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Europe on Its Road to EMU

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Monetary union has become a virtual certainty and it is going to start operating when the European Council on May 1-3, 1998 selects the presumably eleven participants and announces the bilateral exchange rates at which they will enter. The automaticity provided by a time table has been crucial. Residual risks to the decision exist in Germany and France, but they are manageable. The problem of the outsiders, now only four, has been reduced, not least by the announced intention of the United Kingdom to join by about 2002. The net benefits of EMU now appear larger than at the time of the Maastricht Treaty, because the alternative looks more unattractive and more uncertain. But EMU may not have the spillover effects into other areas of "high politics" that proponents hope and adversaries fear.

I. Introduction

The momentous decision to select participants in Economic and Monetary Union (EMU) and establish the euro area from 1 January 1999 is approaching fast. An extraordinary meeting of the European Council has been pencilled in by the UK presidency for 1-3 May 1998 in London, some eight months prior to the start of stage three of EMU.

In a very real sense, to call it a decision is misleading because the Maastricht Treaty does not leave much choice. All EU countries that have not been granted an explicit "opt out" from stage three - and that applies to the United Kingdom and Denmark - are automatically to be regarded as candidates. But admission depends on the fulfilment of the so-called convergence criteria stipulated in the Treaty (Art. 109j) and the associated Protocol. However, only two of the criteria are free of ambiguity – convergence in terms of inflation and long-term interest rates, whereas the other three require the political interpretation of the Council of Finance Ministries (ECOFIN) and of the European Council itself. On the basis of currently available information a total of 11 countries appear, based on their 1997-performance, to meet the two criteria relating to public finances with a high degree of approximation, and they have with one minor exception also succeeded in stabilizing their exchange rate. Despite the preferences of some of the more conservative countries to start with an EMU consisting solely of countries with a long record of stability and minimal risks of a relapse in relation to one or more of the criteria, it would be extremely difficult to deny entry to any of the 11 countries on purely economic grounds. It would obviously be a recipe for political conflict if the attempt were to be made.

The present paper starts in Section 2 with a review of the progress in convergence, which justifies the scenario just mentioned, and of the potential conflict in the Treaty to have both performance criteria and a fixed timetable. It goes on to ask whether residual risks still exist in the two core EU Member States - Germany and France - on whose joint participation the whole project is seen to depend (Section 3). In the main scenario four

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present EU Member States will not join from the start either because they are politically unwilling to take the plunge or because they do not meet the criteria, and Section 4 asks what the prospects are for their subsequent participation. Section 5 discusses briefly the welfare economics of EMU. Section 6 reviews the provisions of the rules for budgetary policy contained in the so-called Pact for Stability and Growth - "the Stability Pact" for short - and the implications for non-monetary macroeconomic management that arise from it. Section 7 asks what the broader consequences the start of EMU are likely to be for the political unification of the EU. Some tentative conclusions are offered in Section 8.

II. Progress in Convergence

If anyone had asked the officials and others involved in preparing the blueprint for EMU when the preparations began in earnest nearly a decade ago with the Delors Committee of 1988-89 - or during the Maastricht conference in 1991 - whether a broadly based EMU could materialize in the course of the 1990's, most would no doubt have replied in the negative. Inflation rates were still divergent as were long-term interest rates. Public finances looked like a number of countries would be excluded, notably Italy, with its deficits (and debt ratios) that remained stubbornly high even during the economic upturn of the late 1980s. The prospects for exchange-rate stability seemed better with an increasingly rigid EMS and a growing number of participants: Spain joined in June 1989, Italy narrowed fluctuation margins in January 1990, the United Kingdom joined in October 1990, the three potential Nordic EU Member States began pegging to the ECU in the course of 1990-91, and Portugal finally joined in April 1992. However, any complacency regarding the robustness of the EMS evaporated in the speculative crises in 1992-93, which ultimately led to the widening of the intervention margins to ± 15% in August 1993. By that time few observers predicted that EMU could be realized even according to the latest deadline available in the Maastricht Treaty of 1 January 1999.

The defection from the EMS of the United Kingdom and Italy, the resumption of devaluations affecting the Iberian currencies and the Irish punt, the continuing attacks on some supposedly stable currencies, and the widening of the margins dealt a heavy blow not only to the well-tested rule book of European monetary integration labouriously put in place over two decades, but also to the plans for achieving EMU. At best, the prospects appeared to have been reduced to the realization of a narrow EMU with six countries in the initial group: Germany, France, the Benelux countries, and Austria. But the political commitment to get ready to join at the postponed deadline of 1 January 1999, confirmed at the Madrid European Council in December 1995, proved surprisingly strong despite a further temporary set-back due to slow growth in most EU countries after the end of the recession in 1993.

Towards the end of the Intergovernmental Conference (IGC), a compromise had been worked out between three different, and apparently irreconcilable, views of the road to monetary unification. In retrospect, it is this compromise - proposed by Italy, but endorsed by France and Germany in the final stages of the negotiations - which is primarily responsible for allowing EMU to go ahead.

The *first* of these views, defended only by the United Kingdom, may be labeled pragmatic: Monetary union may be desirable, but it is safer not to be committed to it since much more experience needs to be accumulated to determine whether convergence has progressed sufficiently for it to become potentially desirable. This view could hardly be accommodated in a treaty implying a passage to full EMU either by a fixed date or automatically on the fulfillment of pre-set criteria. It could only be accommodated by giving the country (or countries) subscribing to the pragmatic view the right to defer any decision on EMU.

Some efforts at the end of the IGC, therefore, took the form of devising a procedure that could allow the United Kingdom (and Denmark) to avoid commitment to EMU. Since, in general, no country likes to be singled out for special treatment but prefers to regard its own hesitations as being shared by others, the UK request was met in a first draft - prepared by the Dutch Presidency in October 1991 - through the inclusion of a generalized clause permitting all Member States only to opt into EMU when the conditions to enter the final stage had been found satisfactory by the European Council in late 1996. This general clause, however, proved unacceptable to a majority; in an ECOFIN meeting shortly before Maastricht, ten out of twelve Finance Ministers said their countries did not need it and wanted it removed from the Treaty itself. The United Kingdom (and Denmark) then had to accept that their concerns had to be dealt with in a separate Protocol, annexed to the Treaty.

The *second* identifiable view, defended in particular by Germany and the Netherlands, put the main emphasis on the conditions for entering full EMU status. Provided tough criteria for nominal and real convergence, to be described below, can be met, this view admits a preference for going all the way to irrevocable locking of exchange rates and subsequently a single currency. But since it is not *a priori* possible to foresee when the convergence criteria will be met, this second view is opposed to a precise pre-set timetable for taking the decision to enter EMU. This German-Dutch view, which may be labeled fundamentalist because it stresses the importance of prior convergence of economic fundamentals, is consistent with the so-called "economist" perception of the European integration process, articulated by the same two countries in the debate on the Werner Report of 1970.

The *third* view was associated in the IGC with the position taken by Italy and, less forcefully, by France. It emphasizes that convergence proceeds much faster once EMU has been achieved or even has been planned with a definitive timetable. Market forces will then be harnessed to accelerate nominal convergence in goods markets as well as in financial markets, and the political readiness to take the tough adjustment measures required to meet the deadline will increase. This view, which may be labeled shock therapy or telescopic because it relies on the catalytic effects of firm timetables, has also gained ground among many professional economists, who had earlier been skeptical of rapid moves to a monetary union. It is close to the so-called "monetarist" perception of the European integration process, articulated in the early 1970s by the same two countries.

The outcome at Maastricht was a compromise between the second and the third views. The fundamentalist view found expression in the convergence criteria; the telescopic view found expression in the firm timetable for taking decisions to move to Stage III, which has now made the monetary union among many Member States of the Community a virtual certainty by the end of the present decade. At this point, we just wish to recall that the Treaty lists in Article 109 j four criteria for evaluating convergence: (1) a high degree of price stability; (2) sustainability of the government financial position; (3) observance of normal fluctuation margins in the EMS for a least two years without devaluation; and (4) evidence of durability of convergence reflected in long-term interest rates. Quantitative precision is given to all of these four criteria in a separate Protocol.

The demanding convergence criteria have formed the basis for monitoring economic performance throughout Stage II. Since 1994, the EC Commission and the European Monetary Institute (EMI) have prepared regular reports to the ECOFIN Council on progress in convergence in terms of criteria (1)-(4). In practice, these reports have remained purely formal since only very few countries have met the fiscal criteria so that there could never be question that enough member countries could be ready to start Stage III. This is the reason why the disposition concerning an early start of EMU has remained a dead letter.[1]

The key concession to the telescopic view was added following a last-minute intervention of France and Italy. It is contained in Article 109 (4), which reads:

> *"If by the end of 1997 the date for the beginning of the third stage has not been set, the third stage shall start on 1 January 1999."*

This seems unequivocal at first sight. However, this disposition does not override the convergence criteria since the same article goes on to say that

> *"Before 1 July 1998, the Council, ,.,,,,, shall, acting by a qualified majority, confirm which Member States fulfil the necessary conditions for the adoption of a single currency."*

The drafters of the Treaty did not imagine the difficulties Member States would have in meeting the convergence criteria. They did not provide for the eventuality that no member country, or only an economically insignificant number of them, would qualify.

The tension in the Treaty between fulfillment of the convergence criteria and the timetable finally appears to have been resolved by the good performance of most economies in 1996-97. But without the last-minute compromise reached at Maastricht, this would hardly have materialized. As Table 1 with the most recent data on convergence shows, inflation and long-term interest rates have moved much closer to one another than ever before, while public finances have been consolidated to an extent that should definitely make it possible for the ECOFIN Council to remove from as many as 11 countries (among those politically willing to join) the label of an "excessive deficit." Exchange-rate stability has also become more pervasive than in any earlier historical period, including that of the rigid EMS between January 1987 and the September 1992 crisis. If it is not possible to realize EMU in effect from 1 January 1999, it is difficult to see when that step could be taken. Let us, nevertheless, look at the residual risks that remain by focussing on France and Germany; if these two countries in fact prove to be ready, there is little doubt that nine other countries would follow them into EMU.

III. Residual Risks in France and Germany

The prospects for EMU were temporarily put into jeopardy following the change of government in France in the early summer and the apparent request by the Jospin government to renegotiate some of the provisions of the Stability Pact proposed by Germany and laboriously agreed upon in the Dublin European Council of December 1996. This agreement - to be commented on in Section 6 below - was seen by Germany (and some others) as an essential elaboration of the rather vague and potentially ineffective discipline on budgetary policies contained in the Maastricht Treaty, but the new French government -

in line with its predecessor, but using far stronger language - objected in the light of the difficulties of reconciling continuing budgetary consolidation with its promises to generate more employment in France.

Table 1

The Maastricht convergence criteria as of 1997 (with whom will EMU start?)

	Inflation[1] (CPI)	10-year govt. bond rate[2]	Budget deficit[3]	EMS participation
On 1 January 1999:				
GERMANY	1.7	5.57	3.1	yes
FRANCE	1.6	5.58	3.2	yes
NETHERLANDS	1.8	5.56	2.3	yes
BELGIUM	1.6	5.71	2.8	yes
LUXEMBOURG	1.5	-	+0.5	yes
AUSTRIA	2.0	5.66	3.0	yes
IRELAND	2.0	6.06	1.2	yes[4]
FINLAND	1.5	5.76	2.0	yes
PORTUGAL	2.4	5.95	2.9	yes
SPAIN	2.3	5.90	3.0	yes
ITALY	2.0	6.03	3.2	yes
EMU-criteria	app.3,0	app.7,6	“near 3”	
Sometime in 1999 – 2004:				
UNITED KINGDOM	2.4	6.66	2.8	no
SWEDEN	2.0	6.35	2.1	no
DENMARK	2.4	6.07	0.0	yes
GREECE	6.0	-	5.2	no

1 CPI inflation as found in OECD Economic Outlook 61, June 1997.
2 10-year benchmark bonds; Financial Times 19 November 1997.
3 Deficit as percentage of GDP.
4 Ireland may have to revalue its currency in 1998 if market exchange rates for the Irish punt remain significantly above its central rate.

The Amsterdam European Council in June 1997 reached an uneasy but workable compromise. The Stability and Growth Pact was preserved substantially unchanged, but the French were able to claim some concessions: an extraordinary European Council on employment policies and objectives, to be held in Luxembourg in November 1997, and further discussions on the mandate of the Council of Finance Ministres (ECOFIN) in informal sessions restricted to EMU participants. These discussions have so far produced an understanding, announced following a bilateral Franco-German meeting in Münster in October, that a restricted ECOFIN will indeed meet informally prior to regular meetings from the start of stage three. It is unclear as yet what its agenda will be, but discussions of the aggregate policy stance, of exchange-rate policy vis-á-vis third currencies - the implementation of the "general orientations" of Article 109, 2 - and EMU outsiders, and presumably, of budgetary and taxation issues that arise as a result of EMU, are likely to figure prominently. While this falls short of French ideas of a "gouvernement économique," it appears to go far enough to satisfy France, at least temporarily. The suspicions that the new body would encroach upon the independence of the European Central Bank (ECB) have been put to rest.

A more substantive step towards assuring the transition was the agreement at an informal ECOFIN meeting in Mondorf, Luxembourg, in September 1997 that the bilateral exchange rates at which the EMU participants will enter stage three on 1 (or rather 4) January 1999 will be announced together with the list of initial participants. While this will not give any certainty as to the conversion rates into the euro - this was not possible for now-outdated reasons imbedded in the Treaty - the agreement has clarified the provisions of the transition and that has obviously been appreciated by financial market participants since short-term interest rates have converged significantly further.

The basic significance of the Mondorf agreement is that the start of the essential element in EMU - a joint monetary policy - has been advanced by about eight months. Once the bilateral rates have been frozen, although only from a date eight months into the future, the scope for any individual central bank to deviate from a common stance will disappear. This marks a break with the earlier German view that monetary policy was to remain in national hands until transferred to the ECB on the first day of EMU. For the eight-month interim period prior to that date, the participating central banks will have to demonstrate their ability to conduct a fully coordinated policy.

Some will say that this situation has already become visible. When the Bundesbank in October 1997 raised its repo rate by 30 basis points that increase was widely matched also in countries where this increase was not seen as appropriate from a strictly domestic point of view. In France, with one of the lowest inflation rates in the EU and historically high and still rising unemployment, the decision to follow a common strategy was strongly criticized and the Governor of Banque de France had to defend the move in a highly charged meeting of a parliamentary committee. On the other hand, financial market participants seemed to welcome the rise as a preparatory step towards the truly common policy stance to be introduced next year. Currently interest futures prices in Europe suggest that markets expect further increases in short-term interest rates from the present level of approximately 3.3% towards the 4.0 to 4.5% range by the time of the May 1998 decision. But the need for such a tightening is not so widely appreciated by policymakers in some of the likely first-round EMU participating countries, notably France. Conflicts could, therefore, arise with a repetition of the public criticisms of policy steps in Germany that have, in earlier EMS periods of turbulence, upset exchange markets.

This is one set of potential threats to stability in the run up to EMU, both before and after the May 1998 decision. But there is also a residual threat in the way in which the other core country - Germany - is likely to handle its 1998 decision.

From the German point of view hesitations about EMU could still surface in the final weeks preceding the crucial meeting on 1-3 May 1998. The Bundesbank may be asked to supply its own report on the convergence criteria if German public opinion senses that German views have been excessively submerged into consensual and supposedly similar evaluations by the European Commission and the EMI - or the Bundesbank may itself volunteer to provide such a report. On the other hand, it will be extremely difficult for the Bundesbank to diverge more than marginally from an EMI report to which its own President has signed up.

Potentially more upsetting is the prospect that the Bundestag (and the Bundesrat) will prepare its evaluation, as it must do in compliance with the German ratification law of 1992, prior to the participation by the German Federal Chancellor in the European Council meeting of May 1998. Though such an evaluation may be unlikely to point fingers at the way in which particular other countries, notably France, try to meet the budgetary convergence criteria; it could well raise broader issues, notably relating to the sustainability of public finances in the participating countries. This concept is mentioned in the Treaty, but it is unlikely to be discussed in any detail in the two official reports since it lacks quantitative precision, however relevant the concept may be. Critical comments in the German political debate could alarm financial markets and renew doubts about the robustness of EMU.

Conflict material on either the French or the German side will not be lacking, and this could make the run-up to EMU an uneasy one. But the probability of upsets to the final decision to start has by now to be rated very low indeed. On both the French and German sides, the realization that the alternative to the EMU in 1999 is highly uncertain and unattractive is now firmly imbedded.

IV. Arrangements for the Outsiders

It was obvious from the start that, despite the rapid progress on convergence, participation in EMU would not be complete. *Greece* is not as yet ready to meet the criteria although she has recently been making such significant adjustments that entry after a delay of a couple of years has become a distinct possibility. But three other Member States - the United Kingdom, Denmark and Sweden - have indicated that they will not join although they currently seem capable of meeting the criteria. Their situations do, however, diverge in significant respects.

The government of the *United Kingdom* announced on October 27, 1997 through a detailed statement in the House of Commons by the Chancellor of the Exchequer that the United Kingdom would not be a candidate for inclusion in 1998. The right not to "opt in" had been obtained in a special Protocol to the Maastricht Treaty in 1991, and it was hardly a surprise that the United Kingdom was not in a position to join the first group in view of some cyclical divergence and considerable and continuing instability in the sterling's exchange rate vis-à-vis the potential EMU currencies. What was disappointing, despite unusually positive words about the single currency in a long-run perspective, was the absence of clear commitments to actions that could shorten the period of waiting. In particular, there was no recognition that the United Kingdom was becoming ready to contemplate joining an exchange-rate mechanism in the transition period to test whether sterling can be stabilized against the euro.

The European Council in 1996-97 finalized the blueprint for a reformed exchange-rate mechanism, generally known as ERM Mark II. This mechanism looks like the post-1993 ERM in its flexibility with margins of ±15% against the euro and with the possibility of realignments retained. It is, therefore, surprising that the UK government considers ERM Mark II excessively restraining. There is no way of obliging non-participants in EMU to adhere to ERM Mark II; but the consequence of not adhering remains, in the view of a large majority of EU Member States, that entry into EMU can take place at the earliest two years after a country has put its currency into ERM Mark II and hence has subjected the agreed central rate for it to the test of the market for a period. The majority wishes to have as good a basis as possible for judging a currency before the conversion rate into the euro is chosen at, or shortly before, entry into EMU itself.

The other country with an "opt-out" - Denmark - in a sense has the opposite problem to that of the United Kingdom. Denmark has indicated that it prefers a tighter arrangement with the euro area other than the lax ERM Mark II. For a country that has converged well to behaviour in the prospective euro area and foresees no problems in conducting similar economic policies also in the future, such a position seems logical. A question that is more difficult to answer is why, given this attitude, Denmark does not wish to reverse the "opt out" (already exercised in 1992-93) and join EMU itself, which would at least contain the benefit of giving the country some, though obviously modest, influence over the monetary policy decisions taken by the European Central Bank and possibly the ECOFIN Council in matters relating to EMU. This can only be explained by the perception in Denmark that EMU is a major step towards political union - whatever that view means is discussed in Section 7 below - an implication regarded with some hostility by the Danish electorate.

Sweden, unlike the United Kingdom and Denmark, does not have an "opt out" from the third stage of EMU but has herself appropriated the right to stay out. The reasons are economic and political in nature. Sweden shares with the United Kingdom the skepticism whether the euro area could function because of the economic diversity inside its frontiers and the risk of significant asymmetric shocks affecting Sweden. She shares with Denmark the unease over political union. In this perspective, the present Swedish government has announced a wait-and-see attitude where the timing of any decision is likely to be linked to a UK decision to "opt in". For the time being, Sweden has no intention of joining ERM Mark II, which will create further problems for the country's eventual participation in EMU, once that is again put on the agenda.

The upshot of these brief remarks on the four outsiders is that ERM Mark II seems likely initially to have no participants in its general version, though probably one (Denmark) is seeking to join a version that resembles the tight pre-1993 ERM. This is paradoxical given the attention devoted to setting up a mechanism for the outsiders. Yet the proposed mechanism may ultimately prove its usefulness, once the EU receives new Member States from Central and Eastern Europe who may find this relatively lax transitional exchange-rate arrangement suitable for their purposes.

V. The Welfare Economics of EMU

There is a tendency, particularly among critics of EMU, to see the project as motivated purely by political aims. Whether political aims can indeed be promoted efficiently in this way is the subject of Section 7. Here we want to take issue with the view that there are no clear net economic benefits associated with EMU.

The weakness of much that is written on this issue is the optimistic bias in the assumptions as to what is the alternative to EMU. When the European Commission prepared its major assessment of the costs and benefits of full monetary union, CEC [2], it was naturally assumed that the alternative was a well-functioning EMS since the system had at the time succeeded in stabilizing exchange rates while reducing average inflation. In such a situation, the benefits from complete elimination of all exchange-rate instability are modest, though not insignificant. But so are the costs; if the potential EMU participants can in any way be regarded as likely to pursue very stable policies, they do not give up much by refraining from independent monetary and exchange-rate policies.

Other studies, mainly by US economists, have analyzed the formation of a monetary union against the benchmark of a well-functioning régime of floating exchange rates. Given the divergences in underlying economic performance and conflicts over policy objectives between the major economies in the global economy, such a regime may have been inevitable for the international monetary system. But the régime has not worked well and smoothly, as the original proponents imagined. Nor has it prevented serious misalignments and tensions over trade policy as claimed in the classic defense of flexible exchange rates by Friedman [4]. One might expect it to function better within Europe, given tighter economic convergence, but the experience with floating in the 1990s has been frustrating also within Europe. The currencies that broke out of the EMS experienced severe overshooting. Even when inflation rates had become nearly identical and were underpinned by official inflation targets consistent with exchange-rate stability, major cycles of exchange-rates have occurred for sterling - even the Bank of England has described its 1996-97 movements as "erratic" - and for the lira. Academic research has been unable to confirm that exchange rates typically move to correct economic inbalances.

In view of these experiences, the alternative to EMU must be viewed in a more pessimistic perspective and the benefits from eliminating exchange-rage variability correspondingly higher than in the early 1990s. In addition, with the significant progress in implementing the European Single Market, an exchange-rate régime that leaves a degree of variability comparable to what has been observed between, say, the US and Canadian dollars is plainly inadequate for even preserving the degree of goods market integration aimed for in the EU. On the whole, it must be questioned whether there is any real cost in giving up movements in the exchange rate as either a policy instrument or a safety valve.

There has been a tendency in academic empirical research to downgrade the costs of exchange-rate variability because it has proved to be difficult to find significant statistical relationships to trade flows. In Gros and Thygesen [5] we report some findings that an unstable exchange rate for the Deutsche mark seems to have had a systematic negative impact on changes in the unemployment rate - or in employment in manufacturing. This result helps to explain why German industry and trade unions are more favorable towards EMU than is the German public in general. Furthermore, these results can also be found in several other European economies.

On the whole, it is easier, therefore, to find support today for the view that there are indeed significant net benefits from EMU for most of the prospective participants than was the case when EMU was put on the drawing board a decade ago. Some may point out that the costs of introducing a new unit with all its ramifications have also been underestimated; and the estimates by banks and non-financial enterprises have indeed been higher than expected. There are still, however, no more than at most one-to-two years of benefits from operating a single currency area - a very short pay-back period by any standards. Furthermore, much of the investment in preparing for the euro has by now been made. For every day that passes, the balance is shifting towards saying that even in these narrow terms, it is becoming more costly to give up the project than to see it through to an early completion.

The welfare economics of EMU is a tricky subject, involving as it does a balancing of largely microeconomic benefits accruing to firms and households against the perceived, though largely illusory, costs to domestic policy-makers of abandoning independent recourse to monetary policy instruments. The subject does not lend itself easily to quantification. But the tendency towards giving more operational independence to national central banks, which has been accelerated both by academic research into the experience of the past and by the EMU process itself, has surely swung the balance of benefits and costs further in favour of the former. Once the setting of interest rates is no longer regarded as a subject to be discussed and decided by governments and parliaments - and that important shift has now occurred even in the United Kingdom - this conclusion is strengthened.

VI. National Budgetary Policies and the Stability Pact

The most controversial part of the blueprint for EMU initially prepared by the Delors Committee and developed much further in the Maastricht Treaty and the Stability Pact, has proved to be the imposition of binding guidelines in the form of upper limits to public sector deficits and debt. Many economists have argued that such rules were at best superfluous since monetary unification would in any case indirectly assure sound national budgetary policies in the long run, once the escape route from unsustainable policies through inflation and devaluation has been blocked. Other observers have in a more intuitive way felt uneasy that constraints were being imposed on the one remaining important set of national macroeconomic policy instruments concurrent with entry into EMU.

Three main arguments were initially advanced to justify rules of the kind embodied in the Maastricht Treaty and further elaborated in the Stability Pact: the need to (1) improve the policy mix between monetary and other macroeconomic policies in the euro area as a whole; (2) reduce the risk of upward pressure on euro interest rates from large deficits in individual Member States; and (3) counter the risk that EMU itself might foster more audacious national budgetary policies.

The first two of these reasons do not appear to carry much weight as arguments for the form that the budgetary rules have taken. The policymix may be helped by imposing upper limits on budget deficits in deviant countries, but such limits are a poor substitute for policy coordination in the sense that term is usually understood. Such coordination would require a more symmetric view of expansionary and contractionary budgetary policies, and there is little in the rules anyway that suggests that the aggregate budgetary stance in the euro area can be addressed through the provisions of the Stability Pact. The need for coordination proper may anyway be overestimated; empirical work, e.g., in CEC [2], suggests that the spill-over effects of national budgetary policies among the EU countries are more modest than is generally recognized. And the second reason is also less than fully convincing. It is not clear that higher public deficits in, say, Italy would be reflected in higher interest rates throughout the euro area; the effect would, at least partly, be contained by rising credit spreads on Italian public debt. But even to the extent that a national deficit does have such generalized effects, it is unclear on welfare grounds whether that could justify blocking this potential pecuniary externality. (See e.g. Buiter *et al.* (1993).)

The third argument is more difficult to recite. It cannot be dismissed out of hand that some governments might be tempted by the more stable external environment of EMU in which exchange-rate or balance-of-payments crises would become effectively damped to go for larger deficits than has been the case outside EMU where they have had to bear more of the consequences individually, rather than collectively. Without some rules on which peer pressure by other Member States, in case by other Finance Ministers in ECOFIN, can be based the considerable weakening of financial market pressure on the individual country inherent in joining the euro area could have harmful effects.

The Maastricht Treaty already recognized this, but the mechanisms through which peer pressure was to be applied were weak and potentially so time-consuming as to lose any real and timely impact. The German government, conscious of the concern to which this fact gave rise in their own domestic debate, proposed a considerable tightening of the enforcement procedures in the form of the Stability Pact. The latter stipulates both the precise nature of the sanctions to be applied to a country with deviant behaviour and the time frame for correcting an excessive deficit. Although the ultimate agreement did not meet all German requests, it went as far as was permissible under the Treaty in establishing a precommitment of the EMU participants to vote in favour of sanctions, except when truly "exceptional circumstances" made their application undesirable.

The most important feature of the Stability Pact is that it establishes as a principle that, in order to avoid transgression of the 3% reference value for the deficit-to-GDP ratio in unfavourable years, budget balance or even a small surplus should be aimed at in normal years, i.e. as an average over the business cycle. If EMU participants succeed in achieving this objective, they will have enough room to maneuver to conduct a countercyclical policy through the working of the automatic stabilizers in their budgets.

It is easy to criticize the arbitrary numbers in the Stability Pact and to reflect on the political difficulties, once the situation of actually applying sanctions, particularly to a larger Member State, approaches. Nevertheless, something like the Stability Pact was needed to prevent budgetary policies from becoming too lax. So far, the clear expression of intentions seems to have improved budgetary procedures within several Member States so that discipline should be easier to enforce. With its long-run perspective, the Stability Pact should also tend to mitigate the excessive short-termism that has characterized many national efforts to qualify for EMU by 1997. One-off measures, including unusual accounting for some expenditures and revenues, have attracted much attention; and, generally, there has been much emphasis on budget consolidation through higher taxes and too little emphasis on longer-term expenditure reforms. With budget balance now established as the long-term norm, attention will have to shift to the latter. It is reasonable, therefore, to regard the adoption of the Stability Pact as a helpful contribution to economic policy formulation in EMU.

VII. Does Monetary Union Lead to Political Union?

Both advocates and critics of EMU have stressed the implications for political union of achieving the objective of a single currency for Europe. Among the former, the German Federal Chancellor has seen the project as essential for consolidating the long process of European integration that started in the early post-war years, the implication being that failure to achieve EMU could lead to a relapse into conflicts among European states and ultimately to a resurgence of nationalism and war. Opponents of EMU, on the contrary, see the risks of trade conflicts and their escalation into major political confrontations as greater with a single currency for a still politically divided continent; Feldstein [3] offers a stark recent account of this scenario.

The argument is basically about the vision of Jean Monnet and other early figures in European integration. Does monetary union, which undoubtedly itself is a major step towards political unification, trigger other important steps in the latter process, such as the evolution towards a common foreign and security policy, including internal security, and more democratic features, notably through a greater role for the European Parliament? Or does the introduction of the single currency, by focusing on a still divisive issue, make constructive integration in other areas and even intergovernmental cooperation more difficult?

It is possible to take an intermediate, lower-key, position. Monetary union ***is*** likely to foster macroeconomic cooperation within or also outside the monetary area where authority is being centralized. The first evidence is the agreement to let the Finance Ministers of the EMU participants meet informally to monitor non-monetary macroeconomic policies. Increasingly, such policies and the public debates on them will become Europeanized, possibly without transferring more authority to the EU level but preferably with some additional elements of such authority to advance tax harmonization in particularly sensitive areas such as capital income taxation (and maybe VAT) and to put in place a modest fiscal transfer mechanism to assist the working of automatic stabilizers in national budgetary policies in cushioning participants against residual asymmetric shocks. In these areas close to monetary union a positive spill-over effect of the type which Monnet envisaged is more likely than the opposite, but the delays could be considerable.

Beyond these areas contiguous to the operation of a joint monetary policy, spill-over effects from EMU - positive or negative - seem unlikely. As the debates in the Intergovernmental Conference, which was concluded in Amsterdam in June 1997 show, a firm prospect of EMU did not modify the very cautious and hesitant approach of nearly all EU Member States to political union and, in particular, to a federal structure of decision-making. Integration of foreign and security policies into the EU structure is being and will be judged on its own merits, and they are currently found wanting. The achievement of monetary union, significant as it is, cannot in itself trigger deeper integration in other areas of “high politics.” The Monnet mechanism runs out of steam at this level of issues.

But if the aspirations of federalists are likely to be dissapointed, so are the predictions of

Feldstein (and of the UK Euroskeptics) that the difficulties of managing the euro will blow up what already exists in a process of self-destruction. Any political process involving complex relations between still-sovereign nations is full of risks, but the burden of proof that these risks are minimized by giving up the ambition of EMU rather than by achieving it has to be taken more seriously by those who primarily see the conflict material in EMU. It is not difficult to construct a very worrisome scenario of crisis escalation moving from renewed currency unrest to trade conflicts undermining the Single Market to major political conflicts in Europe, even though the surviving structures may well remain strong enough to prevent them from reaching the level of armed conflict.

The dramatic, even cataclysmic, overtones in the debates over the implications of the single currency have become excessive. Monetary union can be viewed as a more pragmatic step with some net economic benefits attached to it and a potential for limited and constructive spill-over effects in contiguous areas. That should be a set of issues, easily substantial enough in themselves, to occupy policy-makers and the public debate for quite some time.

VIII. Conclusions

This article has tried to develop a number of points that arise as Europe approaches EMU. A large number of EU Member States, probably as many as 11, currently seem likely to join EMU on 1 January 1999. This is a testimony to remarkable economic progress and convergence and an achievement of major political significance, particularly since it will minimize the risk of an unfortunate, involuntary division of EU Member States.

The residual risks in the final year before the deadline are to be found in the two core countries, France and Germany, but they appear manageable.

The problems of linkages to those Member States that remain outside EMU have been formally solved by defining an arrangement, the ERM Mark II, for managing currency relationships with them. But, paradoxically, there appear to be no volunteers at present for the general version of the arrangement.

Updating the traditional analysis of the benefits and costs of EMU suggests that the net benefits have increased since the beginning of the 1990s, primarily because the alternative to EMU now looks less reassuring.

The Stability Pact marks a significant elaboration of the constraints on national budgetary policies in EMU. Though inevitably somewhat arbitrary, the Pact is a constructive and well-justified element, and it should foster a better long-run design of national policies.

Both advocates and opponents of EMU have tended to make excessive political claims for their opposite scenarios. The stakes in achieving EMU are high, but they have been overstated.

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NOTES

1. Article 109j implies that the ECOFIN Council could in 1996 assess (by a qualified majority vote) for each Member State whether the conditions for the adoption of a single currency are fulfilled and subsequently whether those who qualify constitute a (simple) majority of Member States**.** The recommendations of the ECOFIN Council would then be forwarded to the European Council, who could then not later than 31 December 1996 (1) decide, on the basis of the recommendation from the ECOFIN Council, whether a majority of Member States fulfil the necessary conditions for the adoption of a single currency; and (2) decide whether it is appropriate for the Community to enter the third stage. This obviously did not happen.

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