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# Convergence, Credibility and the Welfare Effects of EMU

Sparked off by the European Commission's Green Book, the discussion on the European Economic and Monetary Union (EMU) has flared up again. Following the interim report of the Cees Maas Group, it has been given an additional dimension: the dimension of the "How" of the transition, which is concerned primarily, but not exclusively, with technical aspects. The fundamental question of "Who" has also taken on a new dynamic. In contrast, the "When" appears to be settled now that most of the member states have accepted the postponement of the date for the start until 1999.

Of course, surprises cannot be ruled out. The European Commission is insisting not only – and quite rightly so – on the correct implementation of the procedure laid down in Art. 109j EC Treaty. The Commissioner in charge of currency matters, Yves-Thibault de Silguy, apparently also sees the chance that a majority of the member states will already be able to meet the convergence criteria for Stage Three in 1996 and that the transition to a one-year preparation phase could already take place at the beginning of 1998. Come to that, almost all the member states have announced that they will fulfil the necessary requirements by 1997 at the latest, in time for the start on 1st January 1999. Even the United Kingdom is apparently aiming for this and would thus keep all its options open. Since even member states which are presently far removed from the threshold figures are going all out to be one of the party from the beginning and since, in addition, France is pressing for all of the larger countries to be included if at all possible in order to rule out competitive devaluations, the solemn declarations repeated unanimously in Cannes by the European Council, the Finance Ministers and the Commission that the convergence criteria would be "strictly observed" sow the seeds of mistrust rather than of confidence. Do the politicians all mean the same thing when they talk of "strict observance"?

Strict observance of the convergence criteria can, on the one hand, mean: observance of the intention, the spirit and the text. The economically well-founded call expressed in Art. 109j for "sustainable" convergence – a fundamental condition for the realisation of the welfare-increasing effects of the monetary union forecast by the Commission – would thus be accorded outstanding importance. Fulfilment of the criteria, including the (general gist of the) exchange-rate criterion, over a longer period of time would then be a precondition for participation in Stage Three: the EMU would start off in the circle of those member states which had convincingly proved that they had a common "culture of stability" under changing economic constellations. Only if that were the case would it be possible in Phase 3A, between the decision and actual entry into Stage Three, to expect stabilising market behaviour, as the Green Book promises, because these currencies will be regarded on the markets as practically perfect substitutes. Only in this case can it be expected, in addition, that the monetary union will also be able in the long term to show positive effects as an economic and political "engine of integration", and that the risk will be minimised that it develops into the dynamite of the Community instead.

Strict observation can, however, on the other hand mean: observation only of the formal conditions of the Maastricht Protocol on the Convergence Criteria, if necessary generously utilizing the latitude for assessment it provides. In that case the preconditions for participation in Phase Three would already be met if a country – benefiting from advantageous cyclical conditions and/or with the aid of a short-term political/financial tour de force – fulfilled the criteria in the reference period of 1-2 years before examination. The exchange-rate criterion could thus be interpreted in the sense that observance of the fluctuation margin of 30% would be enough to qualify for participation, as long as the country had not devalued its central rate "on its own initiative". According to the convergence protocol, the

budget and debt criterion is observed if "at the time of examination" no Council decision (!) on an excessive deficit exists; the example of Ireland gives food for thought here. The purely formal observance of the convergence criteria would contradict the call to set up the EMU as a stability union and to provide it with credibility from the beginning.

The establishment of credibility with regard to stability policy is in fact the most important – and the most difficult – task facing the EMU and it already begins before entry into Stage Three with the selection of the participating countries. The Green Book is correct in emphasizing the risks for the development of exchange rates in the transitional period which could arise from a lack of credibility. These risks are large enough to be able to cause the entire project to fail at the last minute. The political interest of individual member states in participation must take second place compared to the interest of the Union in a transition to Stage Three with as little friction as possible and, above all, in the continuous well-functioning of the EMU, in as far as these members' economic performance to date threatens to affect adversely the achievement of these Community goals. The interest of the Community is identical with the correctly understood medium-term economic interests of these countries themselves.

Developments since 1992 have in fact made more plain not only the possible gains for the member states from participation in EMU but also the macroeconomic costs of a too early entry. The gains result primarily from the removal of the exchange-rate risk within the Union; from lower transaction costs for cross-border payments; lower costs of financing due to the more intensive competition on a larger financial market; and, in many countries, lower interest rates as a result of the confidence bonus gained from being a member of EMU. Macroeconomic costs, on the other hand, can result from a forced adjustment to the convergence criteria; losses of employment if wages catch up too quickly following the disappearance of the currency illusion connected with the existence of different currencies; the abandonment of the exchange rate as an instrument of adjustment; and the renunciation of monetary policy autonomy, which – other than is assumed in the Green Book – does in fact exist with floating exchange rates. The probability that the macroeconomic and microeconomic costs are greater than the gains is so much the larger, the less the "cultures of stability" have already drawn permanently close to one another.

It is therefore wrong to imagine that participation in the monetary union is automatically beset with welfare gains and non-participation with welfare losses. For countries with inflation rates which are generally higher than those of the "core" stability-oriented countries, an economic policy strategy which continues to leave open the possibility of devaluation – and, if necessary, of an autonomous monetary policy – can make more sense from the point of view of employment and growth than a too hasty entry into Stage Three. Also, if the budgetary and debt criteria are continuously greatly exceeded, the step-by-step reduction of the deficit and of debts – with a correspondingly later entry into the final stage – can be superior to a strategy of rapid participation "at any price".

The question, therefore, cannot be whether the group of countries participating in EMU as a whole will show a surge in growth – this (one-off) growth effect will, according to earlier calculations of the European Commission, at half a percentage point probably be low in any case – but whether it would be better for each individual member state to participate early or not to participate for a while. There is no reason to assume that the Community will in the medium term show greater divergence with regard to growth, income and employment if some countries do not at first enter into EMU than if the number of participants in Stage Three were maximised. The opposite is more likely.

The recession and the exchange-rate turbulences of the last three years have revealed that a number of countries are not yet economically ready for an early entry into Stage Three. The convergence criteria confirm this. Their participation in EMU would serve neither these countries themselves nor the Union. The (necessary) discussion on the technical preparations should not be allowed to let us forget these truths.

*Hans-Eckart Scharrer*