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THE POLITICAL ECONOMY OF MONETARY UNION IN EUROPE

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ABSTRACT

The Political Economy of Monetary Union in Europe*

The Maastricht transition strategy towards monetary union is based on the idea that the transition strategy should be gradual, and that entry into the union should be conditional on the fulfilment of convergence criteria. It is argued in this paper that this approach is not based on an economic necessity, but on a political one. In particular, it serves the political objective of Germany to keep the union small.

JEL classification: F33, F36, F42
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NON-TECHNICAL SUMMARY

Monetary union has been seen by many potential EC members as a means of solving a credibility problem in their national monetary policies. This is especially the case in countries like Spain and Italy, for which a European monetary union promises to yield a more stable and low-inflation environment. For other countries, like France, European monetary union has been pursued in order to increase the influence of the French authorities in monetary affairs. All this makes European monetary union unattractive for Germany, which stands to lose its reputation and its dominant influence in monetary affairs. As a result, the overriding interest of Germany is to keep the size of the union restricted, so that it can continue to dominate monetary policy-making in Europe. The objectives of the other countries are exactly the opposite. These countries seek to ensure that the monetary club is large enough to include them.

This conflict of political objectives explains the Maastricht approach to monetary union. This approach is based on the idea that the transition to monetary union should be gradual, and that entry into the union should be conditional on the fulfilment of convergence criteria. There is now a widespread consensus in the economic profession that there is no economic case for stretching the transition period to monetary union. The gradual Maastricht approach serves a political objective, i.e. it makes it possible to postpone political conflicts. Similarly, the convergence requirements, as formulated in the Maastricht Treaty, do not seem to be based on economic analysis. A monetary union, if desired, could be achieved in the short run without the convergence requirements being satisfied. In other words, the convergence criteria are not necessary, from an economic point of view, as a precondition for monetary union. These convergence criteria only serve a political necessity. They allow Germany to restrict the number of countries that are going to participate in the union, so that it can maintain a dominant position in the monetary policy-making process.

The major risk for Germany, paradoxically, is that a significant number of countries would actually meet these requirements in 1999. If this happens, a political crisis is likely to emerge. The conflict in political objectives will then surface. It is unclear today how this conflict will be resolved.

The Maastricht Treaty was supposed to be a programme that would lead to monetary union in Europe before the end of the century. This programme has now become very much in doubt.

In this paper we analyze the reasons why the Maastricht programme for monetary union is unlikely to be successful before the end of the decade. We organize the analysis around some well-known propositions derived from the theory of optimum currency areas, and contrast these propositions with the political problems of moving towards monetary union.

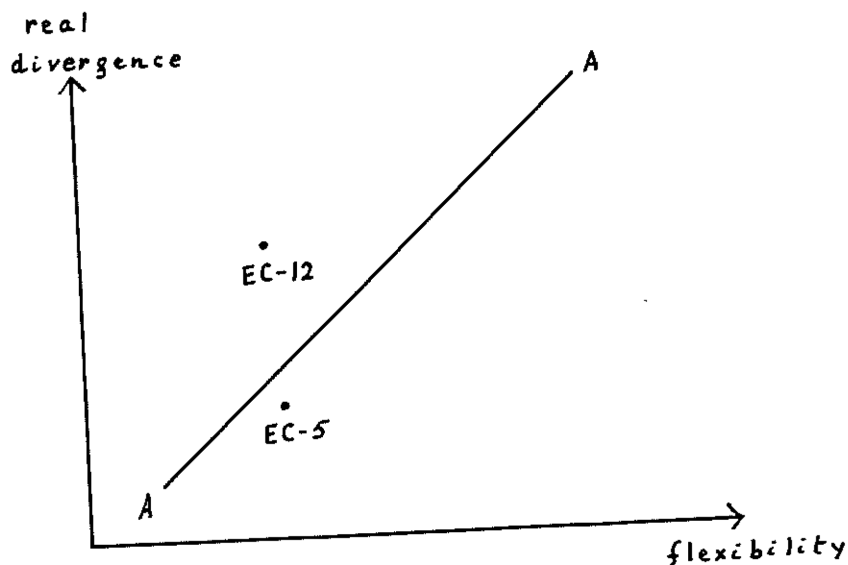
1. THE ECONOMIC COSTS AND BENEFITS OF MONETARY UNION

The prospect of monetary union in Europe has resuscitated an old literature, the optimum currency (OCA) literature, dealing with the question of whether countries gain from joining a monetary union. The main insight of this theory can be represented graphically as follows (see figure 1). On the vertical axis we set out the degree of "real" divergence between regions (countries) who are candidates to form a union. With real divergence is meant here the degree to which the growth rates of output and employment tend to diverge as a result of asymmetric shocks. On the horizontal axis we have the degree of flexibility of the labour markets in these regions (countries). The flexibility here relates to real wage flexibility and interregional (international) mobility of labour.

The central insight of the OCA-theory is that countries or regions that experience a high divergence in output and employment growth need a lot of flexibility in their labour markets if they want to form a monetary union, and if they wish to avoid major adjustment problems. The larger is the degree of real divergence the greater is the need for flexibility in the labour markets to make a smoothly functioning monetary union possible. This relationship between real divergence and flexibility is represented by the upward sloping line AA. Countries or regions located below the AA-line can form a union without "excessive" adjustment costs. In the jargon of the OCA-theory, they form an optimum currency area. Countries

above the AA-line will experience a lot of adjustment costs if they form a monetary union. In other words, these countries have too low a degree of flexibility in the labour market (given the level of real divergence). They do not form an optimum currency area. They are, therefore, well advised to maintain some degree of exchange rate flexibility. Of course, these countries are still free to form a monetary union. The theory, however, predicts that they will suffer economically from this decision.

Figure 1 : Optimum currency areas



Where should the European Community be located in figure 1? There is now a broad consensus among economists, who have tried to implement the theory empirically, that *the Community of Twelve is not an optimum currency area.* (See Eichengreen (1990), Bayoumi and Eichengreen (1991), Neumann and von Hagen (1991), De Grauwe and Vanhaverbeke (1991), De Grauwe and Heens (1993))[1]. Thus, according to these empirical studies, the EC as a whole is located above the AA-line. As a result, from an economic point of view, a monetary union involving all EC-member countries is a bad idea. The economic costs of a monetary union are likely to be larger than the benefits for a significant number of countries.

Whereas there is a strong consensus among economists that the Twelve should not form a monetary union, there is an equally strong conviction that *there is a subset of EC-countries which form an optimum currency area.* The minimum set of countries that could form a monetary union is generally believed to include Germany, the Benelux and possibly France (EC-5). This conclusion is buttressed by the same empirical studies as those quoted earlier. Beyond this group of countries there does not seem to be much agreement on whether or not other countries should profit from a monetary union. In figure 1 we have put the EC-5 below the AA-line. Note that within these countries the degree of labour market flexibility is not higher than among the member countries of EC-12. The empirical evidence seems to indicate that the degree of real divergence is lower.

The economic analysis based on the OCA-theory, therefore, strongly suggests that a two-speed approach is desirable in the monetary unification in Europe. In other words, it would be optimal today to start a monetary union with a limited number of countries, and to think about enlargement at a later stage when other countries are ready to join.

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1 A dissenting view is presented in EC-Commission (1990). See also Gros and Thygesen (1992).

2. THE POLITICAL COSTS AND BENEFTIS OF MONETARY UNION

The conclusion derived from the economic analysis leads to problems when confronted with the political analysis of the costs and benefits of a monetary union. The political problem inherent in European monetary unification arises from the conflict of interests of the major participants.

The fundamental interest of Germany is to keep a monetary union small. This can be explained as follows. Today Germany sets the monetary policies in the European monetary system. This German hegemonic position in the monetary field has its roots in the strong reputation of the Bundesbank and in its uncompromising pursuit of price stability as the major objective of monetary policies. All this is going to change in a monetary union. In the future European central bank the German representative will be only one of Twelve. The dominating role of Germany in monetary matters will disappear. It is not inconceivable that Germany will be put in a minority position when important decisions concerning interest rates and money stocks have to be taken. For Germany, a European monetary union necessarily means a loss of power to determine monetary affairs in Europe.

Thus, the political cost benefit analysis for Germany is almost certainly negative. Germany can limit the political damage, however, by aiming at a union with a limited number of countries. In such a small monetary union, Germany can still play a major role. This contrasts with a large union involving twelve members where Germany can easily be put in a minority position.

It wil be no surprise that Germany has developed a strong affinity to the economic analysis stressing that only a small number of countries could form a monetary union today. The economic analysis serves Germany's interests well.

The fundamental political interest of the other major countries is completely the opposite to Germany's interest. For the other major partners, the overriding political objective is not to be left out of the monetary union. For France, for example, the political cost-benefit analysis is the mirror image of Germany's. In the EMS, France has de facto lost its monetary sovereignity. French monetary affairs are decided in Frankfurt by Germans. European monetary union is a way

for France to regain some monetary influence. In a European central bank, the French will sit around the same table as the Germans, and will be the equal of the Germans. From a political point of view a European monetary union (which involves France) is certainly better than the present situation in which France has as much to say about its monetary affairs as Belgium.

Although the political calculus of the other partners may not be as sharp as the French one, it is clear that countries like Italy and Spain have the same primary objective not to be left in the cold. For them also, the possibility of sitting around the same table as the Germans to decide about monetary affairs in Europe is politically attractive. In addition, for these countries a monetary union has the added attraction that it can help to solve a chronically weak and inflationary monetary environment.

The clash in political objectives between Germany on the one hand and the other major countries on the other is the single most important stumbling block to monetary union. Its resolution will determine whether or not we move to monetary union in Europe. The economic question whether Europe forms a optimum currency area, although an interesting one, will have no influence on this outcome.

This is also confirmed by historical analogies (the latest one being the German monetary unification of 1990). Not a single monetary union in the past came about because of a recognition of economic benefits of the union. In all cases the integration was driven by political objectives.

The absence of a common political objective in Europe today, in fact, the clear antagony in political objectives has made the prospect of a speedy union remote. The Maastricht Treaty has not come to grips with this problem. Instead, it has defined a very elaborate transition process. It will be argued in the next section that this transition programme serves to hide the political conflicts.

3. THE OPTIMAL TRANSITION PROCESS TO MONETARY UNION

Economists have also been thinking about how the transition process towards monetary union should be organized. The views of economists clash with the transition strategy spelled out in the Maastricht Treaty. The latter is based, first, on the idea that the transition should be slow and, second, on the idea that the entry into the union should be conditional on achieving a sufficient degree of convergence.

3.1. The gradual transition process

Economists have pointed out that a long transition period is potentially unstable (see Giovannini (1990), Giavazzi and Spaventa (1990), Begg, et alii (1991), De Grauwe (1992) Fratianni and von Hagen (1992)). The reason is the following. During the transition period, exchange rates are fixed, but national monetary authorities remain independent. These national monetary authorities have different reputations, however. This leads, for example, to different expectations of inflation, and therefore also to different inflation rates. As a result, doubts will continue to exist as to the fixity of the exchange rates. In addition, as monetary authorities remain independent, they regularly disagree on the optimal stance of monetary policies. These conflicts then lead to doubts about the commitment of the authorities towards fixed exchange rates. As shown by the recent upheavals in the foreign exchange markets, these doubts can easily generate speculative crises, and can force countries to devalue or to drop out of the system. As a result, the transition period is likely to be bumpy, with many accidents under way. The longer the transition period lasts the more likely these accidents become. A long transition period, therefore, does not help. On the contrary, it makes the transition all the more problematic.

The economists' view about the transition to EMU implies that once the decision to have a union is made (which presumably was done in Maastricht), the union should and can be organized in a very short time, say, six months. The only constraint to a quick transition seems to be a technical one, i.e. how to print enough money in such a short time period. From an economic point of view the long

transition period required in the Maastricht Treaty is senseless and makes monetary union more difficult to achieve.

Why then did the drafters of the Maastricht Treaty choose a long and hazardous road to monetary union? There can be only one explanation. The long transition process serves a political purpose. That is, it postpones the resolution of the political conflicts that we described in the previous section.

3.2. The convergence requirements

A second feature of the Maastricht Treaty is that it sets convergence criteria that countries have to meet before they can join the union. These criteria involve the rates of inflation, the interest rates, a no-devaluation requirement during two years preceding the union, and budgetary stringency requirements (3 percent of GDP for the governement budget deficit and 60 percent for the government debt to GDP ratio).

Are these entry requirements necessary from an economic point of view? It is striking to observe that these convergence requirements seem to be largely unrelated to the OCA-theory discussed in the previous section and summarized in figure 1. According to the OCA-theory, in order for the EC-12 to form a monetary union it should move to the other side of the AA-line. This can be achieved by a combination of policies that reduce the degree of real divergence and policies that increase the degree of flexibility of the labour markets. The Maastricht Treaty is completely silent about the need to increase labour market flexibility in order to enter into a monetary union. Therefore, the Treaty puts all the burden onto policies aimed at reducing economic divergence. It is questionable whether this is the rigth approach. To the extent that economic divergence occurs because of different economic policies, the emphasis on convergence of economic policies is important. A significant part of the economic divergence observed between EC-countries, however, is due to the occurrence of asymmetric shocks. These happen because economic and industrial structures differ across countries. These structural differences cannot easily be eliminated by convergence of economic policies. Therefore, a much greater emphasis should be put on policies aimed at making labour markets more flexible.

There are other reasons why the convergence criteria formulated in the Maastricht Treaty can be said to be ill-chosen. Let us take the inflation convergence criterion, first. A necessary condition for a well-functioning monetary union is that inflation rates should be the same throughout the union. In a similar way, fixed exchange rate systems (like the EMS after 1987) can only function satisfactorily if inflation rates are equalized across the participating countries. This "nominal convergence" requirement is essentially the same for monetary unions and for fixed exchange rate regimes[2].

One of the interesting features of this nominal convergence requirement is that it is relatively easy to achieve in the context of a monetary union, whereas it appears to be hard to reach in the context of fixed exchange rates. As a result, most fixed exchange rate arrangements tend to collapse, whereas relatively few monetary unions do.

As an illustration of this striking difference in the ease with which nominal convergence is achieved in different monetary regimes, we show the divergencies in regional inflation rates in West-Germany (a monetary union) and compare these with those observed in fixed exchange rate regimes. We selected the Bretton Woods system during the sixties and the EMS during its fixed exchange rate period of 1987-92. The results are shown in table 1. They indicate that in the two fixed exchange rate regimes the cumulative national inflation differentials were ten to twenty times higher than the cumulative differential observed between the German Länder during a period of comparable length[3].

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2 Obviously it does not mean that inflation rates should be identical at all times. Temporary or relatively small deviations in regional (national) inflation rates are often observed and do not endanger the union of the fixed exchange rate arrangements.

3 Lack of available data prevented us from computing differentials for comparable periods.

Table 1 : Cumulative differentials of national (regional) inflation rates

	standard deviation	range
Fixed Rate systems :		
Bretton Woods (1961-68)	6.1%	20.0
EMS (1987-92)	6.4%	17.7
Monetary union :		
W. Germany (1986-90)	0.5%	1.0

Note : The range is defined as the difference (at the end of the period) between the price index of the country (Land) with the highest rate of inflation and the price index of the country (Land) with the lowest rate of inflation.

Why is it that the nominal convergence requirement is so much more difficult to achieve in the context of fixed exchange rate regimes than in a monetary union? The reason is very simple. Inflation in a country is the loss of purchasing power of the money issued by the monetary authorities of that country. In fixed exchange rate systems, each country maintains its own central bank and its own money. Therefore, the existence of different moneys, managed by different institutions with different preferences and policy objectives, makes divergencies in national inflation rates almost inevitable. This is not the case in a monetary union where the same money circulates everywhere, and is managed by the same central bank.

In this sense a fixed exchange rate regime is fundamentally different from a monetary union. In the former regime nominal convergence is very difficult to achieve. As a result, this monetary regime tends to disintegrate over time. In a monetary union, however, nominal convergence is achieved almost automatically and stops being a problem, because the same money circulates everywhere.

The previous analysis has important implications for the transition to EMU in Europe. The Maastricht Treaty has defined tight nominal convergence requirements as a *precondition* for starting a monetary union. This is very paradoxical. The tight convergence criteria for inflation are easily met within monetary unions.

They are most unlikely to be observed between countries maintaining separate currencies, except when some of these countries (like the Netherlands) completely abandon their monetary sovereignity. Thus the paradox is that the Maastricht Treaty imposes inflation convergence as a condition for the regime shift to monetary union, while the available evidence indicates that one needs the regime shift to achieve tight nominal convergence. It appears, therefore, that the Maastricht nominal convergence requirement will be an obstacle to monetary union instead of being a condition which facilitates the transition to monetary union.

We conclude that the existing inflation differentials between European countries that now amount to less than a few percentage points a year are not an obstacle to start a monetary union. Similar arguments can be developed about the interest differentials. Here also the conclusion is that the now prevailing interest differentials in the EC are such that they should not impede the movement into successful monetary union. Once countries are inside the union, and one money circulates throughout the union, interest rate differentials will disappear automatically.

What about the budgetary requirements for entry? The Maastricht Treaty wants countries to move their government budget deficits towards 3 percent of their GDP prior to joining the union, and their government debt to GDP ratio to 60 percent. These budgetary requirements have certainly been the most hotly debated. Many economists have criticised the numerical precision with which these entry requirements have been formulated (see e.g. Bishop, et alii (1989), Eichengreen (1992), von Hagen (1990), Wyplosz (1991), Buiter, Corsetti and Roubini (1992), Corsetti and Roubini (1992), Fratianni and von Hagen (1992)). It appears that these cannot easily be grounded on economic analysis. For example, countries that are on a high growth path can sustain a larger deficit than slow growing countries. Countries with a large government debt (e.g. Belgium and Italy) cannot sustain the Maastricht 3 percent norm today, and should probably aim at a lower deficit.

On the whole, the need for budgetary stringency is not questioned by most economists. What is being disputed, is the excessive precision and uniformity with which this has been formulated. Such precision and uniformity for all

countries seems to be a sure way that these conditions will not be met by many countries[4].

Why then were these entry requirements defined so tightly in the Maastricht Treaty if the economic basis to do so is so weak? The main reason must again be sought in a political calculus.

For Germany these stringent convergence requirements serve the political objective of keeping the number of countries in the monetary union limited. Today (in 1993) only one country (Luxembourg) satisfy all the entry requirements. Given the tightness with which these requirements were formulated, it is unlikely that this number will increase significantly. This serves Germany's political objectives. As argued earlier, Germany's interest is to restrict the size of the union so that it will be able to dominate the making of monetary policies in Europe.

Why then did the other countries accept these conditions for entry? After all, it is in their interest to be included in the club. The only sensible explanation seems to be that these other countries gave themselves a good chance of meeting all these entry conditions. In addition, these other countries had no other choice. They had to accept the terms dictated by Germany. By adhering to these conditions they also showed their commitment to the goal of monetary union. Some countries must surely have been convinced that they can beat the Germans at their own game.

Thus, the tight entry conditions of the Maastricht Treaty have quite a different meaning for the major participants. For Germany the convergence criteria are a way to exclude a sufficient amount of countries from the club. For other countries they are a mechanism of inclusion. They give them the opportunity to join the club by their own efforts, and to show to the others, and especially to Germany, that they are not second-class countries. This conflict about what the entry conditions are supposed to achieve will continue to haunt the signatories of the Treaty.

What are the prospects of success in this game? Let us take two possible scenario's. In the first one (which is the most likely) only a handful of countries

4 See De Grauwe (1993) where it is argued that in the present state of recession in Europe, countries should set aside these budgetary requirements for a while.

qualify at the end of the decade. Suppose also that this group includes Germany (which is not at all assured). This small group of countries can then, according to the Treaty, start a union. It is clear that this will lead to a political crisis. For it is evident that the countries left out (which in this scenario form the majority) will not give their agreement to a union from which they are excluded.

In a second scenario, a majority of countries satisfy the entry requirements, and start a monetary union. If that happens Germany will have to set aside its objections against relinquishing the German mark. It is unlikely to be willing to do so. What is likely to happen in that case is that a true monetary union (i.e. one European currency taking the place of national currencies) will not be instituted. Something in between may see the light. Countries will keep their national currencies and declare their exchange rates "irrevocably fixed". (It should be mentioned that this possibility is actually foreseen in the Treaty). Such a solution has nothing to be recommended about. It will quickly create problems of credibility, and cannot be the basis for a stable monetary union in Europe.

It is fair to conclude that the transition process spelled out in the Maastricht treaty (a long transition period and tight convergence criteria) has been devised for political reasons. Most of these conditions could be dispensed with if the political will to go ahead with EMU was present. In other words, the entry conditions specified in the Maastricht Treaty are not necessary from an economic point of view. It is the lack of political will of the major partner, Germany, which makes these conditions necessary.

CONCLUSION

Monetary union has been seen by many potential members as a means of solving a credibility problem in their national monetary policies. This is especially the case in countries like Italy and Spain, for which a European monetary union promises to yield a more stable and low inflation environment. For other countries, like France, European monetary union has been pursued so as to increase the influence of the French authorities in monetary affairs. All this makes European monetary union unattractive for Germany, which stands to loose its reputation and its hegemonic influence in monetary affairs. As a result, the overriding interest of Germany is to keep the size of the monetary union restricted, so that it can continue to dominate monetary policy-making in Europe. The objectives of the other countries are exactly the opposite. These countries' interest is to make sure that the monetary club is large enough to include them.

This conflict of political objectives explains the Maastricht approach to monetay union. There is no *economic* case for stretching the transition to monetary union. The gradual Maastricht approach serves a political objective, i.e. it makes it possible to postpone political conflicts. Similarly, the convergence requirements, as formulated in the Maastricht Treaty, do not seem to be based on economic analysis either. A monetary union, if desired, could be achieved in the short run without the convergence requirements being satified. In other words, none of the convergence criteria are necessary from an economic point of view as a precondition for monetary union. These convergence criteria only serve a political necessity. They allow Germany to restrict the number of countries that are going to participate in the union, so that it can keep a dominating position in the monetary policy making process.

The major risk for Germany paradoxically is that a sufficient number of countries would actually meet these requirements in 1999. If this happens, a political crisis is likely to emerge. The conflict in political objectives will then have to come out in the open. It is unclear today how this conflict will be resolved.

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