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## **Some Political Economy Aspects of EMU**

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## I. Introduction

European Monetary Union (EMU) is here at last, but according to economists' traditional perspective on economic policy making it shouldn't be. Given the nontrivial nature of this occurrence, it offers an important warning signal that policy economists need to reexamine our assumptions about the forces generating economic policy decisions.

Economists, of course, have strong preferences for analysis based on assumptions of rationality and efficiency, and with good reason. When we turn from the analysis of market behavior to that of policymaking, however, the simple application of these assumptions does not stand up as well. The economists' traditional approach in this area, has been to attempt to figure out what policy will maximize aggregate economic efficiency and then assume that this is what the government will adopt. This benign dictator or optimal social planner approach is not totally devoid of predictive power. Similar predictions can be derived from idealized models of democratic processes and are roughly approximated by the fully informed median voter model of public choice analysis. Most economic policy choices cannot be explained in this manner, however, and the creation of EMU is no exception.

The choice of international currency policy has been a major area of monetary research. The theory of optimum currency area (OCA) pioneered by Robert Mundell, focuses precisely on the factors which influence the economic costs and benefits of adopting fixed versus flexible exchange rates. Over time the number of criteria found to be relevant for this cost-benefit analysis has multiplied and many of these criteria have

proven difficult to operationalize empirically. Thus, the development of OCA theory has not eliminated disputes among economists about the balance of costs and benefits for specific countries. Still the theory has proven to have a good deal of power to explain which countries with independent currencies tend to maintain pegged exchange rate regimes and which have adopted more flexible arrangements. However, as Charles Goodhart (1995) has recently emphasized, OCA theory works much less well for its initial application: the domains of common currencies. What explains most of the global pattern prior to EMU is the almost one to one mapping between national political units (nation states) and independent currencies. OCA theory explains well why some small countries de facto adopt the currency of a larger neighbor, but it cannot explain the formation of the EMU. To be sure, many of the arguments put forward by the political leaders advocating EMU were economic, but these were frequently providing cover for political objectives and were often based on extremely sloppy, if not outright fallacious economic analysis.

It is true that some economists with great enthusiasm for fixed exchange rates were strong advocates of EMU; Robert Mundell is a leading example. Many economists argued that the economic case was strong for a small EMU based around Germany, but no solid systematic evidence has suggested that the broad based EMU, which actually emerged made sense on economic grounds.<sup>1</sup> Thus it is difficult to disagree with the conclusion of Eichengreen and Frieden (1994) that “uncertainty about the empirical magnitude of every one of these benefits and costs suggests the absence of a clear

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<sup>1</sup> See, for example, Bean (1992), DeGrauwe (1992), Eichengreen (1992), and Masson and Taylor (1993).

economics case in favor of EMU” (p.9), [and that](#) “... events in Europe are being driven mainly by political factors” (p.5).<sup>2</sup>

Major aspects of the politics of EMU are briefly reviewed in the following section. It is of course not at all inconsistent with rational choice analysis for political considerations to dominate economic efficiency in the policy process. This is after all the bread and butter of modern public choice analysis. What is so disconcerting about the case of EMU is the highly questionable quality of the thinking that dominated the political dynamics that culminated in the creation of EMU. This suggests the need for economists interested in the policy process to give much more attention to the role of the ideas and mental models that influence the behavior of key participants.

While politicians can often succeed in ignoring economic realities when selecting policies, the economic consequences of such policy choices will ultimately come home to roost. The same applies to the consequences of faulty political analysis. The concluding section of this paper addresses some of the implications of this for the outlook for EMU.

## II. The Political Economy of EMU

It is certainly understandable that national leaders would place major national security goals above economic considerations. Adam Smith well understood that defense was more important than opulence. Thus, the sacrifice of some economic well being for the attainment of broader goals is not at all in conflict with the economists’ assumption of rational behavior. What is so disconcerting about the push for EMU is rather how faulty was the analysis of the leading advocates. Public choice analysis explains how the self-interest of voters often leads them to be rationally poorly informed about many public

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<sup>2</sup> Leading economists who have reached this conclusion include Fratianni and von Hagen (1992), DeGrauwe (1993) (1994), Feldstein (1997a) (1997b), Goodhart (1995), and Minford (1995).

issues. This costs of information logic should not apply so strongly, however, to the leading advocates of programs. In the case of EMU, despite the enormous stakes involved, the actions of political leaders appear to have been motivated much more by grand fuzzy visions than by thoughtful analysis and the careful balancing of costs and benefits.

The pursuit of rational self-interest by multinational corporations and financial institutions was of course also an important source of pressure from EMU. For such large competitive entities, the benefits of fixed exchange rates would far outweigh their share of the macroeconomic costs that the defense of fixed exchange rates would likely impose on them. It is not clear, however, that many of the business and financial leaders advocating EMU really looked beyond the direct favorable effects. These internationally oriented lobbyists were at least partially offset, however, by the negative attitudes of a majority of small businesses and organized labor. Given the better organized lobbying strategies of the former, there was likely a net pro EMU tilt from the behavior of the traditional major economic interest groups, but this was not the dominant force behind the push for EMU. This came from the government elites in France and Germany, especially the Germany Chancellor Helmut Kohl.<sup>3</sup> The major motivation was a highly worthy one – limiting the possibilities of a future intra European war. But good intentions are not an adequate substitute for sloppy analysis. In essence, the primary promoters of EMU failed to understand the difference between marginal and total benefits and the difference in patterns of economic effects between trade liberalization and the formation of a common currency. (See Willett (1994).

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<sup>3</sup> For references to the literature on the political economy of EMU, see the review article by Andrews and Willett (1997).

Simply put, the push for EMU by the political elites of Europe was the poorly thought out continuation of the European project started in the early post war period. Jean Monnet's idea was that the creation of greater economic linkages within Europe would foster a web of political ties that would eventually make a repeat of the World Wars unthinkable among the participating countries. Such an idea seems quite naïve to a cynical realist, but the amazing fact is that it worked. Despite the unfortunate step of making the costly and inefficient Common Agricultural Policy a centerpiece of the European integration movement, the move through the common market to the single European market brought both substantial economic benefits and the desired political spillovers. Monnet's vision ultimately worked.

The problem was that leaders such as Kohl didn't know when to stop. Perhaps partially blinded by desires to further secure his place in history, Kohl did not seem to understand that the process of economic integration had already secured its primary national security and foreign policy goals. Economic arrangements had already done virtually all that they could to in Kohl's phrase "contain a potentially dangerous Germany within Europe".<sup>4</sup> But European leaders appear to have come to think of economic integration as an institutional process that must always be ongoing. This is sometimes referred to as the bicycle theory. If you don't keep moving forward, you'll fall over. Thus, with the successful completion of the negotiations for the single market – Europe 1992 – leaders began to look around for the next economic project and monetary union was the last remaining candidate for a big push. Of course, fears of possible adverse

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<sup>4</sup> Of course, giving up one's national currency limits a government's scope for war financing, but this is of little relevance in cases where war is already unthinkable. From this perspective, the additional constraints on Germany implied by monetary union would be largely infra marginal.

implications of Germany reunification heightened concerns with binding Germany more strongly to Europe. While such fears seem to me to have been quite exaggerated, ~~that~~ they had considerable impact on ~~public opinion, for a time~~ political elites in Europe.

Normally, in international negotiations over macroeconomic and exchange rate policy coordination, national governments are, if anything, excessively jealous of preserving national autonomy. Thus, coordinated policy actions are so seldom achieved. On this basis, the chances for EMU would be almost nil. With discussion framed with the context of the European project, however, it is as if a different set of mental models were adopted and the traditional concerns with preserving national macroeconomic sovereignty were set aside. Thus it is not surprising that the UK, always much more ambivalent about the European project than France or Germany, did not succumb to this switch in mental models and as a consequence did not go along with the first wave of fervor for the EMU.

The leaders of the political push for EMU seemed totally unaware of the considerations emphasized by economists in the theory of optimum currency areas. They stressed economic benefits as a sales technique, but it was clear that their basic objective was political, and discussion of EMU quickly took on all the signs of ideological debate. It is perhaps because economists in America have been less caught up in these ideological dimensions that they have tended to pay much more attention to the prospective costs of EMU than have European economists on average.

A particularly dangerous oversight of the European political elite was to ignore the warnings of OCA theory that the sign of the net economic costs-benefits equation of monetary union can vary across countries. Some countries would have net benefits,



others net costs. There will be differences in the patterns of the internal gains and losses across countries from trade liberalization and there may be differences in the size of the net gains across countries, but the divergences in these national cost-benefit ratios from trade liberalization are likely to be quite small compared with the pattern from broad monetary unification. By any reasonable interpretation, broad monetary union fails the test of subsidiary.<sup>5</sup> It may be welfare enhancing for a “core” group of members, but clearly not for the full set of EU members (See DeGrauwe (1992)). Yet the political dynamic unleashed by the French and German governments led to the enshrinement of monetary union as the test of European commitment and membership in the true European club.

Part of the motivation of the push for EMU clearly went beyond concern with war prevention to goals of greater European political integration, but these goals were typically only vaguely perceived and, as Feldstein (1997a) has emphasized, were based on incompatible expectations of French and German elites about what a more politically integrated Europe would look like. Little concern was given to attempting to develop broad based public support for the project and the combination of this with the inevitable adverse economic effects of monetary union on some countries is likely to generate a good deal of political tension. Thus even viewed in political terms alone, there is a good chance that the net effects will be the opposite of those initially anticipated by key EMU supporters. It may well prove true that critics such as Feldstein have been too pessimistic in their analyses of the political tensions that will be generated within Europe as a result

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<sup>5</sup> While there is lack of agreement on a precise operational definition within the context of the European Community, the basic idea of subsidiary is that responsibilities should be placed on the lowest level of government that can effectively carry them out.

of EMU, but what is distressing from the standpoint of models of rational decision making is that there is little indication that the political elites of France and Germany paid any serious attention to analyzing such possibilities before leaping to their support of EMU. (The Bundesbank is of course, an important exception to this generalization). Rather, what seems dominant in the case of the push for EMU was the power of a fuzzy idea in framing the issue in the minds of key leaders.

Once these mental commitments were made, there was no turning back. The perseverance of the French is the easiest to understand. Given their long standing distaste for flexible exchange rates and the difficulties of running adjustably pegged regimes in a world of high capital mobility that had been demonstrated once again in the crises of the European Monetary System in 1992 and 1993, the French felt committed to a hard currency peg against the German mark. Thus having already effectively given up domestic monetary independence, it is easy to see how the French perceived an interest in transferring the de facto control of their monetary policy from the Bundesbank to a group decision-making process through a European Central Bank. The same type of analysis applies to the smaller economies of Austria, Belgium, and the Netherlands that had adopted hard currency pegs against the DM.

The difficult question is why would Germany be willing to agree to give up its monetary independence. While some economic considerations such as concern with trade competitiveness may have played a minor role, there is little question that the dominant concern was the desire of Helmut Kohl and much of the rest of the German policy elite to tie Germany even more strongly to Europe. This lay behind Kohl's insistence that within the Maastricht Treaty monetary union be linked to greater European

political integration. At the same time, some attention would be paid to Germany's traditional concern with monetary stability by providing tight entry criteria which would limit at least the initial stage of EMU to a small group of sound money countries.

The political discord that would likely have been generated by such a split of ins and outs along North-South lines within Europe appears to have been of little consideration at this stage. In the event, however, this split did not come about. A combination of desires to import discipline and, more importantly, to not be left out of the new inner European club led to strong pushes by the leaders of the Southern countries to meet the initial conditions for entry.

The German trade off strategy fell flat. Apart from some increase in the power of the European Parliament, little in practice has come from the supposed linkage of monetary union and political union. Indeed the meaning of the latter is still quite unclear. Meanwhile loose interpretations of the Maastricht entry criteria facilitated the initial creation of a large EMU rather than the small one the German government had envisioned. Despite considerable opposition from the German public and the failures of his linkage strategies, once he had committed to monetary union, Kohl never wavered in his determination to see the process through.

### III. The Outlook for EMU

For good or bad reasons, EMU has arrived. What will its consequences be? There has been no shortage of opinions offered and these have covered an extraordinarily wide range. Many commentators in the popular press have seen EMU as the dawning of a new era of economic prosperity in Europe and many financial advisers have recommended that global investors should step in quickly to take advantage of these

opportunities. Some see the Euro as having profound implications for the international monetary system as it quickly becomes a major competitor to the dollar. Others counter that historically there has been considerable sluggishness in changes the positions of major international currencies and thus suggest that the effects of the Euro will be relatively minor in the short run.<sup>6</sup> On the pessimistic side, as discussed above, because of the failure of so many of the members of EMU to closely approximate the criteria for optimum currency areas, one can easily envision scenarios in which members of EMU suffer from considerable economic distress which generate substantial political tensions.

Likewise, one can tell quite different stories about the interrelationships between U.S. and European interests. From a currency competition perspective, one could conceive of a U.S. interest in poor economic performance under EMU. This is far too narrow a point of view, however. The U.S. has a strong interest in the stability of the international monetary system and this objective is best met by a successful, albeit perhaps not too successful, performance of the European economy. As has been recognized by U.S. policy makers for many decades, despite elements of rivalry, the United States' overall economic, foreign policy, and national security interests are best served by a strong Europe.

The initial weakness of the Euro, of course, fits better with the pessimistic than the optimistic scenarios, but we should be cautious of reading too much about the long-term outlook from the short run behavior of foreign exchange markets. The initial weaknesses of the Euro can be attributed in considerable part to temporary economic

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<sup>6</sup> For a useful range of views on the effects of EMU on the international monetary system, see Masson et al (1999).

conditions and to various signals from the European Central Bank and national political leaders that did not inspire confidence in the market. The latter were likely due in some part to start up costs, and might be substantially reduced through time. Thus, the rocky start of the Euro is not necessarily inconsistent with an optimistic scenario for the longer term.

I have nothing to add to the range of possible scenarios for the EMU that have already been posited and see so many uncertainties that I am loath to champion a particular forecast, although I lean toward the moderately pessimistic side. What I would like to do instead is briefly discuss some insights in this area that can be gained from adopting a political economy perspective.

Perhaps the most important of these was highlighted in the introduction. It is dangerous to assume that governments will follow the dictates of aggregate economic efficiency. This is directly relevant to the optimistic scenario under which the act of joining a currency union is seen as inducing institutional and behavioral changes that will cause the economies in question to conform more closely to the criteria for optimum currency areas. This possibility of induced changes is an important conceptual point, but its empirical relevance can be easily exaggerated. In the context of the EMU, the argument is that joining a currency area will raise the costs of domestic labor market rigidities. Therefore, there will be pressures for reforms to improve labor market flexibility. This is true, but it is far from clear that these pressures will be very powerful compared with the domestic political economy considerations that generated the rigidities in the first place.

Despite the pressures of high rates of unemployment and repeated calls of economists and international organizations such as the IMF and OECD, the EMU process has so far generated little overall improvement in labor market flexibility. Of course, some individual European countries have made considerable strides, but these have included EMU outsiders such as the UK, as well as insiders such as the Netherlands. To date, there seems little basis for optimism that Europe will see substantial improvements in labor market flexibility over the coming decade.

This, combined with the centralization of monetary policy, is likely to put greater pressures on national fiscal policies. Demands for greater use of national fiscal policies to counter unemployment and other structural problems are, in turn, likely to run into conflict with the national budget deficit limitations imposed by the Growth and Stability Pact. In principle, there need be no conflict between the Pact's three percent deficit limitations and scope for discretionary fiscal policy since the goal is to run balanced or surplus budgets in normal years. There is little basis for optimism that such leeway will typically be achieved, however.

It is true that desires to meet the Maastricht convergence criteria did lead to substantial reductions in budget deficits in a number of countries. There was a genuine discipline effect at work. Unfortunately, however, this may have been largely a one shot effort, to be followed by budget fatigue and domestic political pressures for easing now that admittance to EMU has been achieved. A good bit of the statistical improvements were due to accounting gimmicks. More importantly, even the genuine improvements were due primarily to discretionary policy changes that can be reversed. What was really needed was to make use of the political momentum for EMU to implement major reforms

in national budgeting procedures that would make it easier to sustain strong budget positions over the longer run. Unfortunately, as with labor market policies, little overall process has been made on this front. As a consequence, the fiscal norms of the Growth and Stability Pact are likely to prove to be a source of contention.

Just as political economy considerations are likely to substantially mute the effects of aggregate economic efficiency costs on labor market reforms, so too will they make it unlikely that economic tensions within EMU will generate sufficient conflict to lead to its abandonment or even the withdrawal of individual countries (for which no provision is made within the Maastricht Treaty). Sufficient political conflict could well be generated, however, so that contrary to Chancellor Kohl's objectives, the overall momentum toward greater political integration in Europe is slowed down rather than speeded up. Such are the dangers of political decisions that fail to take economic consequences adequately into account.

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