely Britain, Italy, Spain and Sweden—have reduced their inflation rates and now all have inflation rates below 3 percent. Moreover, the favorable inflation experience in a wide variety of non-European countries, including Canada, Japan, New Zealand and the United States, also shows that any country can reduce its inflation rate to a very low level without any explicit or implicit link to other currencies.

The charter of the European Central Bank contained in the Maastricht treaty, like that of the German Bundesbank, makes price stability its primary objective. The charter also provides that the ECB should be independent of political control by both the member states and the European political institutions. But even if the ECB is independent of the political process, it may be much less concerned with inflation than either the Bundesbank or those central banks under its influence have been. The member countries of the European Union differ in their traditional attitudes toward inflation. Although Germany has been a fervently anti-inflationary nation in which opposing inflation has been politically popular with the voters, the same has not been true elsewhere in Europe. Their representatives on the ECB Governing Council may reflect their national attitudes and be subject to political pressure to represent what domestic governments perceive to be national interests. Because many of the European Union countries have been depressing demand in recent years to achieve the Maastricht conditions for EMU membership, once the EMU is established there would be strong pressure to deal with the current double-digit European unemployment rates by a more expansionary monetary policy.

How independent the European Central Bank would be in practice and how committed it would be to price stability remain quite uncertain. The ECB's six member Executive Board would be politically appointed by the European Council at level of the heads of state or government. The Governing Council of the ECB, consisting of the ECB's Executive Board plus the central bank governors of the EMU member countries (appointed by their national governments) would make monetary policy decisions by simple majority. Thus, the group that sets monetary policy at the ECB would be political appointees of their national governments.

Although the Maastricht treaty specifies that the European Central Bank will be fully independent, there is no tradition in Europe to support such independence. Until relatively recently, virtually every central bank was subject to control by the nation's ministry of finance. There is no reason to believe that the voters in Europe are prepared to leave the making of monetary policy to a body that is beyond political control. The ECB may therefore evolve into an institution that is much less independent than its conception in the Maastricht treaty.

It was not totally surprising, therefore, when President Mitterand of France assured the French public on television before France's Maastricht referendum that, contrary to the explicit language of the Maastricht treaty, European monetary policy would not be under the direction of European central bankers. President Mitterand's statement was a political forecast rather than a basic misunderstanding of the treaty or a simple lie aimed at securing a favorable vote on the referendum. France recognizes that the institution of the EMU will evolve over time and continually presses for some form of political body (an "economic government") to exert control over the ECB. It has already made significant progress toward that end.

The December 1996 meeting of the Council of Ministers redefined the German "stability pact" (intended by Germany to limit fiscal deficits), eliminating the automatic penalties for excessive deficits and making growth as well as price stability the explicit goals of EMU policy. Although the newly created stability council is now officially described as a "counterweight" to the European Central Bank rather than as a way of exercising control over the ECB, it marks a first French success in establishing that monetary policy should be subject to some "counterweight" and that growth (in this case, macroeconomic expansion) as well as price stability should be a goal of EMU policy. At the European summit in Amsterdam in June 1997, the newly elected French government made further progress; the treaty revision agreed to at Amsterdam makes employment a goal in parallel to price stability.

More importantly, the Amsterdam summit appears to have redefined the role of the political authorities in making exchange rate policy. The Maastricht treaty divided responsibility for exchange rate policy between the European Central Bank and the ECOFIN Council (the Council of Economics and Finance Ministers) in an ambiguous way. The drafters of that part of the treaty and the German participants in Maastricht in particular intended to limit the ECOFIN's role to fundamental aspects of the exchange rate system; for example, a decision to fix the exchange rate between the euro and the yen. The French, on the other hand, expected that the ECOFIN would eventually get to give orders about the desired level of the euro exchange rate. Although the rules are still ambiguous, the agreement at Amsterdam appears to have shifted responsibility for exchange rate policy, including changes in floating exchange rates, to the ECOFIN. Since sustained changes in nominal exchange rates can only be achieved by changes in monetary policy, this appears to establish a much more fundamental monetary policy role for the ECOFIN. Only time will tell whether that is true and, if so, how that power is used.

There is a widespread view in Europe that a currency depreciation of the euro would reduce unemployment by making European products more competitive. During the past year, French officials indicated that although they did not want a devaluation of the French franc relative to the German mark, they would favor a lower value of the European currencies in relation to the dollar. Even some German businessmen have been advocating EMU on the grounds that it would give them a weaker and therefore more competitive currency. Whether this will cause the European Central Bank to pursue an easier monetary policy or will cause the ECOFIN council to try to impose such a policy may provide an early test of the new arrangements.

One further recent development about the independence of the European Central Bank is noteworthy. Members of the key monetary policy committee of the European Parliament have called for a role for the Parliament in supervising the ECB, including interest rate policies. They have specifically pointed to the U.S. Federal Reserve as a possible model for such supervision. Although this may be a reasonable balance between independence and accountability in the United States, it would clearly be a major shift from the complete independence called for in the Maastricht treaty.

The recent maneuvering by the governments as they seek to qualify for EMU membership may give some further indication of the reliability of the Maastricht treaty guarantees and the probity of the European Central Bank. Much has been made (especially in Germany) of the need for the Maastricht conversion criteria to be applied "strictly" as a way of demonstrating the likely soundness and stability of the future economic policies. The explicit numerical criteria call for a budget deficit of no more than 3 percent of GDP. As the final date for evaluation approaches (in the spring of 1998 based on the performance in 1997), it is clear that very few of the countries are likely to meet this criterion based on traditional budget accounting. The result has been a willingness to accept a number of temporary budget accounting gimmicks designed to make 1997 look better, including a French government receipt in 1997 equal to 0.5 percent of GDP from the national telephone company (France Telecom) in exchange for the government's assumption of the company's unfunded future pension obligations. Even the German government succumbed to this temptation, by seeking to reduce its 1997 budget deficit by revaluing the government's gold stock to market prices, but was stopped by a public outcry of disapproval led by the Bundesbank. As it becomes clear that even with accounting gimmicks, France and Germany may not meet the 3 percent budget test, the notion of "strict" interpretation of the Maastricht criteria is being redefined to include the language in the treaty that permits joining the EMU even if the 3 percent test is not met if the deficit is at a "level that comes close" and has "declined substantially and continuously." The heads of government who will eventually vote on membership will no doubt be able to fit Germany and France into this redefined measure of "strict" standard by the way they define "close" and "substantially" and by their selection of a time interval over which to measure the continuous decline. But this process inevitably raises serious doubts about the extent to which other aspects of the Maastricht treaty will be observed in practice.

The current system of fixed but adjustable exchange rates and the leadership of the Bundesbank have worked well in creating a climate that has led to increasing price stability in Europe since the early 1980s. The shift to a new and untried European Central Bank and the associated "stability council" would at best be a gamble with future inflation.

**Structural Unemployment and Protectionist Policies**

While some of Europe's current double-digit unemployment rates may reflect inadequate demand brought about by tight monetary and fiscal policies, I have no doubt that most of the high unemployment is structural. Unemployment rates have been rising for two decades and remain high today because high unemployment benefits and other transfer payments discourage working, high minimum wages and the nonwage costs of employment (like payroll taxes, mandated fringe benefits and work rules) reduce the demand for labor, excessive regulations impede the creation of service sector jobs, and high income taxes induce the substitution of home production for market services.

The pressure of high and rising unemployment is causing some European countries to seek policy changes that will reduce the costs of employment and improve workplace efficiency. If EMU succeeds in strengthening the political and economic unity of Europe, the decisions on such structural economic reforms will shift from national governments to European political institutions. Some of this is already happening. As decisions shift away from national governments, it may become harder to reach agreements on the needed policy changes. The shift of policy decisions from national governments to the European level also eliminates the ability to learn from the experiences of individual countries and to benefit from competitive pressures to adopt national policies that are seen to succeed.

The changes in labor market rules and social benefits that have been proposed by national governments are being opposed not only by labor unions within the individual countries but also by other European governments that fear others will benefit from the resulting gains in competitiveness. Thus we hear of opposition to "social dumping" when an inefficient enterprise is closed and witness the imposition of a European maximum on the number of hours that employees can work in a British firm. A politically more unified Europe would make it easier to enforce European-level policies that would prevent a nation from seeking to increase its competitiveness or to reduce its structural unemployment through changes in its labor laws or transfer payments.

If European Union legislation succeeds in preventing member countries from competing with each other, they will collectively become less able to compete with the rest of the world. The result would undoubtedly be pressure for increased European Union trade barriers, justified no doubt by reference to differences in social policy between Europe and other countries. The damage of such protectionist policies to Europe and its potential for undermining the entire global trading system could far outweigh any gains from increased trade within Europe.

None of this need happen. But to the extent that EMU achieves its political agenda, it is part of the risk that makes EMU an economic liability.

## Conclusion

Although the major countries of continental Europe now appear committed to adopting a single currency for Europe in January 1999, the events in the summer of 1997 show that this process may still be derailed by basic conflicts between France and Germany about the appropriate stance of monetary and fiscal policy, about the long-run independence and goal of the European Central Bank, and about the future limits on fiscal deficits. These disagreements about monetary and fiscal policies may have broader effects on the relations among European countries, creating conflict rather than the political harmony that many of EMU's advocates seek.

The economic consequences of EMU, if it does come to pass, are also likely to be negative. Imposing a single interest rate and an inflexible exchange rate on countries that are characterized by different economic shocks, inflexible wages, low labor mobility and separate national fiscal systems without significant cross-border cyclical transfers will raise the overall level of cyclical unemployment among the EMU members. The shift from national monetary policies dominated by the Bundesbank within the European Monetary System system to a European Central Bank governed by majority voting with a politically determined exchange rate policy will almost certainly raise the average level of future inflation. The emphasis on common economic and social policies will reduce the scope for the experimentation and competition that would otherwise lead to reductions in the current extremely high levels of structural unemployment.

Political leaders in Europe seem prepared to ignore these adverse consequences because they see EMU as a way to further the political agenda of a federalist European political union, which will have a common foreign and military policy and a much more centralized determination of what are currently nationally determined economic and social policies. Although such a policy is often advocated as a way to reduce conflict within Europe, it may well have the opposite effect. Uniform monetary policy and inflexible exchange rates will create conflicts whenever cyclical conditions differ among the member countries. Imposing a single foreign and military policy on countries with very different national traditions and geographic circumstances will exacerbate these economic conflicts. So too will the inevitable struggle between Germany and France for leadership and among the other countries for a share in the decision-making power.

The Maastricht treaty contains no provisions allowing a country to leave the monetary union once it has joined. Membership in the monetary union and the adoption of a single currency is intended to be permanent. The adverse economic effects of EMU and the broader political disagreements will nevertheless induce some countries to ask whether they have made a mistake in joining. Although a sovereign country could in principle withdraw from the EMU, the potential trade sanctions and other pressures on such a country are likely to make membership in the EMU irreversible unless there is widespread economic dislocation in Europe or, more generally, a collapse of peaceful coexistence within Europe.

In the end, the desirability of a European monetary union will be judged not by its impact on inflation and unemployment but by its effect on peace and conflict within Europe and with the rest of the world. A united Europe of more than 300 million people with a single foreign and military policy would be a formidable participant in the global balance of power of the twenty-first century, capable of projecting force and forming important strategic alliances. Only time would tell whether the creation of such a global power would be a stabilizing or destabilizing influence on world peace.

■ *I am grateful for comments on an earlier draft of this essay by Alberto Allesina, Elhanan Helpman, Mervyn King, Paul Krugman, Richard Portes, Horst Siebert and the editors of this journal.*

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