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Horst Feldmann\*

## Economic and Political Risks of European Monetary Union

*As demonstrated by the last European Union summit meetings, the heads of government and of state of the EU's member states appear firmly intent on starting the planned monetary union on schedule on 1st January 1999. The statements they make, and also any pamphlets and advertisements published by their governments and the European Commission, tend to concentrate one-sidedly on the purported advantages of monetary union. Nevertheless, in most EU countries plans for monetary union are greeted with scepticism or disapproval by a large section of the general public. There are good reasons for this reaction because, as will be explained below, European Monetary Union is in fact associated with serious economic and political risks.*

The European Commission in particular,<sup>1</sup> but also other bodies such as the Federal German government are emphasizing that a single European currency is necessary in order to complete the single market. It is true that within a monetary union transaction costs in respect of currency conversion and exchange-rate hedging cease to be incurred and that exchange-rate risk no longer applies. A common currency also improves the transparency of price structures. In this respect a single European currency may accelerate the process of economic integration within the EU. However, it is equally true that the welfare-enhancing impact of the free movement of goods, services and factors of production will be felt whether or not there is a single currency. This is demonstrated not only by the single European market itself, but also by world trade as a whole. As empirical research has shown, even large fluctuations in real exchange rates hardly impair international trade and the movement of capital, not least because nowadays several instruments for low-cost exchange-rate hedging are available.<sup>2</sup> However, the most important consideration is that the variability of exchange rates constitutes an important balancing mechanism between economies which are at different stages of development and which have different structures. This balancing mechanism would be forfeited once and for all in a monetary union. As explained in more detail

below, monetary union may lead to considerable economic fault-lines and upheavals, the cost of which is likely to far outweigh the savings offered by a single European currency in terms of transaction costs.

However, the reason why European governments are seeking to achieve monetary union is not, in the first instance, based on supposed economic advantages: it is chiefly regarded as necessary because of overriding political considerations. Leading politicians regard monetary union as an "engine of European integration"; for them it is an instrument for making European integration irreversible.<sup>3</sup> Without monetary union, so argues especially Chancellor Kohl of Germany, Europe would revert to self-centred national preoccupations during the next century; monetary union is seen as indispensable if the resulting risk of war is to be averted.<sup>4</sup> In fact the opposite is more likely to be true.

<sup>1</sup> See in particular: Commission of the European Communities: One market, one money, in: *European Economy*, No. 44, October 1990.

<sup>2</sup> An overview of the relevant empirical research is given by the International Monetary Fund: *Exchange Rate Volatility and World Trade: A Study by the Research Department of the International Monetary Fund*, Occasional Paper, No. 28, Washington D.C. 1984.

<sup>3</sup> This is the view of, for example, Germany's Minister of Foreign Affairs. Cf. Klaus Kinkel: *Europa braucht eine gemeinsame Stabilitätspolitik*, in: *Handelsblatt*, 6th December 1995.

<sup>4</sup> See H. Kohl: *Rede des Bundeskanzlers anlässlich der Verleihung der Ehrendoktorwürde durch die Katholische Universität Löwen am 2. Februar 1996*, in: *Presse- und Informationsamt der Bundesregierung*, Bulletin, Nr. 12 vom 8. Februar 1996.

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Due to the economic fault-lines created by monetary union, a single currency will lead to serious political conflicts between the member states of the European Union. This would represent a considerable setback for the process of European integration. Monetary union itself constitutes a threat to peace in Europe.

### **The Psychological Issues**

In fact, the problems inherent in European monetary union even begin one stage earlier. The introduction of a single currency necessarily means the abolition of national currencies. However, these embody an important part of each country's national identity. They are an emblem of national sovereignty. Each currency is a symbol of the economic, political and social order of the particular country and its wealth to its citizens, and of the (relative) security of their savings. The significance of these aspects can be seen particularly clearly in the case of Germany. Having lost two world wars and lived through two periods of hyper-inflation which destroyed their savings, as well as having experienced a worthless socialist currency in East Germany, the German people regard the deutschmark as a symbol of the successful social market economy, of the prosperity which has been achieved under this economic system, of the security of their savings because of the Bundesbank's commitment to stability and, not least, of the worldwide recognition and respect which Germany now enjoys once again thanks to its economic success.

The adoption of a single European currency will mean the loss of national currencies together with their symbolic power and their ability to generate national identities. The new European currency will not be able to take over these functions because:

- the citizens of Europe regard themselves as French, British, German, etc., that is, as citizens of their native country in the first instance, and only secondarily as Europeans;
- the euro does not yet have the reputation of being a stable currency. As such a reputation can only be built up in the long term, the euro will not enjoy the confidence currently enjoyed by a number of European currencies for quite some years.

With the abolition of their national currencies the citizens of Europe will also lose their familiar means of exchange, accounting and storing value. They will be unfamiliar with the new currency and the prices expressed in that currency, especially at the beginning

of monetary union. These psychological problems should not be underestimated, because the quality and acceptance of a currency depends ultimately on these psychological aspects: on the confidence which a currency enjoys, on its symbolic power and on its ability to create an identity within a particular society, and on the availability of a means of exchange, accounting and of storing value with which the people are familiar. As the new currency will be inferior to the present national currencies on each of these counts, and the citizens of Europe (except in Denmark and France) have not been asked to give their consent to monetary union, then lack of acceptance of the euro and even a growth in anti-European sentiment are quite likely. Hence the cohesion of the peoples of Europe, the basis of European integration, will not be strengthened, but will be weakened, by monetary union.

### **The Risk of an Inflationary Monetary Union**

If monetary union were to lead to inflation, the economic and political risks would be particularly serious. As inflation impairs the function of prices as providers of information and distorts the productive structure of the economy, an inflationary monetary union would prevent further deepening of the division of labour within the single European market. Economic growth would be dampened. As a result monetary union would not, as its advocates hope, have a positive effect on the single market but a negative one. Nor, if monetary union were to be inflationary, would international investors gain confidence in the new currency. The value of the euro would be under permanent downward pressure and international investors would have to be offered a risk premium in the form of higher interest rates. That in turn would have a damaging effect on economic growth and employment, too. As inflation also leads to a steady reduction in the real value of financial assets and to a redistribution from the private sector to the state, an inflationary monetary union could be regarded as an unreasonable burden, at least by the citizens of stability-oriented countries. Anti-European feeling would increase and the process of European integration would be impeded.

There are indeed a number of signs that monetary union will be inflationary in nature. For example, public opinion in many EU states is significantly less conscious of price stability than it is in Germany. This is not only evident from the fact that a number of member states have recorded much higher rates of inflation than Germany over the last few decades, but

also from the fact that many influential politicians, industry representatives, journalists and intellectuals in other EU member states have consistently criticized the monetary policy of the German Bundesbank for being overly restrictive, even though the Bundesbank has pursued a comparatively expansionary monetary policy over the last few years.

A further factor is that the convergence criterion of a high degree of price stability is defined very broadly in the relevant protocol to the Maastricht Treaty. The definition states that a member state must have a rate of inflation "that does not exceed by more than 1½ percentage points that of, at most, the three best performing Member States in terms of price stability."<sup>5</sup> There is therefore no absolute inflation ceiling, only a relative ceiling. The ceiling is so generous that only a few EU states have exceeded it in the last few years. As the other convergence criteria are also very broadly defined and the Council of heads of state and government does not need to put a strict interpretation on the degree to which the convergence criteria have been met when it decides whether a country will be admitted into the monetary union, but only to "take account" of this (Art. 109j), it is possible that even countries with a low preference for stability could be admitted into the monetary union.

A further problem is the fact that the primary objective of the European Central Bank (ECB) under the Maastricht Treaty "to maintain price stability" (Art. 105) is neither related to a specific target in the Treaty nor in the statute of the ECB (for example, by the setting of a maximum medium-term inflation rate of 1%). The Council of the ECB is entirely free to decide upon a specific target for this objective. As it must be assumed that even countries with a clear inflation mentality will be admitted into the monetary union, it is likely that there will be a broad interpretation of this objective and that there will therefore be creeping inflation.

This expectation is also underpinned by the absence of incentives and penalties which might help to ensure that the governors of the ECB will pursue a stability-oriented monetary policy. The statute of the ECB does not provide for the remuneration of its governors to be dependent on the level of price stability achieved. Nor does it require the members of

the Council of the ECB to resign if they pursue a monetary policy for a relatively long period of time that is liable to encourage inflation. A final reason why the governors of the ECB have too little incentive to pursue a stability-oriented monetary policy is that the stable value of money is not one of society's top priorities in many EU countries. It is difficult for the governors of the ECB to increase their prestige through such a policy. For all of these reasons, the European Central Bank is unlikely to pursue a rigorous stability-oriented monetary policy of its own accord.

Were the governors of the ECB nevertheless to endeavour to pursue a stability-oriented monetary policy, however, they could be pressurized into pursuing a liberal monetary policy by the governments of the member states. Certainly, Art. 107 of the Maastricht Treaty does prohibit the ECB, the national central banks and the members of its decision-making bodies from seeking or receiving instructions from Community bodies or from the governments of the member states, but the governors of the ECB are not sufficiently independent of the governments of their home countries. For example, according to the Statute of the European Central Bank the term of office of the members of the Executive Board of the ECB may not be extended beyond eight years.<sup>6</sup> As the members of the Executive Board will generally try to find attractive political posts in their native countries at the end of their term of office, they will principally pursue the objectives of their national governments during their time at the ECB. The governments of the member states will also be able to exercise influence on the monetary policy of the ECB through the governors of the national central banks. The very fact that they are anticipated to occupy about two thirds of the seats on the European Central Bank's Governing Council will mean that national political interests will exercise a strong influence. Furthermore, the minimum term of office for the governors of the national central banks of five years is relatively short;<sup>7</sup> since they can be reappointed repeatedly by the particular member state it can be assumed that the governors of the national central banks will also support a monetary policy which is in line with the views of their governments. It is of course conceivable that at least the governments of those member countries in which there is a broad consensus for stability will make their influence felt in terms of pursuing a stability-oriented monetary policy. However, since almost all EU countries have high levels of national debt and because even countries with high levels of national debt may be admitted into

<sup>5</sup> Protocol on the convergence criteria referred to in Article 109j of the Treaty establishing the European Community, Article 1.

<sup>6</sup> Cf. Protocol on the Statute of the European System of Central Banks and of the European Central Bank, Article 11.

<sup>7</sup> Cf. *ibid.* Article 14.

the monetary union owing to the broad definition of the convergence criterion concerned (Art. 104c (2)), virtually all governments will have a strong incentive to urge the European Central Bank to adopt a non-restrictive monetary policy in order to reduce their interest costs and to erode the value of their debt through inflation.

However, the primary cause of the risk that monetary stability may be threatened is the fact that according to the Maastricht Treaty (Art. 109) the Council of Ministers may agree fixed exchange rates with third countries and may stipulate general guidelines to the ECB on exchange rate policy vis-à-vis states with which there is no fixed exchange rate system. Although the decisions of the Council concerning exchange rate policy are meant not to affect the primary objective of the ECB, that of maintaining price stability, any resulting obligations to intervene on the ECB's part could in practice give rise to considerable risks for the control of the money supply. These risks are particularly large because France in particular has traditionally regarded the exchange rate as an instrument of its trade and industrial policies. A low exchange rate is seen as a means of stimulating exports. However, that low external value requires an expansionary monetary policy, which in turn gives rise to inflation.

France is also demanding a so-called Stability Council as a political counterweight to the ECB. In the words of President Chirac, this is intended „to provide orientations” to the European Central Bank and „to clearly stake out the limits of its activities“. Prime Minister Juppé has announced that France would refuse to leave the decisions relevant to monetary stability to a “technocratic, automatic system which is subject to the exclusive control of the ECB”. This is based upon the traditional French view that the central bank is only a subordinate administrative agency which is put in place to achieve politically motivated objectives.<sup>8</sup> This means that monetary policy would be used primarily to stimulate demand and exports. If France were to succeed in gaining acceptance for these views this would have disastrous economic consequences. European Monetary Union would become an inflationary community and there would not only be losses in terms of growth and employment, but there would also be the likelihood of a massive flight of capital. However, the political implications would be even more serious. The French views are incompatible with Germany's fundamental conception of monetary policy which has largely been reflected in the

Maastricht Treaty. This is that control of the money supply ought to be largely depoliticized and, to this end, entrusted to an independent central bank. France is not prepared to relinquish such sovereignty with regard to monetary policy. This means that a common monetary culture does not yet exist in the EU. Instead the models of monetary policy are diametrically opposed to each other. Owing to these fundamental differences, serious political disputes are set to occur continually in monetary union, which might not only jeopardize the existence of monetary union *per se*, but could also represent a crucial test for the EU as a whole.

Further dangers for monetary stability result from the fact that the European Central Bank cannot secure a high degree of price stability on its own. It needs to be supported by the member states' adoption of stability-oriented fiscal policies. If, however, a majority of the member states pursue an expansionary, credit-financed fiscal policy, then it will be very difficult for the ECB to keep the value of money stable, firstly because such a policy adds to credit formation and therefore makes it difficult to control the growth of the money supply, and secondly because any government pursuing an expansionary fiscal policy is likely to exercise political pressure on the ECB to be accommodating in its monetary policy.

As fate would have it, monetary union itself entails an incentive to pursue a fiscal policy which is not compatible with price stability. A national government can secure the support of its country's electorate by instituting extensive expenditure programmes; the rise in price levels resulting from its expansionary fiscal policy will be lower inside a large common currency zone than it would have been solely within its own economy, and the burden will have to be shared by the other states participating in monetary union. As there will be a larger capital market in the monetary union the borrowings of one member state will also lead to a smaller rise in interest rates and therefore to a lower additional debt-servicing burden in that country. As a government can therefore fully internalize the positive effects of an expansionary fiscal policy (the winning of votes), but can partly pass on the negative effects (inflation, increase in interest rates) to the other member states, every government will have an incentive to pursue an expansionary fiscal policy detrimental to monetary stability.

Owing to these difficulties Germany called for a

<sup>8</sup> Both statements are quoted from: Gemeinschaft zum Schutz der deutschen Sparer: Mitteilungen und Kommentare zur Geldwertstabilität, No. 2 (1997), 25th February 1997, p. 4.

stability pact, according to which specific penalties would automatically be imposed on any state participating in the monetary union if its public sector deficit exceeded 3% of its gross domestic product. Most EU states were, however, opposed to the automatic imposition of penalties. Arrangements were subsequently agreed by the heads of state and government at the Dublin summit in December 1996, under which a member state cannot effectively be prevented from pursuing policies inimical to stability. According to the compromise formula agreed in Dublin,<sup>9</sup> a country will not incur any penalty at all for exceeding the deficit ceiling of 3% if its real gross domestic product has declined by at least 2% per annum. If its GDP has declined by between 0.75% and 2% p.a. the Ministers of Finance will decide, by a qualified majority vote, whether to impose a penalty. Since virtually all the recessions in Western Europe in the last few decades have involved a decline in gross domestic product of this magnitude, and Ministers of Finance who are motivated by similar interests and are mutually dependent on their colleagues in the Council cannot be expected to impose penalties on their counterparts, this largely removes the disciplinary effect of the Stability Pact. A participating state does not even necessarily have to expect penalties at a figure lower than the 0.75% threshold; in this area the threat of sanction has been diluted by the addition of the words "as a rule".

As each government therefore has an incentive to pursue an expansionary, potentially inflationary fiscal policy at the expense of the other member countries and the Dublin compromise formula cannot effectively prevent this, monetary union is likely to give rise to high government borrowing and consequently to increased crowding-out of private-sector investment and weaker economic growth. Increasing government debt is also liable to undermine the confidence of international investors in the euro. This would give rise to a further increase in interest rates, which would further reduce economic growth. The euro would come under downward pressure, and the combined effects of any devaluation together with the expansionary fiscal stimuli would fuel inflation.

### Insufficient Adjustment Mechanisms

Even if the European central bank governors wished to pursue a stability-oriented monetary policy, if they were not pressurized by national governments to relax the monetary reins, and if all the governments involved supported the ECB by pursuing fiscal policies compatible with price stability, a single

European currency would still be associated with serious economic and political risks. The reason is that the economies of the member states of the EU are substantially heterogeneous, with different patterns of output and foreign trade, different levels of development and different development dynamics. Changes on the supply and demand sides of the economy, e.g. the availability of new production technology, fluctuations in the prices of raw materials or changes in the demand for particular products, can have very different (asymmetrical) effects on the individual EU countries.

Any such change that occurs suddenly and is relatively strong is normally referred to as an economic shock. Bayoumi and Eichengreen have compared the type and scale of such shocks and the speed of adjustment to them in the EU countries, on the one hand, and in individual regions of the USA on the other, during the period 1960–1988.<sup>10</sup> The USA is suitable for such a comparison because it is of a similar size, its economic strength is similar to the EU's, and it has a functioning monetary union. Bayoumi and Eichengreen came to the following conclusions:<sup>11</sup>

□ The magnitude of the supply-side shocks was greater in the EU than in the USA, whereas that of the demand-side shocks was greater in the USA than in the EU.

□ The shocks were much more asymmetrical in the EU than in the USA. The asymmetry was somewhat lower in a small core group around Germany including Denmark, Belgium, France and the Netherlands than in the EU as a whole, but was still greater than in a comparable core region of the USA.

□ The adjustment to both demand and supply shocks was much slower in the EU than in the USA.

The introduction of monetary union will cause the loss of two mechanisms which are of fundamental

<sup>9</sup> Cf. Dublin European Council, 13th and 14th December 1996. Presidency Conclusions.

<sup>10</sup> Cf. T. Bayoumi and B. Eichengreen: Shocking Aspects of European Monetary Integration, in: F. Torres and F. Giavazzi (eds.): Adjustment and Growth in the European Monetary Union, Cambridge 1993, pp. 193-229.

<sup>11</sup> The empirical research carried out by other authors has essentially confirmed the results of the research carried out by Bayoumi and Eichengreen. Cf., e.g., P. De Grauwe and H. Heens: Real Exchange Rate Variability in Monetary Unions, in: *Recherches Economiques de Louvain*, Vol. 59 (1993), No. 1-2 pp. 105-117; J. von Hagen and M. J. M. Neumann: Real Exchange Rates within and between Currency Areas: How Far Away is EMU?, in: *Review of Economics and Statistics*, Vol. 76 (1994), No. 2, pp. 236-244; D. Neven and C. Gouyette: Regional Convergence in the European Community, in: *Journal of Common Market Studies*, Vol. 33 (1995), No. 1, pp. 47-65.

importance for the adjustment by EU countries to different economic trends and, in particular, to asymmetrical shocks – exchange rate flexibility and national monetary policy. Here is an example to illustrate the point. If foreign demand for a country's products reduces, the demand for its currency also declines. In a system of flexible exchange rates this leads to depreciation of the currency which stimulates the demand for the country's products and cushions the initial demand shock. The country's central bank may also cut interest rates in such a situation, which will increase the depreciation of the currency and make it easier to overcome the demand shock.

The introduction of monetary union will not only mean the loss of these adjustment mechanisms, but it may also intensify the heterogeneity of the economic structures of the participating countries and, therefore, increase the need for adjustment. By enabling transaction costs to be reduced, monetary union will strengthen the trend resulting from the completion of the single market, whereby the various countries in the EU will increasingly specialize in producing goods and services in respect of which they have comparative advantages. In particular, the sectors whose production is subject to economies of scale could become more regionally concentrated within a monetary union. Company-specific returns to scale are not the only factor here, the beneficial externalities arising from local agglomerations, which can particularly result from a local concentration of specialized suppliers and skilled labour, also play a role. Owing to such factors, many sectors of industry, such as the car industry, are much more heavily concentrated in terms of region in the USA than in the EU.<sup>12</sup> With the completion of the single market and the introduction of a single currency, economic activity could also become much more regionally concentrated in the EU.

In view of the heterogeneity of economic structures, which is actually liable to increase under monetary union, and the loss of two important adjustment mechanisms, differential economic trends and shocks will have to be offset within the monetary union by two other adjustment mechanisms: flexible wages and labour migration.<sup>13</sup> However, this gives rise to a dilemma: on the one hand, these are the very mechanisms that are not sufficiently effective within the EU; on the other hand, serious political conflict would result from any attempt by politicians to make them fully effective.

The importance of wage flexibility as an adjustment mechanism can be illustrated by the example of a

decline in the demand for the exports of a participating country outlined above. Since the country will no longer have the option of allowing its currency to depreciate and reducing its interest rates once inside the monetary union, wages in that country will have to fall relative to those of other countries in order to offset the unemployment resulting from weaker demand in its economy. Flexible wage adjustment will also now be necessary when supply-side shocks occur. In the case of a sudden increase in the price of oil imports, for example, a reduction in wages rather than currency depreciation will be necessary if job losses are to be avoided. As a general principle, the wages of all countries participating in the monetary union will need to be determined strictly by national levels of productivity and there will also have to be differentiation according to regions, sectors and skills. If, for example, the general level of productivity growth in a country is lower than that in other countries, wage growth will have to be lower in that country if unemployment is not to rise.

Current differentials between productivity and wage levels in the EU countries are indeed still very large. Average wages in Portugal are just one fifth of average wages in West Germany. However, as indicated by the high unemployment trend which has persisted for many years, wage flexibility in virtually all the EU countries, unlike the position in the USA, is exceedingly low. In the 1980s the elasticity of nominal wages relative to the unemployment rate was thus -0.29 in France, -0.27 in the Netherlands, -0.20 in Spain and -0.11 in Germany, whereas in the USA it was -0.61.<sup>14</sup> Although there has been evidence of greater flexibility over the last few years, rigid, inefficient wage determination systems still predominate in the EU countries. Levels of pay are hardly ever left to market forces, and wages are normally negotiated between trade unions and employers' organisations. The state also contributes to wage inflexibility, in particular, by declaring the resulting

<sup>12</sup> Cf. P. Krugman: *Geography and Trade*, Leuven, Cambridge, Mass., London 1991, pp. 75 ff. The fact that the size of the demand shocks in the USA is greater than in the EU is probably attributable to this regional concentration. Cf. T. Bayoumi and B. Eichengreen, *op. cit.*, pp. 216-217.

<sup>13</sup> See also the standard work on the theory of optimum currency areas: R. A. Mundell: *A Theory of Optimum Currency Areas*, in: *American Economic Review*, Vol. 51 (1961), pp. 657-665; R. I. McKinnon: *Optimum Currency Areas*, in: *American Economic Review*, Vol. 53 (1963), pp. 717-725; P. B. Kenen: *The Theory of Optimum Currency Areas: An Eclectic View*, in: R. A. Mundell and A. K. Swoboda (eds.): *Monetary Problems of the International Economy*, Chicago, Ill., London 1969, pp. 41-60.

<sup>14</sup> Cf. B. Eichengreen: *Should the Maastricht Treaty Be Saved?*, Princeton, N.J. 1992, p. 21.

collective agreements generally binding and by paying generous substitute benefits (e.g. unemployment benefits and welfare benefits) to those not earning a wage.

If the politicians wanted to try to create the wage flexibility required for monetary union that would entail, in a country such as Germany, making it impossible for collective agreements to be made generally binding, permitting collective agreements to be modified, at any time and unconditionally, by plant agreements and individual employment contracts, reducing the level of substitute benefits, and cutting back on protection against dismissal. Similar reforms would have to be implemented in virtually every other EU state. As attempts in 1996 to reform the system of sick pay in Germany have shown, such reforms would be strongly resisted by employees in general. They would also stir up anti-European feeling among the workforce. A number of labour market reforms have been carried out for example in Germany and in Spain recently, but reforms cannot be implemented on the scale required by monetary union in Germany, Spain, France, Italy or in most other EU countries for political reasons.

The more probable scenario is that there will be a tendency to increase wages in the economically weaker countries in the monetary union to the levels of those in the countries with stronger economies. This would raise some significant economic problems. However, the single currency will make the current wage differentials within the EU much more transparent. The trade unions of the richer countries will support a rapid harmonization of wages in the poorer countries in order to prevent pressure on wages in their own country. The Federation of German Trade Unions is already talking of the danger of "wage dumping" in the monetary union and demanding a Europeanization of collective bargaining policies with cross-border coordinating bodies and common agreements.<sup>15</sup> Even employers in the richer countries stand to benefit from wage harmonization with the poorer countries because this may weaken their competitors from those countries. In the poorer countries the improved transparency of wage differentials will increase employees' desire to receive the same wages as are paid in the richer countries.

<sup>15</sup> Cf. Deutscher Gewerkschaftsbund: *Zur Europäischen Wirtschafts- und Währungsunion (EWWU)*, Düsseldorf 1995, p. 7.

<sup>16</sup> Cf. B. Eichengreen: *Is Europe an Optimum Currency Area?*, in: S. Borner and H. Grubel (eds.): *The European Community after 1992*, Basingstoke, London 1992, pp. 138-161.

Owing to their lower level of productivity, the desire for wage harmonization will bring increased demands for transfer payments to the weaker countries. The EU already has extensive structural, regional and cohesion funds which are intended to help the poorer member states to close the economic development gap between the richer countries and themselves. The trade unions could argue that both wage harmonization and the increased transfer payments would help to achieve this objective which is set down in the Treaty of Maastricht (Art. 130a). However, if transfer payments were used throughout Europe to compensate for the wage harmonization in the poorer countries, this would reward and actually stimulate inappropriate behaviour by the trade unions and employers' associations as they reach their pay agreements.

In the richer member countries increasing transfer payments would give rise to a higher tax burden, thus reducing economic incentives, weakening growth and finally undermining the ability to make transfer payments to the poorer countries. As the willingness of citizens to support poorer countries would also be overstretched, this would give rise to political opposition to European integration.

The excessive wage rises would impede attempts by the economically weaker countries to catch up with the stronger economies. The compensating transfers would only serve to support the unemployment caused by the wage increases and to preserve outdated economic structures. Their effect would therefore be the opposite of what the Maastricht Treaty intends. Increasing unemployment would also fuel anti-European feeling in the poorer countries. It is also probable that the European Central Bank would be pressurized to combat unemployment by running an expansionary monetary policy. If it resisted such demands there would be a further increase in anti-European feeling in the countries affected by higher unemployment. If, however, the ECB yielded to this political pressure, this would not only result in inflation and the depreciation of the euro, it would also strengthen anti-European feeling in the countries whose citizens have high expectations in terms of stability. In both cases monetary union and the entire EU would be put to a very difficult political test.

As mentioned earlier, the migration of labour may also act as a balancing mechanism in the case of monetary union. In this scenario labour would move from member states which are developing at a slower rate or which have been affected by a negative



economic shock to countries which are developing more rapidly or which have escaped such shocks. At the same time, labour mobility would contribute towards higher pay in low-wage countries and to a reduction in pay in high-wage countries.

However, labour mobility in the EU is very low. In particular, there is hardly any significant migration between member states because of language barriers and cultural differences. Even within national borders labour mobility is two to three times lower than in the USA.<sup>16</sup> Whereas labour mobility in the USA makes an essential contribution to the adjustment of the various regions to different economic trends and to the cushioning of asymmetrical shocks, this adjustment mechanism hardly has any effect within the EU.<sup>17</sup>

On the other hand, if labour were to move increasingly from low-wage to high-wage countries following the commencement of monetary union, or if they migrated from countries which had suffered a negative economic shock, or whose development was slower over the long term, to others which were developing more successfully, that would mean that the countries with net outward migration would lose young and highly skilled labour in particular. Their economic development would be impeded. Thus, attempts by the low-wage countries to catch up with the stronger economies would also be impeded. The wealth gap within the EU would widen. Anti-European sentiment would increase in the countries losing labour. At the same time, these countries would demand additional transfer payments which would, however, be resisted in the countries with net inward migration of labour. Political conflict would be unavoidable. The European integration process would also be adversely affected because the migration of labour would put pressure on wages in the countries to which labour was migrating. This would give rise to protests by the domestic workforce in those countries. If the governments concerned nevertheless permitted the immigration to take place, hostility towards foreigners would increase and the consensus for European integration would weaken.

The more likely scenario, however, is that the labour-mobility adjustment mechanism will also prove less effective than necessary for a monetary union. Owing to language barriers and cultural differences, most workers are not prepared to move to other EU countries. If there were nevertheless to be significant labour mobility then, under pressure from the domestic workforce, the governments of the countries to which labour was migrating would probably stipulate that the immigrants could only be employed

at the agreed wage rates applicable in these countries.<sup>18</sup> That would render the adjustment mechanism virtually ineffective, since foreign workers would hardly have any employment opportunities at these wage rates because their productivity tends to be lower. It is also conceivable that the governments of the recipient states could be pressurized by their domestic workforces to take measures to restrict immigration. These would not only render the labour-mobility adjustment mechanism ineffective, but they would also contravene the regulations of the single market and would therefore provoke political conflict within the EU.

If the labour-mobility adjustment mechanism were to be ineffective for one of these reasons, unemployment would rise in any countries which had suffered a negative economic shock or which were lagging behind in the long term with regard to their economic development. Once again, demands for transfer payments would be made. In the paying countries increasing taxation would weaken economic growth and fuel anti-European feeling. In the recipient countries the increase in unemployment would mean welfare losses which would be blamed on the EU, so anti-European feeling would be fuelled in these countries as well. The ECB would also probably be urged to combat unemployment by pursuing an expansionary monetary policy. The Council of Ministers might possibly try to achieve an undervaluation of the euro by using their powers over exchange-rate policy. The consequences would be inflation, flight of capital, rising interest rates and therefore further losses in terms of growth and employment.

### Concluding Remarks

As the analysis shows, European Monetary Union is associated with serious economic and political risks. In all probability it will lead to considerable welfare losses and to serious political conflicts. In the end this might not only cause the collapse of monetary union

<sup>17</sup> Cf. B. Eichengreen: Labor Markets and European Monetary Unification, in: P. R. Masson and M. P. Taylor (eds.): Policy Issues in the Operation of Currency Unions, Cambridge 1993, pp. 130-162; J. Decressin and A. Fatás: Regional Labor Market Dynamics in Europe, in: European Economic Review, Vol. 39 (1995), pp. 1627-1655.

<sup>18</sup> There is already a precedent for this. In 1996 a law was passed in Germany known as the Secondment (or „Sending“) Law, which provided that the employees of foreign construction firms employed on German building sites would in future have to be paid wages at least equal to those agreed under collective agreements in Germany. The aroused sentiment among German construction workers which led to this law offered a mild foretaste of the political conflict that can be expected after the beginning of monetary union.

itself, but the process of European integration as a whole might also be seriously damaged. The idea of monetary union ought therefore to be abandoned. Instead the national currencies should be retained and their exchange rates should be determined solely by market forces. In this way all the problems associated with European Monetary Union would be avoided:

□ The national currencies would continue to be part of each member state's national identity and to be a symbol of prosperity and secure savings. Citizens would not have to become accustomed to a new currency regarded as artificial.

□ In the case of flexible exchange rates the risk of inflation would be checked by the disciplinary effect of currency competition. Nowadays the international financial markets, which are becoming steadily more efficient, react to any policies inimical to monetary stability in a particular country by withdrawing capital on a massive scale. Individual countries therefore

have an incentive to align themselves with the most stable currency, which in Europe's case means with the deutschmark.

□ Exchange rates and national monetary policies would continue to serve as mechanisms of adjustment to asymmetrical shocks and to divergent economic trends in the long term. The demands placed upon the labour markets of the EU as an adjustment mechanism would not be excessive.

Under these circumstances, with the completion of the single market and the admission of Central and Eastern European countries as member states, the economies of Europe would gradually be able to deepen their integration. At the same time a political order could be developed which would reflect the national identities of the peoples and would act as a lasting guarantor of peace in Europe. A common currency is neither a prerequisite for this process, nor is it beneficial to it.

Phedon Nicolaides\*

## Competition versus Social Responsibility in the European Union

*Recently, in the European Union there has been extensive public debate on the nature of public services, the means of delivering them and the role of public companies. The Commission is pushing for greater liberalisation, more extensive common rules and increased transparency in the application of national regulations. Prof. Nicolaides argues that the state should function as the regulator of the providers of such services rather than as a provider itself. Moreover, in the Community's single market, national regulatory systems should be neutral and should rely more on price-based instruments rather than statutory and administrative measures.*

The Commission's XXV Report on Competition Policy, published in mid 1996, states that "... the development phase of Community competition policy is completed. Policy and law are now well established through the Commission's administrative practice and the principles developed by the European Courts."<sup>1</sup>

This is a fairly sweeping and surprising statement, especially when one considers the obstacles that the Commission has encountered in its attempts to subject undertakings with special or exclusive legal rights to the Community's rules of competition. That statement may be correct as far as private undertakings and Articles 85 and 86 are concerned, but it is doubtful whether it provides an accurate description of the state of play as far as public

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<sup>1</sup> European Commission: European Community Competition Policy, 1995: XXV Report, Brussels: 1996, p. 14.