HM Treasury

The pros and cons of EMU

by David Currie

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Preface

The introduction of the single currency in Europe raises issues that are of vital importance to this country's interests. Whether or not the United Kingdom eventually participates in the single currency, it will affect us. British business has important markets and investments in Continental Europe, and European businesses sell in Britain and invest in our industries. A single currency will affect our financial services. It will affect employment. We have a responsibility to get involved in the debate about the economic future of the Union.

For too long the debate in Britain has been polarised by extreme views. The issues involved are complex and varied, and reasonable people may disagree about them. But it is essential that they are considered carefully and with proper regard for the facts.

This report, by David Currie, is a summary of a paper which he wrote for the Economist Intelligence Unit earlier this year. It is an admirably clear and objective analysis of the issues surrounding EMU. I hope that by publishing his analysis in shorter and more accessible form the Government can help it to reach a wider audience, and shed further light on this important subject.

The views expressed in the report are the author's, and do not necessarily reflect the views of the Government. As the author states in his introduction, the report does not attempt to push a particular line, but to promote a better informed and more reasoned debate. Any decision about Britain joining the single currency must be determined by a hard-headed assessment of Britain's economic interests. In the meantime I commend this report as an excellent survey of the issues.

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Introduction

Europe has embarked on an extraordinary undertaking: to create a single European currency. Although the Maastricht Treaty committed the European Union to the goal of economic and monetary union (EMU) several years ago, debate over the matter continues to rage. What kind of project is it: an economic initiative, intended to derive the greatest benefits from Europe's single market, or a broader political idea, leading to closer integration of Europe's governments? Can the Maastricht plan be made to work? And supposing it can, will Europe's new currency, the euro, prove to be a blessing or a curse?

Why EMU excites such strong emotions

The debate is polarised to an extraordinary degree. For many who **oppose** the single currency, it is not merely an ill-advised undertaking, but a disastrous one: a stride further along the road to a European superstate that will submerge the individuality of the European nations in an unwieldy federation, hobbled by bureaucracy, commanding little popular support and imposing a crippling burden of regulatory and other costs on Europe's economies. Opponents also see it as a distraction from the two most urgent tasks currently facing the EU: completion of the single market and enlargement of the Union to the east. Many argue that EMU will prove unworkable and divide Europe dangerously into "ins" and "outs".

Many **advocates of EMU** reply in kind. They see not only a chance to achieve worthwhile economic benefits, but also a fleeting opportunity to grasp an historic prize. They regard EMU as essential to creating a stronger EU, with greater economic, political and social cohesion. This offers the best hope for helping the former communist-bloc countries: closer integration among the current EU members helps, not hinders, the prospects for enlargement. Without the single currency, they say, the reality of the single market will not be achieved and Europe's economies will remain divided and weak, unable to compete internationally either with the low-wage economies of Asia or with the large, integrated, high-wage economy of the USA. Only a stronger and more integrated Europe will be able to exercise leadership on the global issues facing the world economy.

The UK perspective

What is at stake seems no less momentous from a UK perspective. Opponents of British participation argue for steering well clear of an ill-considered experiment that will impose a severe competitive handicap on the countries that participate. By standing aside, the UK will avoid the instabilities that the single currency will cause, and will keep its present competitive edge. Taking a broader view, some opponents of EMU argue that the UK's future lies not in economic alliance with Europe, weighed down by sclerotic and over-regulated economies, but rather with the dynamic market economies of the Pacific Rim. The UK should be thinking not at a European level but globally about its economic and political place in the world.

Advocates of the UK's participation say this is all wrong. If the country stands aside it will be marginalised in its most important market, with consequences that go far beyond trade with the EU. The UK would become a much less attractive location for inward direct investment from other parts

of the world, which has played a crucial role in transforming the UK's industrial performance. More generally, they see the UK's future as part of Europe, and fear that a decision to stand aside will merely repeat the pattern of the past, when the country repeatedly chose to play no part in planning Europe's future, only to be forced in time to follow the course charted by others.

Clearly the questions involved are complex, and reasonable people may well disagree about them. Yet all too often the debate on EMU is conducted in terms of headlines and slogans, from entrenched and unalterable positions, without regard for the facts. The aim of this report is to analyse the issues surrounding EMU in as objective and dispassionate a manner as possible, and to disentangle the various elements of the argument. The purpose is not to push any particular line, but to provide the basis for a better informed and more reasoned debate.

Will EMU happen?

At the time of writing, there is again speculation over whether EMU will be delayed or postponed. It is inconceivable that EMU would go ahead without France and Germany, and the governments of both countries are committed to joining EMU in 1999. However, across Europe achieving fiscal convergence has proved more difficult than expected. Yet there is considerable political momentum behind the Treaty timetable and companies and governments across Europe have invested in new equipment ready for 1 January 1999. The uncertainty makes it more important than ever to take a clear-headed look at the arguments, not least on the problems Europe as a whole needs to address to make the single currency a success.

This paper is an updated summary of a larger report published by the Economist Intelligence Unit in February 1997 and follows the same structure. First it looks at the nature of **national monetary sovereignty** in a modern economy, and the relationship between monetary and political union. What powers will national governments lose in EMU, and will EMU necessarily be followed by greater political integration in Europe?

Second we consider the **economic costs and benefits** of the single currency—how well will it work, what it means for national budgetary policy, and whether EMU members, lacking national control of interest rates, could cope adequately with economic shocks.

Third, we look at how EMU will affect **Europe's businesses** and particularly the financial sector, and what difference it could make to UK firms if we join or stay out.

Economics and politics are brought together in the final section, which discusses how EMU could affect the **future direction of the European Union—**whether it will be a source of division and stagnation, or provide a new momentum for the Union to face the challenges ahead.

Monetary union and national sovereignty

One money, one nation?

EMU affects a crucial aspect of a country's independence: control of a national currency. Over the centuries, the nation's currency, bearing the head of the king, queen or president, has everywhere symbolised national autonomy. One of the very early acts of the new countries that sprang from the ashes of the ruined Soviet empire was to design a new currency. Significantly, countries that lacked a secure basis for independence subsequently re-established their link to the rouble, perceived as a powerful symbol of their dependence on Russia. In Europe, abandoning the national currency in favour of the proposed euro appears to many to signify a loss of nationhood.

For many people, friends and foes of EMU alike, the single currency points inescapably to closer political union. Looking at history, monetary unions linking independent states of dissimilar size and power (like that of Belgium and Luxembourg today) have not been uncommon. But there has so far never been one enduring monetary union of strong independent states. This, and the commitment of a number of key EU member governments to further political integration, suggest that over time EMU could indeed favour federalism.

Yet in theory there seems no compelling economic reason why this should be so. The extent of "political union" remains essentially a matter of political choice. The crucial point is that the EU is already a federation, albeit a loose one. Adopting the single currency means, by definition, surrendering national control over monetary policy, but no further loss of national sovereignty would necessarily be bound to follow. Europe's governments may well choose that course. Or they may choose otherwise. Participating in EMU does not pre-ordain that decision.

Money and the state

EMU itself does of course involve some loss of sovereignty - giving up control over national money. What is the real *economic* value of this to governments?

In the past, the functions of money—as medium of exchange, unit of account and store of value—have been performed by all manner of things. What is used at any particular time and place depends on what suits the parties on each side of the transaction. Any good which has scarcity value, which retains its value, and which is divisible and standardisable can play the role of money. Grain, shells, metals, and more recently cigarettes (in prisoner-of-war camps) have all served as money.

Usually, however, money is associated with the power of the state. The state uses its legal and political authority to make the money that it issues acceptable to sellers. In the past the state guaranteed the quality of its money with a gold or silver content. More recently this assurance has come from promising a responsible monetary policy that does not result in inflation. The power of the state ensures that sellers will accept it, confident that it will be accepted again when they come to buy.

This brings unique powers to the state as the monopoly supplier of money. With the advent of paper money it brought financial gains too. Printing notes and coins costs almost nothing, but by issuing it the state is able to purchase goods and services in return. In times of rising prices, when more money is needed, this can yield considerable financial benefits. The power to inflate is one that governments have used in the past, particularly in times of national emergency such as war.

These days the power to resort to the printing press to fund spending or inflate away debts is not one that wise governments use; it could easily precipitate a major flight from the national currency and a financial crisis. But in conditions of extreme emergency, it would not be impossible. Some would argue that the history of war in the last century makes it wise to retain this emergency policy option.

Internationalisation and the erosion of sovereignty

The globalisation of financial markets has also constrained the value of an independent currency as a tool of **economic policy**. Business and even individuals have choice as to which money they use, and can switch funds from one currency to another. With more than a trillion dollars trading across the foreign exchanges daily, the **powers of the markets** are manifest. Governments can retain their independent currency, but only by ensuring that it remains as attractive to hold as its rivals.

This constrains the conduct of monetary policy in important ways: monetary freedom goes with strict limits on monetary discretion. Arbitrage between currencies by footloose international capital means that there are powerful forces bringing **long-term real returns** on different currencies into line. So, if D-mark interest rates are 6% and UK rates are 8%, the markets will only accept this if they expect sterling to depreciate by 2% a year. In the long term, a steady 2% depreciation of sterling against the D-mark probably means that UK inflation will be some 2% higher than German inflation, so that *real* interest rates paid to investors are equalised.

Since it is *real* interest rates that have the most important effects on the real economy, does this mean that national monetary policy has no power? The answer is that monetary policy can still affect the economy for quite extended periods. Except in the long-run the link between exchange-rate movements and inflation is quite tenuous, (as the post-ERM UK experience shows) so there is ample scope for differences in nominal interest rates to be translated into differences in real interest rates, and therefore have distinct effects on national economies.

So the exchange rate matters

The upshot is that monetary policy can still operate effectively at a national level, despite ever more integrated international capital markets. Moving to EMU means giving up this policy instrument, and is likely to involve a cost. The principal form that this cost will take is in being unable to lower or raise interest rates independently of other countries when domestic conditions require it. This situation will occur when the domestic economy goes into a recession or inflationary boom not shared by other countries in the EMU zone.

Is monetary freedom worth having?

The proponents of EMU can reasonably argue that the value of monetary independence is not always very great - for two reasons.

First, if the linkage from the exchange rate to domestic prices is very close then the *real effects of policy changes* will not last very long. This may happen if the goods and labour markets of the country in question are highly integrated with those of the other members of the EMU; or if there is a very high degree of real wage resistance, so that price increases are quickly translated into wage increases and then back into further price increases. In each of these circumstances, a fall in the currency will translate quickly into a corresponding rise in prices, so the monetary authorities are only able to influence real interest rates rather briefly. The power of monetary policy will be very limited. Both conditions may well be relevant to the smaller economies of continental Europe, suggesting that for them the benefits of an independent monetary policy may be limited.

And an independent monetary policy may well be a curse if the freedom to devalue the currency is misused. The case of Italy, for one, demonstrates that countries with structural problems cannot escape them by devaluing their currencies. The same has been true of the UK over the past three decades. In 1966, sterling traded at about DM11; an independent UK monetary policy had allowed this to slip to around DM2.3 in 1996, an average depreciation of nearly 5% a year over 30 years. Monetary freedom has offered little real benefit to the UK; the principal result has been that it has experienced on average nearly 5% more inflation than Germany. Moreover, the UK economy has exhibited greater instability over this period than any of its major competitors. The independence of the Bank of England should help to break the cycle, though the Bank will need to build up a track record before the markets take this on trust.

To sum up, the European economies, which are each quite small individually, face quite strong constraints on their conduct of monetary policy, whether or not they participate in a single European currency. But monetary policy undoubtedly would be more constrained within EMU. Whether this should be seen as a disadvantage or benefit depends on one's confidence in the national monetary authorities to use monetary independence wisely. This is an area of policy in which a government has a great capacity to get it wrong. The point has wide application: modern governments retain great powers, but in a modern interdependent world, many of these powers are negative ones to mess things up, not positive ones to direct events for the good.

The macroeconomic consequences of EMU

The ERM debacle does not seal EMU's future

Whether or not it is worth giving up these powers depends on how well the single currency itself will work. This section considers the main economic pros and cons of EMU - whether it will create a more stable and successful economy in Europe.

Critics of EMU, citing the chaos that engulfed the European exchange rate mechanism in 1992 and 1993, argue that it is simply unworkable. This is mistaken. EMU is partly a response to the flaws of the earlier system, which sought monetary stability through *cooperation* among autonomous national central banks. Because it involves *pooled* monetary policy, EMU could not be subject to foreign exchange speculation of the kind that brought down the ERM, any more than could the sterling value of the Scottish pound.

This helps to explain why EMU is still on the agenda, despite the ERM crisis. Indeed, one objective of proponents of EMU is a monetary policy that takes account of economic developments in the EMU bloc as a whole, not just in Germany as the Bundesbank did in 1992. This is not to say that there will not be different tensions in EMU - we return to this below.

Savings of money and time

One of the most obvious benefits of EMU is the resulting **ease of transactions** across the EU. This will save both money and time. The likely amounts are not however very large, and once the one-off costs of converting to the euro are taken into account as well, the net transactions savings do not provide a strong reason for moving to the euro.

EMU also eliminates the possibility of **exchange-rate variation** within the euro zone. If it is true that exchange rates move to help macroeconomic adjustment, this may well represent a cost of EMU. But if exchange rates more often move erratically and unsystematically in response to arbitrary speculation, exchange-rate volatility imposes a macroeconomic cost, and its elimination represents an advantage. Both views capture an aspect of the truth: exchange rates do tend to play a useful adjustment role, but also incorporate a large arbitrary and disruptive element.

Controlling inflation

For many proponents of EMU, the most important economic advantage is the prospect that the independent European Central Bank (ECB) will deliver durably low inflation for the EMU area. For Germany, which has enjoyed low inflation for decades, the ECB can scarcely offer more on this front than the status quo. These reservations probably apply also to those countries, such as Austria, France and the Netherlands, that have attached their currency to the D-mark and hence adopted the Bundesbank as their *de facto* central bank. For them, however, the creation of the ECB offers a voice in the conduct of monetary policy which they currently lack.

The disinflation benefits will plainly be greatest for EMU countries that have not enjoyed stable low inflation hitherto. These include Ireland and the UK (were it to join) together with Italy, Portugal and Spain.

Low inflation implies low interest rates, as the premiums for inflation and exchange-rate risk would be eliminated from interest rates. Despite the independence of the Bank of England, the UK still faces a premium of more than 1% on long-term borrowing rates compared to Germany and France.

Three factors could, however, make the ECB's performance somewhat more erratic than the Bundesbank's. First, governors of central banks from all participating countries will influence the ECB's decisions on interest rates. Although the Maastricht Treaty safeguards the ECB's independence, it is legitimate to ask at what level of pressure their political resolve might buckle, for example if unemployment remained very high. Second, unlike the Bundesbank, the ECB has a reputation to establish, and to start with a period of higher interest rates may be needed to demonstrate anti-inflation resolve. This in turn could reinforce internal dissent in the ECB. Third, EMU will be a profound economic change which may well alter the workings of the joint monetary economy in significant and unpredictable ways. All central banks have to cope with such changes from time to time: examples include the shift in UK demand for money after financial markets were liberalised in the 1980s. At such times, policymakers can lose their bearings, and the conduct of monetary policy can become volatile. The ECB will enjoy the monetary equivalent of a baptism of fire.

On balance, it seems likely that the ECB will be able to establish a record and reputation for conducting monetary policy in a sound manner. But this may take time, and in the meantime euro monetary policy, and the markets' judgement of it, may prove erratic. These problems could be particularly acute if EMU starts on weak foundations, with insufficient convergence.

Government borrowing

A big concern of rigorous-minded EMU doubters is that EMU will ease the market constraints on excess borrowing by profligate governments, leading to an EMU "debt trap". Germans, in particular, worry that they will be called upon in EMU to bail out high-borrowing governments. This concern motivated the formulation of the Maastricht fiscal convergence criteria and the later "stability and growth pact" agreed at the Amsterdam summit in June. It also motivated the drafters of the Maastricht treaty to incorporate the no bail-out clause, which precludes the ECB from bailing out bankrupt governments by buying their debt.

Two kinds of excess

Two distinct types of government debt problems may arise.

- First, unsustainable debt. This happens when governments borrow in a way that cannot continue indefinitely, since it leads to ever-larger accumulations of debt and eventual insolvency.
- Second, high but sustainable debt. This is where governments are able to service their debt indefinitely (ie, the debts are sustainable) but the levels are unduly high. An example is Belgium, which has sustained a debt level of 130-140% of GDP since the early 1980s.

The two problems give rise to different concerns. If a government participating in EMU gets into a **debt crisis**, there could be pressure on other member governments to bail it out, providing subsidies to help service the debt, or taking over responsibility for it. For example, say the worriers, Germany and France would surely be unwilling or unable to stand aside and see the Italian government collapse in financial insolvency, with all the implied disruption to economic, social and civil society.

If the debt is merely high, rather than unsustainable, there should be no need to bail out other governments. Instead, the concern is that heavy borrowing from some governments would push up the general cost of borrowing in euros to the detriment of all, and to the particular chagrin of thrifty governments.

The role of market discipline

Although these concerns are real, their underlying logic is not watertight. A single currency does not automatically make it easier for profligate governments to borrow, any more than a single currency in, say, the UK makes it easier for profligate individuals or organisations to borrow pounds. Financial markets judge **credit risk**, and penalise borrowers who represent a poor risk. In EMU, different governments will be required to pay different rates of interest on their euro debt, depending on their credit rating.

Even if a country hit a crisis, it is not clear that EMU increases the risk of a bail-out. When New York City ran into debt problems in the early 1980s, neither federal nor state government came to its aid. If a bail-out were motivated by concern over the social and political consequences of a debt crisis, this applies as much within today's EU. In practice, when governments face debt problems they do not go bankrupt—they adopt tough fiscal measures to resolve the crisis.

Unfunded pension liabilities - a hidden risk?

The spotlight has recently turned on future pension liabilities in many Continental European countries. The OECD has estimated the capitalised (or net present value) cost of current pension arrangements to be 98% of GDP in France, 113% of GDP in Italy and 139% of GDP in Germany, compared with a mere 19% in the UK. These numbers are fraught with difficulty, and subject to a very wide margin of error. But it cannot be denied that they point to a real public policy dilemma in the countries concerned.

Whether they are a problem for EMU is a different matter. EMU sceptics fear that debts of this scale are a risk for the stability of the single currency, and that there will be pressure for bail-outs. But it seems unlikely that the principle of no bail-out, written into the Treaty, will be overthrown in respect of pensions. Also, governments have assets as well as liabilities which should be taken into account in any analysis of the balance sheet. In the end, the most likely outcome is that governments will take national measures to deal with their future funding liabilities. Nevertheless, for many the pensions spectre will not be laid to rest until this happens.

So much for unsustainable debts. Paradoxically, the problem of high but sustainable debts is potentially more difficult. With a single currency, it is argued, governments can borrow partly at other governments' expense, because their extra demands on the capital market force up the interest rate across Europe, rather than forcing up merely their own interest rate. This will encourage more borrowing. European real interest rates could rise sharply, worsening the prospects for investment and long-term growth.

The argument has some force. But the effect is unlikely to be large, because the borrowing of no one country is very great in relation to Europe's public borrowing in the aggregate. And another factor acts to offset this incentive, such as it is. With a single currency, governments know that they will be unable to reduce the burden of their debts by letting inflation rise (an option that many of Europe's national governments have used in the past). In the end, they will have to finance their borrowing through explicit taxes, not through the hidden tax of inflation. This should help to *encourage* sound public finance.

This discussion is not to argue against restraints on borrowing, for current levels of borrowing across Europe are too high. But it suggests that EMU, in itself, is unlikely to worsen the problem, and may well ameliorate it.

Managing the economic cycle

Proponents of EMU argue that giving up the exchange rate as an instrument of economic policy prevents governments from resorting to the **soft option of devaluation**. The much vaunted independence of monetary policy has meant, in the experience of the UK and other countries, the freedom to inflate faster and to engage in a progressive devaluation of the currency.

Against this, critics rightly say that EMU means giving up an important economic policy instrument. Outside EMU, the UK has the freedom to set interest rates appropriate to its domestic economic circumstances. This independent monetary policy will be reflected in movements of the exchange rate, but such movements can *support*, not undermine, domestic policy.

Is the UK out of synch?

The loss of monetary policy as an independent tool for dealing with economic cycles would not matter if two conditions were satisfied.

- If economic cycles in the different EMU countries coincided; and
- If the effects of a given monetary policy were the same in each of the EMU countries.

In fact neither condition applies. Evidence on the cycle across the European economies shows both a common element, due to aggregate shocks affecting all economies together, and a national element due to so-called asymmetric shocks. An example of an *aggregate* shock would be a fall in demand in non-European countries; this would affect every European exporter in broadly the same way, even though the severity would vary from case to case. A good example of an *asymmetric* shock is an increase in the price of oil: the UK, as an oil exporter, gains; other European countries, net

oil importers, lose. The economies at the heart of the EU (Germany, France, and the Benelux countries) seem more closely integrated and somewhat less susceptible to asymmetric shocks. But if a wider group of countries join EMU, whether at the start or a few years later, there would be greater risks.

The evidence on monetary policy in the EU also shows a differential effect, reflecting the different structures of European financial systems. In particular, UK households are much more sensitive to interest rates than their German equivalents. They tend to borrow heavily (mainly in the form of mortgage finance) and at a variable rate of interest. German households generally owe less, and more of the debt is at a fixed interest rate. If the UK and Germany both participated in EMU, changes in interest rates would have greater impact on the UK economy, and the UK could experience a stronger cycle relative to Germany.

Integration may bring convergence

Yet these arguments should not be overstated. With growing integration among Europe's economies, the significance of differential shocks may well diminish. Moreover, differences in financial structures are largely a product of different economic policies and history, and with time these will dwindle. Thus, for instance, the high level of personal sector debt in the UK reflects the benefits of investing in housing in a chronically inflation-prone economy, where the government gave generous tax incentives to invest in bricks and mortar.

The UK economy's response to monetary policy may therefore become more like that of Germany over time. Reductions in debt are already apparent, and fixed-interest loans are gaining in popularity. But the adjustment will be slow: it will take many years for household debt in the UK to fall to German levels, in relation to income. In the meantime, the UK personal sector will respond much more sensitively to changes in monetary policy. This is a good argument for the UK remaining outside EMU so that it can apply an independent monetary policy appropriate to its particular economic circumstances.

But for Europe as a whole, susceptibility to shocks is still likely to be less than, for example, in the US. The states of the USA tend to be much more specialised in production than do the states of the EU. Europe may become more specialised over time, particularly with the further development of the single market. But in the meantime, EMU may be less susceptible to asymmetric shocks than its critics often suppose.

Flexible adjustment to shocks

If one EMU member experiences shocks that are different from those in the rest of the monetary union, how can their economy adjust? The exchange-rate weapon will be ruled out, so adjustment will be forced through other channels. There are two primary ones:

- workers can move;
- wages can change.

The first adjustment mechanism is labour mobility. If one country in EMU suffers a sustained recession, then the resulting unemployment may well encourage workers to move to seek jobs. This helps to rebalance the labour market and the rest of the economy more quickly.

Language and loyalty to nation and the national way of life mean that few people move around Europe in search of a job in the way that they move within the USA. This may change, but until then main burden of adjustment in any country with above-average unemployment will be downward pressure on wages.

The evidence on wage flexibility in Europe is uncertain, but suggests that real wages are quite sluggish. If, for example, demand falls in a recession, unemployment tends to need to rise, and stay high for some time, before wages adjust to the change in circumstances. This is not a good recipe for stability. However, it does not necessarily mean that losing flexibility in the exchange rate, by joining EMU, would make things worse. A fall in the exchange rate is only helpful if it is *nominal* wages that are sluggish - so that the lower exchange rate means higher prices, but does not feed into nominal wages, thus eroding the value of the real wage. In practice, wages in Europe tend to show a reasonably quick response to prices, so that any real impact of exchange rate movements is quickly eroded.

The upshot is that flexibility in Europe is not ideal, but that exchange rate flexibility provides a poor alternative in any case. This underlines the need for Europe to tackle the structural problems which create inflexibility in the first place.

Fiscal federalism

Many have argued that for EMU to survive over the longer term, it will require a system of interstate transfers, so- called “fiscal federalism”. These will be needed to help to balance the economies of the euro zone if they face different shocks.

It is true that all existing monetary unions involve substantial fiscal transfers. These run the gamut from European states such as Germany or France, where the degree of redistribution is very high, through less centralised states such as the USA, to the loosest example, Switzerland, where approximately 20% of income is redistributed at the margin through the central budget. This redistribution happens automatically through the federal element of the tax systems. If one part of the monetary union moves

into recession, its tax payments (linked to income and sales) to the centre will naturally fall and federal benefit payments will rise; while the opposite will happen for those regions in boom. All that is required for this to happen is that some tax or transfer mechanisms work at the level of the monetary union as a whole.

But it is important to remember that these are all examples of mature monetary unions. In the era of small government up to the second world war, monetary unions existed for many decades without major fiscal transfers. This could be taken as evidence that while monetary unions tend over time to foster the political and social conditions for fiscal transfers, such transfers are not necessary for the operation of a monetary union.

A system of fiscal transfers

Within EMU there may be pressures, nonetheless, for the evolution of a system of fiscal transfers. What would this mean in practice? The EU currently takes an average of around 1.4% of EU tax revenues, resulting in a total annual budget of Ecu82bn. This seems low by comparison with mature monetary unions. But there is an important distinction between the marginal and average redistribution. An overall budget of 2% of the EU's GDP could, on reasonable assumptions, be used to make redistributions of 20% at the margin between EMU members. But this would require the budget to be targeted specifically for this purpose, and not be used, as at present, for sustaining inefficient European agriculture and heavy industry.

It is important to appreciate that the transfers in question do not relate to sustained differences in economic performance. There is no reason why the rich countries in EMU, such as Germany, should compensate the poorer ones. Since the poorer countries are likely to remain poorer, whether inside or outside EMU, this is not a factor that need influence the cohesion or otherwise of EMU. The cyclical differences are what matter. These could be accommodated without any net transfers over time from rich countries to poor ones. Countries would gain in recessions and pay in booms, with the flows balancing over the cycle

The role of national fiscal policies

Furthermore, in EMU national governments will retain considerable powers to operate *national fiscal policies* to balance the economy. National budgets are much larger than, for example, those of the US states, suggesting that there is less need for fiscal transfers at a centralised European level.

The stability and growth pact will however set constraints on the use of these powers in EMU. It sets out fines for deficits in excess of 3% of GDP, unless corrective action is put in place to bring the deficit back down below 3%. The stability pact incorporates a let-out for severe downturns. Nevertheless, national governments will need to aim at a balanced budget or surplus, or the deficit limit of 3% could well prevent the proper working of fiscal stabilisers over the economic cycle. This means that governments

could be required to raise taxes, or cut government spending, as the economy moves into recession, thereby exacerbating the downturn.

The stability pact therefore poses a dilemma: in aiming to prevent high and rising debt levels, it could constrain responsible flexibility of fiscal policy over the cycle. The consequence could be a bumpier ride for the European economy, as the national levers of policy are constrained. This points to a need for the stability pact to be interpreted as flexibly as possible, especially for those governments whose trend debt ratio is low and stable.

A new kind of exchange-rate uncertainty

Summing up, EMU is intended to eliminate exchange-rate uncertainty within Europe and bring low inflation and economic stability to its members. However, critics of EMU argue that the institutional architecture of EMU creates serious weaknesses that could lead to *more* instability than before. They argue that while greater certainty in exchange rates may be achieved *within* the euro zone, this could be at the expense of more uncertainty vis-a-vis other currencies such as the yen and the dollar as the ECB's monetary policy suffers from uncertainties.

Some sceptics argue that the lack of political accountability of the ECB could undermine their legitimacy, particularly in arguments with the Council of Finance Ministers (Ecofin). Ecofin has a role in setting exchange-rate policy in consultation with the ECB. This could become a testing political issue. If the ECB is unable to establish its legitimacy, it may find itself on the losing side of any such arguments.

To illustrate this possibility, consider the following scenario. Five years after its creation, EMU has not resulted in the prosperity that its advocates envisaged. Unemployment remains high across the EMU zone, and continues to climb in some regions. Criticism of the project is rife, and opponents of EMU are winning electoral support. Ecofin takes the view that monetary policy needs to be relaxed to stimulate the economy of the euro zone. This is in conflict with the ECB's stern restatement of the need for continued tight monetary policy. Changes of national government bring to power politicians who had no role in choosing the members of the ECB's executive board. The bank's legitimacy is challenged not just by opposition parties but by national governments.

Perhaps EMU will work well, and such tensions will not emerge. But if they do, far from creating exchange-rate stability, EMU could destabilise exchange rates beyond the EMU zone. Predictions that EMU will necessarily fail on these grounds are likely to be proved wrong. A well-managed ECB could find solutions to the technical issues and the political forces may develop in a benign way. But the risk that volatility will undermine EMU cannot be dismissed, particularly as the date for selecting the EMU participants comes closer without the prospect of clear signals from the official convergence criteria on who should join. The ECB will have a more difficult task unless the politicians can deliver an initial membership for EMU that is defensible on both political and economic grounds.

EMU and business

A single European currency will have important consequences for European business. Of course, if EMU yields significant macroeconomic costs—if lower inflation and higher investment are outweighed by higher unemployment in weaker economies—then these could easily outweigh the potential benefits that we consider below. By the same token if EMU yields important macroeconomic benefits, then these could easily swamp the possible costs at the level of individual firms.

Simplified cash-management

Moving to a single currency offers three main benefits for business.

- Lower costs of managing cash. For companies operating across national boundaries in Europe, it eliminates the costs of converting money from one national currency to another within the EMU zone. These costs are quite small for big companies, which enjoy benefits of scale, but may be more significant for small and medium-sized companies. These often lack the money and expertise for proper cash and foreign-exchange management.

- Less currency risk. Within Europe, currency risk would be entirely eliminated. The need to hedge business transactions is likewise eliminated within the euro zone, and is therefore restricted to the dollar, yen and other non-euro currencies, though for some companies this may be the majority of their business.

- Bigger markets. Companies will face a much larger, more integrated market across Europe. Customers will more readily purchase across national boundaries, unimpeded by the complexities of different currencies. The only remaining barriers to crossborder trade of any significance will be non-monetary.

The more competitive market that this creates will pose both threats and opportunities. The efficient, customer-oriented company will have the opportunities of operating across a much larger customer base. But the inefficient or unresponsive company will find itself under pressure from the more intense competition. The resulting rationalisation of European industries will see winners and losers. But the customer will benefit through price reductions and improved service.

A closer look at currency risk

The gain from lower currency risk is often questioned. It is argued that companies can hedge their exchange-rate exposure easily and cheaply through financial markets. Hedging through the forward and swap markets is straightforward, with margins for such transactions measured in decimal points of percentages. Since hedging against exchange risk is so simple, the benefits of eliminating such risk through a single currency cannot be significant.

This frequently advanced argument rests on a false assumption: that it makes sense for companies to hedge their currency exposure in full. In practice, however, full hedging is unattractive for at least two reasons.

First, it may be impractical. For a multidivision company, full hedging requires different exchange-rate exposures to be netted across all the divisions of the company. This creates major problems if payment to those working in different divisions is based on recorded results, in order to provide incentives for efficiency. Full hedging may mean that an unexpected currency movement will result in a large loss for a manufacturing or sales division and a corresponding profit on the associated hedge by the treasury division, for example.

There is also a more fundamental reason why full hedging does not make sense. In practice, companies face many uncertainties: exchange-rate uncertainty is just one. Faced with multiple uncertainties, it does not pay a company to hedge fully against one particular risk, because that may leave it more exposed to other risks. So it is usually best to hedge only partially against any one risk. Only in the very special case where one can hedge against all risks simultaneously (which would require very complex forms of contract, which with good reason markets are usually unwilling to supply), would it make sense to hedge fully.

A danger of Eurosclerosis?

Many sceptics see EMU as a diversion from serious structural problems that the EU needs to address. These include burdensome taxes, especially on labour, inappropriate regulation of labour and product markets; and state subsidies that encourage inefficiencies. Rather than galvanising the single market, they fear that EMU, will generate an inward focus, and move the EU further down the road to excessive harmonisation and regulation.

However, EMU is already forcing a reconsideration of the high-tax, high-regulatory tendencies of European countries. There is a growing appreciation among policy-makers that countries may reduce structural unemployment within the EMU zone by addressing the structural rigidities in their economies.

Some people have a different concern - that the introduction of the euro could increase the role of cross-country wage comparisons in European

wage-setting. If wages in all parts of the EMU zone move increasingly in lock-step, because of the ease of comparison between countries, then EMU implies more wage rigidity and less labour-market flexibility. Such rigidities will impede the medium- and longer-term growth of the European economies and impair Europe's capacity to compete internationally.

Optimists reply that exchange-rate flexibility offers no way out of these problems anyway. Devaluation to deal with problems of excessive product and labour market rigidities generates inflation in the longer term, not lower unemployment, since unemployment in the long run is determined by structural factors.

And it is not obvious why companies should allow wage bargainers to impose these rigidities. The issue of wage comparisons is a familiar one inside multinational companies operating across many countries. Such companies are well used to deploying the weapon of productivity comparisons to rebut unrealistic wage comparisons, and indeed this is often a good way to spur rationalisation and greater efficiency. In any case, as we discussed earlier, mobility of workers in Europe is not high. If workers are unwilling to move from one country to another then high wage claims based on comparisons across countries are somewhat empty.

Which companies gain most?

The manufacturing sector, with long-lived factories, would benefit most from the elimination of exchange risk. Companies with long-lived assets are the ones most subject to exchange-rate uncertainty. Financial businesses, and the trading sector more generally, are also exposed through their investment in reputation, goodwill and personnel development. But their exposure tends on average to be less. This is true even when they trade in long-term assets, because their positions in these are more easily liquidated. So they have less to gain from greater stability of exchange rates within Europe.

Profound change for the financial sector

For the financial sector the effects of EMU may be more profound. For banks and other operators in the markets for money and foreign exchange, currency is the raw material of the business. In ordinary commercial banking, the presence of many currencies has acted like a barrier to competition: a bank wishing to enter the market of another member country needed to establish systems allowing it to operate in the other national currency, and this raised the costs of entry. More generally, European banking has been very balkanised, with severe limits on crossborder competition.

By removing this barrier to entry, EMU will strengthen competitive pressures among the various national banking systems. In effect, it will reinforce the various banking directives associated with the single market. So far, the single market has had disappointing results in this industry, largely because the second banking directive, which was agreed to in 1992, has only recently come into force. EMU should rationalise the banking system and deliver a cheaper and better service with wider choice: the customer will be the ultimate beneficiary, though there could be job losses in certain traditional sectors such as branch banking.

Foreign exchange operations

EMU will also influence the foreign-exchange operations of banks. It will eliminate altogether the transactions that currently take place between the currencies of the countries participating in EMU. How large a volume of transactions this will be depends on the number of countries participating.

EMU will also shift the pattern of other foreign exchange dealings. If most EU countries participate in EMU, and if EMU monetary policy makes the euro a stable currency, then the euro may well become more attractive as a vehicle currency in world trade, taking some of the trade currently conducted in dollars. Today, for instance, most trade between Asia and Europe is conducted in dollars, not in European currencies. The euro could change this, though it may take time.

Security markets

EMU will have important implications for the development of financial markets in Europe. It will create a large market in government debt all denominated in euros, and a large stock of euro equity. Which financial centres will attract the business? How would the City of London fare if the UK were to stay out of EMU?

With modern IT and communications capacity, there is no reason why securities trading should be in the country where it originates. Rather it will go through the financial centre or exchange that offers the most efficient trade, measured by the cost, speed and integrity of the transaction.

The advantages of London

Hitherto within Europe, London has offered the most competitive trading environment, and has attracted much trade from other financial centres. Its competitive strength has rested on a number of factors: a large pool of financial expertise, a wide range of ancillary support services, light regulation of security trading, a favourable tax regime for expatriates moving to London, language (attractive to Americans, Japanese and others) and a location in a major political and cultural centre. On most—if not all—of these, Paris and Frankfurt have been uncompetitive. Virtuous circles are at work, reinforcing London's competitive strength: high volumes of trade allow London to offer competitive terms for trading; London's pre-eminence has made it easier to attract first-rate financial experts; the availability of expertise makes London attractive both for trading and locating an operation.

However, Paris and Frankfurt are making strenuous efforts to catch up. They are modernising their trading systems, and France is relaxing its tax laws to persuade overseas experts to locate in Paris. The strategy is to use the changes and opportunities provided by EMU as the stimulus for change.

In this, they may be helped by two factors that act to London's disadvantage. First, there is the risk that London's preparations for EMU will be held back by uncertainty while the question of UK participation or non-participation remains open. Second, there is the recent spate of financial scandals in London (though these have not been absent elsewhere). The danger is that these will weaken the reputation of the City, call into question the light regulatory framework, and lead to a loss of business to other financial centres. At the very least, the challenges by Paris and Frankfurt have been given a boost by the perception that London has vulnerabilities.

Nonetheless, while some business may be lost, London's strong competitive position is unlikely to be appreciably undermined in the foreseeable future whether or not the UK joins EMU, though it may be harmed if the UK stands aside permanently. Unless London plays its hand very badly, the reinforcing virtuous circles are likely to prove just too strong. Realisation of this could tempt the French and German governments to try to find protective barriers to ensure that some business remains at home. But such measures rarely work. Either they fail to bite because of the fluidity of financial market business, which allows it to get round or through most sorts of barrier. Or they do bite, but force the business offshore.

It would be ironic, but not surprising, if discriminatory controls in the euro zone aimed at weakening London's position encouraged the development of a significant volume of euro trading outside the scope of the controls. Since French and German policy-makers acknowledge the force of this argument, discriminatory action of this kind will probably not occur.

The future of Europe

We have already seen that one effect of EMU, if it happens and if it works, will be that participating economies will become more closely integrated. By removing the currency factor in intra-EMU trade and competition, one obstacle (of a non-tariff, non-regulatory kind) to head-on competition between European companies will be removed.

Drawing the political and economic strings together

But this is only part of the story. EMU is sometimes discussed as though the economic and political arguments are separate and additive, that one can simply add the economic arguments to the political ones to arrive at an overall view. In reality, economic and political forces interact; economic developments help to decide what becomes feasible politically. At the start of this paper, we considered the relationship between money and the state, and then went on to consider economic implications. To conclude, we once again draw together the economic and political aspects.

At this broader level, a range of questions about EMU needs to be addressed. What does a partial EMU, involving some but not all EU members, imply for the future of the EU? What if EMU fails to function well, either continuing as a deflationary, high-unemployment bloc, or falling apart as countries withdraw? The EU is often compared with the wobbly cyclist, who falls off when momentum is lost. Would it return to the stagnation of the early 1980s before the single market project was launched, when many were questioning the dynamism and future of the EU? Or will subsets of countries decide to pursue deeper integration independently of other parts?

EMU is linked to the single market

What these questions challenge is the commonly held assumption, particularly in the UK, that the single market is independent of EMU. The agreement of the single market programme in 1986 marked a major step-up in the pace of European economic integration. Agreement to EMU five years later at Maastricht was for many countries the natural complement. The success or failure of EMU could have profound consequences for the political momentum behind the single-market programme and for all countries in the EU, “ins” and “outs” alike.

EMU creates two tiers

EMU will have enormous consequences for the future development of the EU. It is the first of the EU’s great projects to envisage from the outset two tiers, them and us, and to embody this distinction in treaty form. The distinction is drawn in two ways: first, by allowing Denmark and the UK an explicit opt-out from the main EMU arrangements; and second, by laying down explicit criteria for participation which could, in principle, indefinitely debar certain countries from participation. Previous initiatives have allowed laggards in the process of implementation, as well as some individual tailoring of provisions, but have not allowed exemption altogether.

To some extent, then, Maastricht marked a turning-point. It could lead to an inner and outer division within the EU, not just with respect to EMU but more widely. If this trend predominates, the EU may move towards an inner core of “ins” and an outer periphery of “outs”. The “outs” would not have to assume all the requirements of membership, picking and choosing from the *à la carte* menu, but would have less decision-making power in

consequence. The “ins” would swallow the *table d’hôte* menu whole, and would have greater voting powers to influence EU directions.

If this trend continues, it may not be easy for member states that oppose further integration and pooling of sovereignty to stand in the way of those who favour it. If they try to, the inner core could, in the extreme, go its own way by signing a new treaty. This is an unlikely event, but its possibility reduces the options of opponents to use the national veto to block constructive EU developments that command widespread support.

The “outs” and the single market

If a partial EMU works successfully and a club of “ins” develops, how if at all might countries that remain outside be disadvantaged? In particular, how would such a development affect the single market provisions?

Although the principles of the single market are enshrined in treaty, there is some talk of loopholes that will allow covert discrimination to take place, with the authorities in Brussels and Luxembourg turning a blind eye. Critics of the European Court argue that its judgments are often political, not to be defended on strictly legal grounds.

Economic theory suggests that the damage done by any such protectionism would fall as much upon the excluders within EMU as on the excluded. Unfortunately the political process is usually a poor student of economics—otherwise the history of global trade would have been very different. A better hope lies in recent EU experience. Despite some big devaluations within the single market during the 1990s, most notably by Italy and the UK, complaints about competitive devaluation have not so far been transformed into protectionist deeds, although they did sour French attitudes to the completion of the Uruguay Round of trade negotiations. However, strong-currency governments may take a rather different view under EMU. Once they have thrown away the key to devaluation they may be more resentful of governments that have kept their options open.

The possibility of discrimination arises from the operation of the political process. All governments are subject to lobbying by industrial pressure groups seeking to obtain measures that exclude overseas competitors. Such lobbying is more likely to be effective when it can combine with a wider political current, for example if EMU experiences policy tensions and economic failures.

The “ins” could discriminate against the “outs” by exploiting loopholes in existing single market directives, devising forms of market opening in new, currently closed areas (for example, European gas and electricity markets), or, in the financial area, by claiming that the interests of EMU monetary policy are paramount. (This last is a tactic that the likely participants in EMU have already used over access to Target, the financial settlement system for euros.) Or they may simply fail to represent the interests of the “outs” as strongly—and negotiations often arrive at a balancing of national interests. Finally they may simply flout the rules: by the time that companies or governments have been to the European court, commercial damage may already have been done.

Ultimately these issues will be determined by the institutions of the European Union, and the views of the Commission and the Council of Ministers will be a very important influence. This accounts for unease over the UK's position as a likely "voluntary out". If seen by the other member states as an opting-out from the mainstream of the EU, this might well diminish the UK's influence over key issues, both now and in the future, and could mean that the UK's national interests will weigh less in the balance. Appeal to European law provides some defence against this, but the defence is insecure. An *à la carte* approach to Europe has some undoubted advantages, but it also has its costs.

A tentative conclusion

The argument so far is that EMU is a risky but momentous venture that will determine the future development of Europe over the coming decades, for better or worse; and that the uncertainties about the EMU process are such that no single forecast is worth a great deal since it is too unreliable. The author's position on EMU is best described as that of the "sceptical pro", sympathetic to the EMU project but acknowledging the risks.

On the positive case for EMU, there is a very real risk that exchange-rate variability *will* limit the development of the single market, and that the EU will stagnate. To that extent, we side with those who see the single currency as important for the realisation of the single market.

EMU will go ahead...

It is likely that EMU will proceed on a broad basis, with upwards of eight countries participating in the first wave and a few others following later. It is also likely that the technical problems of the transition will be resolved, and that the ECB will quite quickly develop a reputation for the sound conduct of monetary policy, so that the euro will become a firm, if not a hard, currency and the EMU zone will enjoy low inflation. But the problem of high European unemployment could well remain, and possibly intensify in some parts of the EMU zone. This is because the loss of exchange rate flexibility and the constraints placed on the flexibility of national fiscal policy by the stability and growth pact.

In time, though not quickly, continued high unemployment could weaken the position of the ECB and lead to pressures for change. The future of EMU and of the EU will depend on how European leaders respond to this challenge. A failure to respond could generate national pressures, and lead to a slow unravelling of EMU and possibly eventually the EU itself. The wrong response, such as trying to pressure the ECB to adopt a looser monetary policy, with the consequence of higher inflation, could be equally destructive for the future of the EU. Yet the unaccountable nature of the ECB leaves it a target for such pressures.

What is required is appropriate reform of fiscal, welfare and labour market arrangements within the EU to introduce greater flexibility in European economies. This would in part require a flexible interpretation of the rules of the stability and growth pact, permitting automatic fiscal stabilisers to work whilst simultaneously guarding against recourse to excessive government debt in the longer term. It would also imply reform of those aspects of national labour market and welfare policy that discourage employment opportunities in order to tackle the structural aspects of European unemployment.

With such reforms, successfully implemented, the EU could travel towards a sustainable and well-functioning monetary union. Those concerned with national sovereignty may be concerned that EMU is yet another step down the road to federalism. That may be, but members of the EU have considerable choice as to how far it goes. Europe (and the UK with it) has already moved a long way down that road, and the further movement need not be large, especially if the principle of subsidiarity is applied strictly.

...with appropriate policies Europe could be an economic dynamo...

With the right policies, Europe could become an economic dynamo. Without them, it will continue to decline and lose out to other parts of the world, notably Asia. Moreover, the EU must also face the need to open to the eastern part of Europe, to avoid the political and social unrest that will otherwise result. Getting these policies right will not be easy. If EMU proceeds, the lack of exchange-rate flexibility will mean that regional unemployment and industrial balance will emerge as even more important policy issues than hitherto. The future of the EU will depend on its capacity to address these fundamental issues. Much will depend on whether there are European leaders in the next decade with the right strategic vision for Europe and the capacity to realise it. But that requires a vigorous and informed public debate so that these crucial issues are at the forefront of European politics.

...but the risks are great

Europe faces momentous developments over the next few years and in the first decade of the next century. EMU is a risky venture: ensuring that it works well will be fundamental to the future prosperity of the region and the well-being of its people.

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