European Monetary Union:

A Progress Report

By

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Introduction

My subject tonight, the prospects for European Monetary Union, lies firmly in the field of Political Economy. I shall argue that strategic political concerns dominate the more uncertain economic issues involved, not only within Europe itself, but should also be the main influence on your own attitude and response within the USA to these unfolding issues.

Paul Krugman once quipped that good economists become reincarnated as physicists, and bad economists as sociologists. On that scale I am, perhaps, doomed to return, if not quite as a sociologist, certainly as a political, rather than a pure, economist. But I make no apology for this. Most of the crucial issues in this particular field are essentially political in nature. Indeed some of the economics involved, such as the theory of Optimal Currency Areas, can often distract attention from more central issues.

I shall begin by asking whether it still remains likely that we shall have monetary union among a subset of European countries within the foreseeable future, shall we say by the year 2000. I shall argue that the effective decision on this lies entirely within the hands of the political and economic leaders of one country, and that is Germany. But I shall rehearse the key interests of the major countries involved.

Assuming that Germany allows monetary union to proceed, what will be the likely conditions and transitional process? Some had initially thought that the collapse of the exchange rate mechanism, the ERM, in 1992 and 1993, had derailed, if not forever at least for a very long time, the prospects for EMU. That was mistaken. The ERM collapse has diverted the transition onto a somewhat different track, but in many ways both an easier and superior route towards EMU.

We are used, at least in Europe, to think about the transition to EMU in terms of three Stages, following the analysis of the Delors report. In this respect I believe that both the Delors report and the discussions at the time of the Maastricht Treaty seriously overlooked the problems of moving from the advent of irrevocably linked currencies, what I term Stage 3A, to a single currency,

whereby the ecu becomes the sole currency within the EMU countries, what I call Stage 3B.

Conditional as already noted on German willingness, a sub-set of European countries will move to EMU. In the second main Section of my paper this evening, I shall then ask whether EMU will work successfully. But, in order to answer this, we need to know what its proponents intend it to achieve. Here the main pure economic benefits, certainly those that are quantifiable, look quite slim, even when pushed by their proponents as far as they can go, as for example by the European Commission in their October 1990 monograph 'One Market, One Money'.

One of the interesting issues that appears to separate continental European economists from American, and some British, economists lies in their assessment of how far a single currency is necessary as a support and safeguard for a single market. Most continental European economists think it is; whereas North American economists do not; witness the lack of any serious concern about monetary issues in the NAFTA discussions.

Finally, there is the question of sequencing for those who want to move along the road to federalism. Before Milton Friedman, Allan Meltzer and Tom Mayer hijacked the term Monetarism, a Monetarist within the European context meant someone who believed that monetary union was an essential staging post, a precondition, along the route to full federalism; once achieve EMU, and then the further steps to full federalism would become much easier. Their opponents, often termed the Economists, argued in turn that pushing monetary union, in advance of political and economic convergence and coherence on a much wider front, was risking disastrous failure; instead their 'coronation' thesis was that monetary union should come as the final crowning glory of an already otherwise unified Europe.

What are the dangers that these 'Economists' foresee if monetary union, EMU, is pushed ahead too far in advance of general European convergence? Here we can turn to the analysis set out in the theory of optimal currency areas, and assess the likelihood of differential, asymmetric shocks; the ability of labour markets to adjust to such shocks within a single currency area; and finally the possibility of using fiscal policy to moderate the initial impact of adverse shocks.

The danger is that, once the individual countries in Europe have given up their command over national monetary policy, some large parts of some of these countries might fall into economic decline and stagnation, with high and persistent unemployment. If so, rather than reducing the influence of nationalism within Europe, an unsuccessful EMU might encourage demagogues to

blame EMU and federalism for all their local woes. Federations of peoples with different cultures, traditions and languages are all too likely to break apart under adverse conditions that allow and encourage politicians to play the nationalist card. I need hardly remind you of examples in the world today.

And yet the driving force towards European Union in general, and EMU in particular, is revulsion from the disasters that national rivalries, particularly between France and Germany, has wrought upon Europe over recent centuries. Although greater economic growth is an objective for EMU, the chief prize of the larger exercise is to substitute a multi-layered governmental structure, comprising federal, national, regional and municipal levels for the prior dominance of the nation state within Europe. This is perceived and welcomed widely in Europe with the marked exception of my own country, the UK.

I shall end with a brief review of whether all this should matter, except as a subject of vicarious interest, to you here in the USA. I shall first try to assess the narrow, and quite slight, purely economic consequences of EMU for this country, and then end by discussing where your more strategic interests may lie.

1. Will it Happen?

Let me revert from my general introduction and go back to the beginning to ask what is the likelihood of EMU occurring.

We may start with the fact that there is already a de facto tight currency linkage between Germany, Holland and Austria, with Germany very much the dominant partner. These countries could move to monetary union immediately with no fuss, and they would be willing and prepared to do so as part of a wider European agreement. If France was to join such a monetary union, it would then cover the core of Europe; the post-war rapprochement between France and Germany lies at the heart of the European Union, in the monetary field as well as elsewhere. Should the French participate in EMU, the Belgians would be determined to join also. Not only is Brussels the administrative centre of the Union, but the Flemming and Walloon regions are so mutually antagonistic that Belgium barely exists any more as a viable nation state. Its survival depends in large part on being able to exist within a multi-layered system of government, in which Federal Europe and the separate regions play a larger role vis-a-vis the nation state. Similarly Luxembourg

already has a monetary union with Belgium, and is subject to the same kind of pro-Federal incentives

Unlike Belgium and Luxembourg, France is one of the oldest, greatest and proudest nation states, and one which has historically centralised power at the national centre in Paris. As the referendum called by Mitterrand in the Autumn of 1992 revealed, the French general public have grave doubts about the wisdom of subsuming their national interests and identity within a larger European framework. But the French political elite are virtually unanimous that this is the best way forward for France. Besides the devout wish to prevent any future intra-European war, they feel that, without further steps towards European Union, a middle-sized country, like France, would inexorably fall behind the rising power of Germany, especially following unification and the consequential rising influence of Germany in the East. Meanwhile a divided Europe could fail to compete satisfactorily with the USA, or the two prospective Asian powers.

In the monetary field more narrowly, the French have consistently maintained the policy of pegging the Franc to the Deutschemark, as a precommitment to achieving the counter-inflationary credibility and price stability enjoyed in Germany under the leadership of the Bundesbank. This policy was first adopted in France in 1983, under the guidance then of Jacques Delors, reversing the prior Socialist go-for-growth policy. This policy survived the 1993 forced exit from the ERM. Indeed, it was the French refusal to allow a unilateral German upwards realignment, when the Bundesbank pressed for this in behind-the-scenes diplomacy after the reunification shock, that was partly responsible for the currency pressures and subsequent debacle in the ERM in 1992/93. Whereas the UK and Italy took the opportunity of their own exit to lower interest rates and allow a measured realignment, the French sought to claw their way back to currency parity with all deliberate speed. That episode reinforced French official belief that markets were not giving them due credit for their firmness of policy. Moreover, the fundamental decisions on such policies were made in Frankfurt on almost purely German criteria.

Thus a move to greater European union, in the monetary as in other fields, could give the French a greater role in policy formation, which under current conditions was slipping ever further into German hands. With some considerable justification, the French elite perceives itself as having great ability to manipulate the Federal bureaucracies. There is a common analogy of the functioning of the European Community to being a vehicle like a coach with horses, in which the French provide the coach driver. I shall leave the identity of the horses to your imagination. So the French government, whether left or right wing, has remained an enthusiastic supporter of EMU, as

soon as possible. It was Mitterrand who persuaded Kohl at the last minute at Maastricht to agree the clause, 109j, requiring that the third stage of EMU shall start on January 1, 1999, (irrespective of the state of economic convergence in the Community more widely), over the objections of the Bundesbank, which was trying to play for time.

That means that, conditional on German agreement, there are six, almost automatic candidates for monetary union, Benelux, Austria, France and Germany. In order to start Stage 3 before 1999, at which time any country satisfying the convergence criteria is supposedly required to join, the European Council must assess whether a majority of the member states fulfills the necessary conditions. That assessment will depend in part on which nation states have become members of the European Union in the period 1997-1999. If the Scandinavian states, Finland, Norway and Sweden should have become full members by then, in addition to Austria, achieving a majority will be more difficult since it is improbable that those Scandinavian countries will have met the convergence criteria laid down in the Maastricht Treaty.

These convergence criteria, involving requirements on comparative price stability, long term interest rates, exchange rate stability and fiscal prudence, received a great deal of attention around the time of the Maastricht Treaty. Their importance has been, most likely, exaggerated. First, if a sub-set of members should want to do so, they could move to a monetary union amongst themselves by a separate, private Treaty outside the confines of Maastricht. The constraints on that action are political; it would not be communautaire. Second, the exchange rate condition has been effectively relaxed by the move to wide bands. Strictly speaking, however, this has not yet been agreed, and it may not be a pushover. The French and Dutch, together with others in the (effective) narrow band may make political difficulties, as they still feel sore about the lira and sterling quitting the system. Both these latter need to re-enter the ERM formally to be eligible for Stage III. It is not beyond the bounds of possibility that, if 15% bands are accepted as `normal', the others may insist on adding some supplementary criteria of exchange rate stability by political agreement. Third, the price stability and long-term interest rate conditions should be relatively easy for most Northern European countries to meet, though they may cause continuing problems for some of the Mediterranean member states. The fiscal criteria, the 60% debt ratio and 3% deficit, are widely seen as the most difficult and restrictive, but under Article 104c these can be subject to qualitative interpretation. The three key countries in this respect are Ireland, Belgium and Italy. There are already signs that Ireland, which has recently run a tight current fiscal policy, will be excused its previously accumulated deficit. The problem for the Commission and Council will be to find a way of allowing Belgium to become a member of EMU, despite its even worse debt ratio

and current fiscal position, without making the fiscal criteria a dead letter. To put it bluntly, the Germans, especially the Bundesbank, have to be reassured that, if they allow EMU to proceed, they will not be giving up their prized stability to become a member of a financially ill-disciplined group, and until they have drastically reformed their fiscal position, this would be how the Germans perceive Italy's current status.

It will, therefore, be a tight call whether a majority of member States can achieve the necessary conditions for EMU before 1999, depending on the accession of new members, the interpretation of Belgium and Ireland's fiscal positions and whether Denmark, who would probably meet the criteria, would use its opt-out or not. But in a sense, it is a second-order question whether EMU is achieved just before, or on January 1st, 1999.

The key question is whether it will happen at all, and that depends entirely on Germany. Without Germany the whole exercise would collapse. Although Germany has ratified the Treaty, they may have left themselves enough loopholes, both constitutionally and in terms of interpretations of the convergence criteria, to avoid joining EMU, though should they try to do so they might be held to be in conflict with Community law. With German assent and participation EMU will happen. Without it, EMU would fail. Since the Germans already are the leading political and economic power in Europe, and have a much admired Central Bank and stable currency, why should they share, dilute and even endanger their preeminent position with a rag-tag and bob-tail of lesser nations?

One important answer is that their leading politicians have been imbued, by the lessons of history, with an appreciation of the need for European unity and of the dangers of rampant nationalism. They are, perhaps, purer and keener federalists than the French who see Europe as an indirect route to reassert French influence. But the fact that Germany is putting its dominant position at some risk, and also is the key country for the whole EMU exercise, gives it enormous bargaining power; hence, for example, the location of the European Monetary Institute in Frankfurt.

Whereas the French have been adherents of the 'Monetarist' view, that EMU is a vital staging post on the way to federalism, the Germans have followed the 'Economist' analysis, that monetary union needs at least to be accompanied, and perhaps preferably preceded, by a much wider political and economic convergence and cohesion within Europe, for example in the field of giving a stronger democratic mandate to the European institutions, such as the Parliament. In that respect they feel that the Maastricht Treaty only provided part of the necessary measures to establish a sustainable

and viable European Union. The Germans are likely to come to the 1996 forthcoming Inter Governmental Conference with a long shopping list of mainly political measures to strengthen the central, federal European institutions.

That will bring them face to face with my own government in the UK. The Conservative government has consistently tried to refocus the European Community as no more than a single market agreed among a group of entirely independent, separate nation states, a Europe des patries. In this respect it has tried to divert and weaken the true driving force within the European Union. The forthcoming IGC is likely to represent yet another bruising confrontation between the UK and most of the rest of the Union, as the British Government attempts to resist the federal initiatives proposed by Germany and widely supported elsewhere. Only if the French and Germans antagonize the other smaller European nations by overtly treating the European Union as an effective Franco-German duopoly are the British likely to find many allies. While a future Labour government would, at least initially, be less antagonistic, there is only a small likelihood of a general election in the UK before the IGC.

If the Germans are to share and dilute their current position of superiority, if not dominance in Europe, they will want to mould the European institutions, including the monetary institutions, to their own chosen design. This has already happened with the Protocol for the European System of Central Banks and European Central Bank, which was modelled along Bundesbank lines in a largely uncritical manner. In certain respects, for example its lack of democratic accountability, this is, however, unsuited to a wider European context. Whether Germany succeeds, or not, in revising European institutions to its own design at the next IGC, against probable UK opposition and obstruction, that outcome is probably much more important in determining whether EMU comes into being than the minor technical details of the convergence criteria.

What all this indicates is that the timing, the identity of the member states participating, and even the eventuality of EMU remain highly uncertain. But that uncertainty was only heightened for a brief period by the collapse of the ERM in 1992/93. The attempt to maintain pegged, but adjustable, exchange rates within narrow bands in the run-up to Stage 3 was always likely to generate speculation about final realignment. So the move to broad bands has, in some respects, actually eased the prospects for a smooth passage to EMU. The concept of approaching fixed exchange rates by moving through an approximating process of ever tightening and narrowing exchange rate bands is now perceived as fundamentally flawed. Instead, the new recipe is to try to achieve convergence of domestic, national financial conditions, preferably by the adoption of constitutionally independent national Central Banks, mandated to the achievement of domestic medium-term price stability. If that should also deliver exchange rate stability in advance of EMU, well and good. If not, there could still be a big-bang, single day change to irrevocably-locked exchange rates at the outset of EMU, even if national exchange rates exhibited some considerable residual fluctuation up to then.

The general institutional conditions needed to run a system of irrevocably fixed exchange rates, and a single monetary policy among the participating countries, are becoming clearer now, as a result of the preparatory work done initially in the Committee of E.C. Central Bank Governors, for example the papers by Monticelli and Viñals, and work that is now being carried on by the fledgling EMI under Alexandre Lamfalussy and Robert Raymond. Even so, planning at the national level and amongst commercial financial institutions is hindered by residual uncertainty over when, whether and if participation in EMU will take place.

Measures, such as the introduction of EMU-wide intra-European payments and settlement systems and inter-bank markets, probably (though not strictly necessarily) denominated in ecu from the start, will have to be introduced immediately. But the transition from the irrevocable linking of currency parities, Stage 3A, to the adoption of Stage 3B with a single currency throughout, is likely to be much longer, probably lasting many years, much more difficult and highly unpopular to introduce. In a recent speech, Alexandre Lamfalussy has now semi-officially recognized that this is so. Given the uncertainty over who, whether and when, forward planning, especially by the private sector financial community, has been limited and insufficient. Moreover the combination of the no prior devaluation requirement in Article 109j, with the terms of Article 109l, clause 4, and Article 109g, irrevocably fixing the value of the ecu at the start of Stage 3, would seem to force the member nations to enter Stage 3A and thereafter Stage 3B with the basic unit of their national currencies equivalent not just to a vulgar, but to a totally barbaric and hideous fraction of an ecu.

For example the ecu central rate for Ireland is 0.808628. Normally currency reforms simply shift the decimal point. Not in this case. Far too little attention, far too late was given to the technical details of the transition between Stage 3A and 3B. Trying to change not only all the paper currency, but also the coins, of all the member states into a totally user-unfriendly form, as would seem required by the existing Treaty articles, is going to be so difficult, so expensive and so wildly unpopular that it could endanger the whole exercise.

But a failure to move rapidly to Stage 3B would require all banks and most companies to keep two sets of books, one in ecu and one in domestic currency, and that would be horrendously expensive and complicated for them. There is a simpler alternative, which is just to switch to the Dm as the single European currency, but political sensitivities, particularly in France, are unlikely to allow that. In short, while Stage 3 will happen if Germany agrees, there remain many, serious unresolved problems over the transition from Stage 3A to Stage 3B. Indeed, I wonder sometimes whether Stage 3B will ever occur. After all from an economist's view point, the crucial changes are those that transfer monetary policy into the single hands of the ECB and fix exchange rates absolutely. The subsequent move to a single currency is in some respects only the outward symbol of the precommitment to maintain such a single federal monetary policy. Accordingly we can now turn to an assessment of whether EMU would work well, despite remaining doubts whether the problems inherent in the final transition to a single currency, Stage 3B, can be overcome.

2. Will EMU Work Well?

Even so, certain of the economic benefits of EMU do depend on the achievement of a single currency, Stage 3B. Even if national exchange rates are absolutely and irrevocably linked, there would still be some transactions costs in exchanging currencies. These are non-trivial; Commission studies in 1990 assessed the benefit from getting rid of these entirely within the EC as worth at least ½% of GDP per year. Again, the continuation of separate currencies would lessen the credibility of their future fixity. So national interest rates might still incorporate a premium against potential future realignment, a peso risk, and getting entirely rid of this risk premium was optimistically assessed by the Commission and one of its academic consultants as capable of raising Community incomes significantly, "possibly", I quote, "up to 5-10% in the long run".

Besides these advantages of having a single currency, the Commission emphasized the benefits of price stability that would be brought by a European Central Bank mandated to achieve that primary

objective. While an independent Central Bank is, I do believe, a good thing, what is less clear is why price stability could not be achieved just as well, or better, within their own countries by individual national independent Central Banks. Having an independent European System of Central Banks is indeed a condition of EMU, but even without EMU the separate European countries can and indeed are moving in the direction of having more independent national Central Banks.

The Commission's mammoth study on the economic implications of EMU, 'One Market, One Money', covers several other issues, such as the 'Implications for Public Finance' in Chapter 6 and External Effects in Chapter 7. I do not have time to discuss these in any detail now, though I shall briefly revert to some of the external implications of EMU for the USA towards the end of my talk.

While it is inevitably extremely difficult to assess the effect of major regime changes, such as EMU, the Commission's Study, which was perceived as less than entirely neutral and unprejudiced, did not persuade many independent observers that the quantifiable, tangible economic benefits of EMU would be large.

But it was always a misapprehension to believe that EMU was to be assessed primarily within a narrow economic calculus. Rather it is perceived as a vital step along the road towards greater political and social union. This was particularly marked among French 'monetarists', again using that term in its earlier European rather than its subsequent American usage. Thus Jacques Rueff claimed "L'Europe se fera par la monnaie ou elle ne se fera pas", which I would roughly translate as "Unless Europe has monetary union, it will not have any kind of union".

Indeed, most Continental economists believe that monetary coordination, and preferably monetary union, is essential not only to extend, but even to maintain the achievements that have already been made to obtain a Single Market within Europe. There are several dimensions to this general viewpoint.

First, the facet of the Community which virtually all economists applaud is the Single Market program with free movement of goods and factors of production. Here there is a clear division between the proponents of ERM and EMU, who argue that agreement and mutual surveillance over exchange rates is a necessary precondition for the acceptance, maintenance and success of the Single Market, and the opponents who deny that. The opponents argue that, in theory, flexible exchange rates provide a means of adjusting to external, Balance of Payments, shocks and hence

should allow a free and open international market to operate better and easier; and they argue that, in practice, the North American Free Trade Area Agreement (NAFTA) negotiations involved many contentious points, but concern over exchange rates was conspicuously absent from the discussions. NAFTA has been proceeding without requiring side-agreements over exchange rates; [though the US government was noticeably keen to help shore-up the Mexican peso following the speculative attack on it in the aftermath of the Presidential assassination]; why should not the Single Market in Europe do so also?

Continental European commentators would argue, in reply, that countries, such as France, will not be prepared to leave their economies open to free movement of goods, enterprises and factors of production if they suspect that other countries are trying to obtain an unfair trading advantage, for example by competitive devaluation. If there is to be freedom of trade and migration, there should also, they would claim, be mutual surveillance over exchange rate policies.

One difference between North America and Europe in this respect may have been that Mexico has been following a strong peso as a counter-inflationary policy, while the Bank of Canada has been undertaking a generally restrictive monetary policy in pursuit of a domestic target for price stability. So long as monetary policy is, thus, targeted, either through rules on discretion, on an internal target for nominal incomes, or price stability, then there would seem little need for mutual surveillance of exchange rates. But the objectives of monetary policy can change. Should the monetary authorities, in one part of a free trade area, be perceived to be giving weight to considerations of competitiveness, relative exchange rates and employment, then its neighbours are likely to become concerned, and seek such mutual surveillance. The 'benign neglect' of monetary policy and exchange rate issues in the NAFTA negotiations may be the product of the particular conjuncture of current monetary policy postures in Mexico and Canada. If the latter was to change, the omission of any side-agreement on monetary relative exchange rates might sometime prove quite troubling.

Although currency realignments, if properly controlled, need not impede progress towards a single market, I would argue that the adoption of a single currency supports free trade and the free movement of labour and capital far more effectively than a regime of pegged but adjustable rates. With a single currency there is the inestimable boon that there are no official data on the balance of trade, or balance of payments between States. That, by itself, reduces pressures for measures to be taken that benefit the local economy at the expense of the wider federal whole. No sensible person ever suggests the erection of artificial, internal barriers to free trade, or to the free movement of

factors of production within a single country with a single currency. But once a formerly federal country subdivides into separate countries with separate currencies, as in the former Soviet Union, the barriers go up.

Second, a move to co-ordinated, or preferably fixed exchange rates may be necessary for the success of any centralized fiscal domain. So the continuation, and pro tanto the extension of fiscal competences to the Federal centre may be conditional on progress in moving towards EMU. Certainly, the problems of trying to run the system of levies and subsidies that constitute the Common Agricultural Policy, the CAP, were made so complicated by flexible exchange rates that the agreement nearly collapsed. The political process that sustains agreements like these requires centralized payoffs. This concern played a major role in the establishment of the ERM; as Giavazzi and Giovannini (1989, p. 7) noted, "the common market [in cereals under the CAP] could only function if intra-Community exchange rates remained stable".

The response can be made that such arrangements require no more than the adoption of pegged but adjustable exchange rates, not a move all the way to a single currency. But the proven fragility of pegged but adjustable exchange rates in the absence of exchange controls, as demonstrated in 1992/1993, indicates that the continuation of such a regime for an extended period may not be viable. But, even if it were, there are reasons for doubting whether any regime with periodic exchange-rate adjustments is consistent with sizable transfers of fiscal responsibility to a federal centre. Such doubts become more pronounced the more flexible the exchange-rate regime is, whether a float, a crawling peg, or an arrangement with soft bands.

The first argument is largely presentational, though not less important for that. It is that the existence of separate national currencies facilitates the calculation of the <u>net fiscal transfer</u> between the member states, indeed almost requires such calculations, when transfers involve conversions between domestic currencies and ecus. Partly in consequence, the identification of net fiscal winners and losers within the EC is regularly made in terms of the overall position of each country, rather than of diverse groups of individuals within the whole of the EC. This means that, despite the best preventive efforts of the Commission, the identification of "gainers" or "losers" from the majority of EC economic measures is made largely in terms of the effects the measures have on separate countries. Thus, the battles over EC fiscal policies in Brussels are not about how these affect the welfare of the representative European, but how they change the net position of each separate state. Although it is possible to estimate the net benefits to Wisconsin, Minnesota or Illinois from a change in the federal budget, the existence of a single currency tends to shift the

focus of debate toward the effect on the representative agent defined by type, for example, age, income, and job, and not by geographical locality.

It is, of course, true that US senators support the interest of their own States within the United States, just as heads of member states do in the EC, but they do so to a somewhat lesser extent, I believe, and not so single-mindedly. When the fiscal assessment concentrates on type rather than geographical residence, moreover, the perceived gainers or losers will only occasionally be concentrated in any one locality and, when they are, will often constitute producer groups, such as miners or farmers, whose political clout far outweighs their numerical strength.
Because the continuation of separate currencies encourages the calculation of benefits and costs in national terms, it exerts a centrifugal force, causing national politicians to fight for "our money", the *juste retour*, and so forth. By contrast, calculations that concentrate on a similar treatment of similar types of agents, irrespective of location, exert a centripetal force.

One intriguing feature of the debate over European monetary union is that many of the most skeptical critics and doubters of the value of this step are American economists. Feldstein's 1992 Economist article is a prime example. But how can they advise European countries to abjure EMU, while appearing entirely content with their own even wider monetary union? One answer is that monetary union will only work well when there are appropriate, associated federal fiscal and trade policies. But as I have argued, you may need a currency union to get such associated federal policies in these other fields. It is a chicken and egg problem.

A second answer is that the economic costs to the constituent States of giving up their control over domestic monetary policy may well be less in the USA than in Europe, because the USA could be more akin to an optimal currency area. The costs of not having a separate Wisconsin $, and Central Bank here in Madison, are that you cannot respond to a shock that affects Wisconsin differently from the rest of the USA. If all shocks are symmetric, then the same policy should be followed whether it is promulgated at the federal, or the local level. So, one cottage industry that has developed within the economics profession has been to try to compare the extent to which shocks have been symmetric or asymmetric within both the European Union and the USA. The results of this research have been mixed. They suggest that the inner north central core of Europe, France, Benelux, and the German trading group, may already be as symmetric as the USA; but that the European periphery, Scandinavia, the British Isles, and the mediterranean countries, does face more asymmetric shocks, which would continue to require separate policies. But by the same token some of these studies suggest that the oil states in the USA, Louisiana, Texas, Oklahoma,

might also benefit from a separate petro-dollar.

The likely occurrence of asymmetric, separate shocks to your particular State again matters less if markets, particularly labour markets, can adjust quickly and efficiently to them. It is here that the USA has a clear advantage over Europe. Your wage structure is somewhat more flexible than our own, but where you really score is in the ability and willingness of people to migrate across country to find jobs in the expanding economic regions. European housing policies, employment policies, culture, tradition and above all language differences tie us to our home countries. Indeed even within countries our willingness to migrate in response to differential economic opportunities is far less than your willingness to move between States. Thus if an adverse shock should hit a European country, the population there would be more likely to stagnate in unemployment and fester in discontent than to get on their bikes or cars and search for jobs in other countries. Such rigidities have not been helped by the recent attempts of the Commission to push forward its Social Chapter, much as one can understand its good intentions.

If adverse shocks do differentially affect particular regions, or states, their effects on inter-state inequalities of income can be mitigated by redistributional federal taxation, and their effects on cyclical changes in incomes and employment can be lessened by the stabilizing properties of fiscal measures. Unlike the US, virtually all stabilizing and redistributive fiscal functions in the EC are currently undertaken at the national level, with the monetary and fiscal authorities having the same boundary. Why, when the monetary boundary is enlarged to replace national currencies with a single currency, cannot the fiscal functions of stabilization and redistribution be left at the national level and, if necessary, be pursued at that level more vigorously than before?

There are, however, several arguments for shifting these fiscal functions partly to the federal centre. First, the Maastricht Treaty's convergence criteria proposed limits on both the ratio of government debt to income and the government deficit, and, if allowed to, thereby constrained the future ability of national governments to undertake countercyclical fiscal stabilization. A second argument for centralizing fiscal functions at the federal level is that fiscal-policy measures in one area may spill over into neighbouring areas. Some overspills, such as those resulting from a high marginal propensity to import, may make a national or regional authority less fiscally active than desirable, especially with respect to the smaller EC countries.

A third argument for centralizing fiscal functions is that their continued exercise at the national or regional level is likely to affect not only current levels of public-sector expenditures and tax rates, but also expected future levels. The achievement of EMU may not only require a high level of

factor mobility, at least in theory, but may also induce greater future mobility in response to differing tax rates. It is already increasingly difficult within the EC to impose differential taxes on highly mobile tax bases like financial transactions, savings, or corporate profits. If labour should also become highly mobile, it could become difficult to differentiate nationally benefits to, or taxes on, labour.

The fourth argument for centralization refers to the condition of "social union", when people in a particular area agree that all of them should be treated alike. Assuming that the benefits go to people who are dependent, unemployed, or poor, and that taxes are raised on the usual principles relating to personal expenditure, income, or wealth, there will generally be, often without much public notice, spatial transfers from more prosperous to less prosperous regions (for example, from northern European to Mediterranean regions). Within the EC, however, there is not now, or in sight, an agreement that all area inhabitants should have broadly the same menu of benefits and taxes. Indeed, there is scarcely accord on minimum standards for the provision of public goods. Insofar as redistribution takes place at all, it occurs through the more covert mechanism of structural, or cohesion, funds, which are themselves subject to a variety of operational problems. Any new steps in the direction of social union will be either voluntary, in response to a stronger feeling of common citizenship and solidarity than is currently apparent, or forced, if the international mobility of people interferes with national attempts at interpersonal redistribution. Neither prospect looks likely in the foreseeable future.

Meanwhile virtually no stabilization is achieved through the current federal budget. The gross flows are very small relative to national budgets; the form of the expenditures, mainly through the Common Agricultural Policy (CAP), and of the taxes, mainly through the value added tax, are not highly responsive to economic fluctuations; and the EC cannot, by law, run a deficit.

In existing federal fiscal systems, such as here in the USA, both stabilizing and redistributive functions have been actively carried out through the federal budget. It would be reckless to dismiss the potential importance of these activities for the cohesion and success of such monetary unions.

A final argument for adopting some federal stabilization insurance scheme is, again, unashamedly political. It is that, one Stage 3 is achieved, politicians and commentators will, rightly or wrongly, blame the severity of cyclical downturns on monetary union. They will argue that, without such a union, monetary policy would have been relaxed. So long as the downturn is symmetric over the entire EC, the answer will be straightforward, but, in an asymmetric, particularly adverse situation,

how can a supporter of EMU counter the accusation that monetary union involves a sizable net disadvantage? A significant, timely, and visible fiscal federal transfer to temporarily disadvantaged countries could help to sustain political support for EMU at especially difficult times. But, despite attempts, including a longer paper setting out these arguments which I co-authored, Goodhart and Smith (1993), there is no sign of acceptance of any larger role for a centralized federal fiscal function in Europe.

Monetary union in Europe is, therefore, likely to proceed under the burden of two handicaps, that will differentiate it from most other such unions. First its labour markets are likely to remain quite rigid, especially spatially; and second there will be very few, if any, federal fiscal transfers to alleviate any resulting distress. Whereas there were no federal fiscal transfers to relieve distress in the monetary unions of the 19th century, the Silver Latin Union or Gold Standard, at least when conditions became too bad at home, the unemployed and poor, the huddled masses, just emigrated over here. And that safety valve is no longer available.

The downside risk of moving to EMU in these circumstances is that, without flexible labour markets or sufficient fiscal transfers, adverse shocks will cause persistent pockets of unemployment to occur and persist. Politicians are then bound to arise who will blame it all on the abandonment of national, sovereign control over the key levers of economic policy. It is possible to see how a move to EMU in these conditions could actually generate a backlash towards an even more aggressive nationalism, possibly even fascism.

The upside potential is that a successful evolution to EMU, besides generating greater growth, could lead to a wider acceptance of a multi-layered system of government, in which federal, national, regional and municipal authorities each had their respective roles. Such a vision, however, represents a night-mare to Thatcherite Tories. Mrs. Thatcher sought to concentrate power in her own hands at the national level, much to the consternation of liberals everywhere. Her influence on the Conservative Party is one reason why my own country, the UK, conspicuously fails to share the aspirations of the rest of Europe.

Meanwhile German economists see very clearly that monetary union would be fragile without a supporting nexus of generally agreed policies in the fiscal, trade, social and political fields. French monetarists believe that the best, perhaps the only way, to obtain such supporting policies is to press forward on the monetary front.

What will happen? Nobody knows, but in the short run the most likely outcome is the division of the European Union into groups moving at separate speeds. The core, the German group, France and Benelux, and probably Ireland, will move to monetary union, whereas the periphery will either opt out, like Denmark and, perhaps, the UK, or be kept out by failure to meet the required convergence criteria, as in most, or all, Mediterranean countries and Scandinavia.

3. Implications for the USA?

Let me end with a brief look at some of the possible implications of EMU for the USA. A chief objective of EMU is to raise the growth rate and economic well-being of the inhabitants of Europe. Pace those who worry about exhaustible resources and environmental overload, a stronger economy in Europe would be to the general advantage of all other parts of the world, particularly through the increased opportunities for trade. So a successful Europe would bring some, though not enormous, gains for the US also.

There is, however, little doubt that one of the driving forces behind European enthusiasm for EMU is the view that only through such union can Europe effectively compete with and rival the US. This is particularly so with respect to external monetary issues. One of the objectives of moving to a single currency, the ecu, is the view that only by so doing can the Europeans hope to field a currency that can compete with the US dollar internationally. Thus one of the main conclusions of the Section [Chapter 7] in 'One Market, One Money" on the External Dimensions of EMU was that "the ecu will emerge as a competitor to the dollar as an international currency".

Overall the economic effects of this are not likely to be large. The shift from US$s to ecus as a vehicle currency in exchange rate deals, as the currency in which invoices and deals are made, as the asset in which international reserves and portfolio holdings more widely are held, is not, on most expert assessment, likely either to occur rapidly or to have a noticeable affect on anyone's standard of living. If the Japanese hold some more ecu-denominated assets and equivalently fewer $-denominated assets, it is not going to be a big deal.

And yet when Jacque Delors came to give a speech at LSE a couple of years ago on the advantages of EMU he put great weight on the advantages of having the ecu rival the $. I am sure that he is aware of the small size of the expected economic benefits. As I listened to him, I was impressed,

and somewhat saddened, by the urgency he seemed to feel about overcoming, and somehow mastering, the USA if only in a somewhat symbolic fashion.

I believe that you, in America, have supported both EMU and a federal Europe for two and a half reasons. First, you feel a natural affinity for a United States of Europe. Second, you saw a stronger, more united Europe, as a valued support against Communism and the former Soviet Union. The half reason is that you have been so pre-occupied with your trading relationships with Japan, and your overall international relationships with the two Asian great powers, that you have not perceived Europe as posing problems for you; indeed such problems, as in Bosnia, are seen as arising from European disunity, rather than cohesive strength.

The collapse of the former Soviet Union has, however, changed this appreciation in certain important respects. It has made Europe less dependent on the US nuclear umbrella, and less concerned about potential threats from the East. It is, at least, arguable that a potential federal union, as internally weak and divisive as Europe is likely to be, needs an external challenge and threat in order to rally internal support and cohesion. I have very little doubt that, following the demise of Communism, there is a sizable group of supporters of a federal Europe who would be keen to cast the USA in the role of chief opponent, who must be resisted and whose influence must be overcome. In Europe, we do not have the same concern with Japanese competition that you do; instead, many in Europe see the American influence on policy, economics, language and culture as the pervasive alien influence.

I hope very much that I am wrong to worry that a more united Europe will also be united in its opposition to this country. Certainly my own country's policy will seek to prevent that. But you should, in the USA, take some care that in your general support for a more federal Europe, you are not at the same time building up a power which will turn against your own interests.