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IN EUROPE?

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NORBERT WALTER

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GERMAN ISSUES ■ 17



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ISBN 0-941441-23-7

ISSN 1041-9810

This German Issue is made possible through a grant from the *Bundespresseamt* and The German Marshall Fund of the United States. Additional copies are available from the American Institute for Contemporary German Studies, Suite 420, 1400 16th Street, N.W., Washington, D.C. 20036-2217. Telephone 202/332-9312, Fax 202/265-9531, E-mail: aicgsdoc@jhunix.hcf.jhu.edu, Web: <http://www.jhu.edu/~aicgsdoc/>

A B O U T T H E A U T H O R

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THE ROAD TO EMU

European Monetary Union (EMU) is a logical complement to the European Single Market and represents the necessary deepening of the European Union (EU) without which Europe will not be able to compete with the United States and southeast Asia. Moreover, a deepening of the Union is called for to realize the desired and necessary integration of the post-communist countries, i.e., EU enlargement by the inclusion of Poland, the Czech Republic and Hungary.

The European Council of Heads of State or Government reached agreement on the “Treaty on European Union” at Maastricht in December 1991. Following ratification by the constitutional bodies of all the member states of the European Communities (EC)—thereafter referred to as the European Union—the Maastricht Treaty went into effect in November 1993. This represented an enlargement and amendment of the EC Treaty, which has constitutional character in the individual EU countries. The core economic aspect of this treaty is to create a European Economic and Monetary Union by the end of this century. The Single European Market has already been largely realized. European Monetary Union (EMU), with a single

currency, represents the goal and culmination of monetary integration in Europe, the history of which has so far been marked by ups and downs.

According to the Maastricht Treaty, EMU is to be realized in three stages in line with a fixed timetable:

Stage one of EMU began on July 1, 1990. The major elements of stage one were: the full liberalization of capital movements and closer cooperation between the EC member states on economic, fiscal and monetary matters.

Stage two has been in effect since January 1, 1994 and is intended as the preparatory phase for subsequent monetary union. One of the most important measures was the establishment of the European Monetary Institute (EMI), the forerunner of the future European Central Bank (ECB). Meanwhile, all EU countries with the exception of Britain and Greece have met the requirement that independence be granted to those central banks which were not yet autonomous. Since stage two started, there has been a ban on central bank financing of public deficits, and the economic and fiscal policies of the member states are monitored more closely.

Over the last few years EMU, the project of the century, has gained considerable momentum. Its basic ideas and the

principles of transition from national currencies to the euro have been laid down. At the Dublin EU summit in mid-December 1996 the European Council came to an agreement on three major elements of the future EMU: the legal framework for the currency changeover, the stability pact to ensure budgetary discipline within EMU, and the future ERM II (Exchange Rate Mechanism), in which the exchange rates between the euro and the initially non-participating countries will be organized. The decision on which countries are to participate in EMU is to be taken in spring 1998 by the European Council. It will decide, with a qualified majority, on the basis of reliable 1997 data. Going by this data, it will be determined which countries fulfill the convergence criteria regarding price and exchange rate stability, interest rate convergence and budget discipline in the sense of the Maastricht Treaty, and will thus be among the founding members of EMU. On the basis of this data and the participants, the European Council will decide on the feasibility of monetary union and the starting date of stage three.

In stage three, which is to commence at the beginning of 1999 and represents the last and decisive stage, monetary union will be completed. When stage three begins, the conversion rates of the national currencies to the new European currency will be fixed

irrevocably and hence also the parities of the participating EU currencies. Responsibility for the single monetary policy will be transferred to the European System of Central Banks (ESCB) comprising the ECB and the national central banks of the participating countries. The Maastricht Treaty foresees a “speedy” introduction of the euro after entry into stage three.

The Maastricht Treaty stipulates the transition from the national currencies to the euro. The timetable begins with the decision on the starting date and the participating countries in spring 1998. The ECB will be established immediately after the decision on the participants. Among its first tasks will be the production of euro notes and coin as well as the preparation of the currency changeover.

On January 1, 1999 the conversion rates between the participating currencies and the euro will be fixed. Responsibility for monetary policy will be transferred to the ECB. The changeover in the non-cash area will be largely left to market forces. It is to be expected, however, that in addition to the immediate changeover in the money and foreign exchange markets, large parts of the remaining securities markets and clearing systems will also switch to the euro at an early stage.

Between January 1, 2002 and July 1, 2002 at the latest, euro notes and coin will be introduced. It is to be expected that the changeover for public administrations, companies and households will take place during that period. On July 1, 2002 the national currencies will lose their status as legal tender, but can still be exchanged.

The conversion rates for the participating currencies, which will be irrevocably fixed versus the euro at the start of EMU, are the crucial factor in rebasing all money-related volumes and flows on the euro. The process for determining the conversion rates has not yet been decided upon. According to the Maastricht Treaty the rates are to be fixed by a unanimous resolution to be taken by the Council of Economics and Finance Ministers on the first day of stage three. The external value of the euro must equal the external value of the former basket ECU. Thus, the value of one euro will correspond exactly to that of a basket ECU, i.e., the conversion rate between them will be 1:1. It has yet to be decided whether the market rate on the day before the start of stage three or an average rate will be used.

The risk of “currency dumping” by a country at more or less the last minute to secure a competitive edge after the introduction of the euro is considered low, however, as the decision on the

conversion rates has to be unanimous. Decisions on the modalities of the changeover to the single currency will be taken in the spirit of the Maastricht Treaty, taking into account the aspects of credibility and feasibility.

CHANCES AND RISKS OF EUROPEAN MONETARY UNION

According to the schedule described above, the euro is to replace the national currencies in roughly twenty-one months' time. The Maastricht Treaty and the project it refers to are of historic dimensions as they foresee the creation of a single-currency area in Europe for the first time since the end of the Roman Empire. Many citizens of Europe continue to be critical of EMU.

The single currency, the euro, is a logical complement to the European Single Market, which has guaranteed the basic freedoms for persons, goods, services, and capital since 1992. The advantages of a single currency in Europe are obvious: exchange rate-related transaction and hedging costs as well as exchange rate risk will be eliminated because exchange-rate turbulence within Europe will be a thing of the past. On the one hand, this means cost savings and greater planning certainty for investment, which is required in order to become competitive internationally. "Management," a scarce resource, may focus fully on its real job, the development of new markets, new products and production methods. In addition, the euro will

create a large and liquid financial market with attractive opportunities for investment and financing. Very soon, the euro could play a greater role than the individual EU currencies. We also have hope that the euro will in the future challenge the dollar as a reserve, investment and/or settlement currency.

Finally, the euro will also help to strengthen political unity within Europe. It is important to intensify relationships within Europe to achieve the desired deepening in the common domestic, foreign and legal policies. Another task on the agenda for the next ten years is the integration of the post-communist states of central and eastern Europe.

The process of integration in Europe can and must not be dealt with solely by euro-technocrats. Chancellor Helmut Kohl described the significance of EMU for the process of European integration as a question of war and peace. This does not mean that the peoples of Europe would turn to violence again if EMU were to fail. Future disputes within Europe would likely be resolved by means of economic policy instruments such as trade restrictions or minimum wage regulations for foreign workers. History, especially the period between the two world wars, has shown that those concerned—not only directly affected Europeans but also the Americans—must actively support the

integration process to ensure that the conflicts of the past do not flare up again. This could be helped tremendously by a single European currency.

EMU is the dominant topic on the financial markets, in politics, among the population, in the media, and in the business sector. The introduction of the single European currency, the euro, is the top issue throughout Europe. The probability of its introduction and the potential first round participants are receiving particular attention. Irrespective of the imponderables, microeconomic preparations for the currency changeover—not a currency reform involving the depreciation of financial assets—have been launched in many areas.

Under current conditions the chances of EMU being realized in 1999 should be put at around two-thirds. If EMU does materialize, it will probably start with a core group of six to eight countries: France, Germany, the Benelux countries, and Austria. Other possible participants are Finland, Denmark, Ireland, and the UK. Italy, Spain and Portugal are currently making huge and promising efforts to meet the criteria in 1997. It remains to be seen whether they will succeed. If they continue on their convergence course, they will probably manage to join EMU before the planned distribution of notes and coin. EMU will

undoubtedly not materialize without France and Germany: without France, Europe would regard EMU as a Teutonic block; without Germany, the European currency would lack credibility.

France and Germany are the two main countries pushing European currency integration forward. Following almost fifteen years of stability-oriented economic policy, the political leadership in France and the leaders of the Banque de France are strongly committed to reaching the objective of introducing the euro. The pain caused by this policy over several years is not to be in vain. The second driving force behind European integration is Helmut Kohl. The chancellor of German unification intends to complete his vision of Europe. Before his retirement from the political scene, his objective is to make the process of European unification irreversible by creating further institutional links, such as EMU.

An intensive discussion is currently being held about potentially participating countries and their strict and sustained fulfillment of the convergence criteria laid down in the Maastricht Treaty. Attention is focused on the Mediterranean countries Italy, Spain and Portugal. These countries have made great efforts over the past months to meet the fiscal policy criteria, which would allow them to be among the first

participants. In both Italy and Spain the heads of government have linked their personal careers to fulfillment of the criteria.

It is by no means clear that Germany will not meet the convergence criteria stipulated in the Maastricht Treaty. Three developments seem to suggest that it will be successful: a firmer dollar, supporting exports as a locomotive for the German economy; stable growth expectations in the U.S., east and southeast Asia as well as eastern Europe; and an at least partly successful budget consolidation in Germany. This could lead to a pickup in the German economy so that the convergence criteria could be met in a final spurt. In the case of Germany the debt criterion will be interpreted less strictly by its EU partners because of the massive cost of German reunification.

What is called for in Germany, not least because of the anti-inflation attitude of German society, is a responsible and strict interpretation of the Maastricht criteria. This applies primarily to the fiscal criteria, i.e. the deficit and the debt level.

When the Maastricht Treaty was concluded in 1991, the criteria were not expected to be met under sustained recessionary circumstances. That Brüning's deflation policy should serve as a means to fulfill the Maastricht criteria was not one of the intentions of the architects of EMU. For this reason there must be

a responsible interpretation of the Maastricht criteria, which, however, does not mean they should be “watered down.”

Four risks could prevent monetary union. The probability should be put at one-third. First, it has to be noted again that EMU will not get off the ground without France. If the French government were to give in to pressure from the population, doubts could arise about France’s commitment to its convergence policy. This risk has become less weighty in recent months.

The second risk is to be found in Germany. If the majority of Germans continue to oppose the introduction of the euro, the coalition parties’ base could turn against their leadership. This would mean that the majority of CDU members would decline to follow Chancellor Kohl on the road to the euro. This refusal and its consequences would cause EMU to fail.

The third and fourth risks will only become relevant from spring 1998. In the case that Germany and several of its partners come out against the participation of Italy, Portugal and Spain, in spite of the huge efforts made and the economic policy successes achieved by these countries, the latter could refuse to approve the introduction of the euro in the vote held in the European Council. This decision requires a qualified majority, i.e. sixty-two of

eighty-seven votes. Thus, the third risk is that the European Council will fail to produce the necessary qualified majority in the vote on EMU.

The fourth risk is a factual German opt-out. This means that following the successful conclusion of the agreement at the EU summit in spring 1998, either the upper or the lower house of Parliament would ask the Federal Constitutional Court to investigate to what extent the criteria have been interpreted in a responsible and strict way.

One thing seems absolutely certain, however: monetary union will either come at the end of the century or not for a long time. The current discussion about an “orderly” postponement of monetary union by two to three years is playing with fire. The centrifugal forces that would be unleashed on the financial markets if the postponement of EMU were announced could not be contained. The European economies would diverge rather than converge—European Monetary Union would be dead. After such a failed attempt Europe would not be able to muster the political strength to try again for at least another decade.

If monetary union were to fail, this would have obvious consequences for the general process of European integration. Countries which would give up their convergence-oriented

stability policy for their own particular interests would bring about a resurgence of old prejudices in the markets regarding their fiscal and monetary policies, for which they would be punished with a risk premium on interest and exchange rates. These countries' austerity and consolidation efforts would thus be wiped out virtually overnight. The hard-currency countries would have to face an appreciation. This applies especially to the *Deutschmark* (DM). Such a scenario would lead to a recession, a distinct exacerbation of the problem of unemployment and a continued shift of investment abroad. Weakened governments would be confronted with calls for protectionism from individual groups to which they would find it hard not to respond. Europe's attractiveness to global investors would suffer, foreign capital would shy away from the risks stemming from conflicting factions in Europe. Political and economic decline would be the final result. The consequences for freedom and prosperity in Europe would be disastrous.

If monetary union were to fail, this would also discourage Europe's governments from further consolidating and restructuring public finances. Many people are under the impression that it is the Maastricht Treaty which calls for consolidation and restructuring, and conclude that these sometimes painful

measures will no longer be necessary if the EMU project is abandoned. Reality looks different, though. It is not the Maastricht Treaty but excessive government and the rigidities of Europe's economic structure that make these measures necessary.

If the euro is introduced, it will not only be a stable but also a strong and widely accepted currency. The future European Central Bank, which will keep watch over the European currency, has been designed along the lines of the *Bundesbank*; the independence of its institutions, leadership and operations exceeds even that of the *Bundesbank*. The ECB will comprise the governors of the independent national central banks of the countries participating in EMU and the members of the Executive Board, appointed for an eight-year term. The nomination of Willem Duisenberg, the Dutch "Mr. Stability," as successor to Alexandre Lamfalussy underscores the strong commitment to a stability-oriented monetary policy in the European currency area.

To complete the process of European integration the governments must continue with fiscal consolidation in order to ensure the successful implementation of EMU. Fiscal criteria, debt levels and budget deficits should be interpreted as provided

for in the Maastricht Treaty, and not as often suggested in unenlightened debate. The decisive aspect is that Europe's economies are in the middle of a lasting convergence process, with the convergence of interest rates and inflation rates by and large achieved.

To ensure the long-term success of EMU a lot depends on the stability of fiscal policy. It was in that spirit that the agreements and amendments to the Treaty were made at the EU summit in Dublin.

The creation of EMU is a historic event. If it comes, an essential element will be added to the Single Market which allows its opportunities to be exploited to the full. Its realization is within reach. To convince the citizens of Europe of its merits is a very important factor. The feeling of indifference sensed at the beginning of the Maastricht debate and the widespread scepticism or even rejection must be tackled. Those who are convinced of the advantages of a single-currency area for Europe and for European unification are called upon to convince others, too.

IMPLICATIONS FOR THE U.S. AND THE U.S. DOLLAR

What will be the implications for the world economy and for the United States in particular? Completely unimpressed by the historical dimension of the European integration process, the U.S. has for a long time hardly made any comments on the subject of the European Monetary Union. The planned EMU seemed unrealistic or at least of minor importance to U.S. politicians and managers.

President Bill Clinton seemed to focus on other issues: domestic issues dominated. In the last few weeks Europe, and thus also EMU, have gained in importance supported by the discussion on the eastern enlargement of NATO and the desired eastern enlargement of the EU. It is no longer a matter of benign neglect.

EMU as a model for the world currency system looks to be impossible, since the economies of the U.S., Japan and Europe are too divergent. The three big currency areas, the U.S., Japan and Europe, should give preference to flexible rates since these regions respond differently to macroeconomic shocks and their economic structures are too diverse to allow exchange rates to be

fixed. However, the potential EMU members—at least the core group countries—constitute an economic area with close trade relations, a similar economic structure throughout and parallel economic cycles, thereby providing the necessary prerequisites for a successful and thriving monetary union. With respect to global currency stability, EMU could contribute to more stable exchange rates vis-à-vis the other major currencies and reduced volatility.

Euro as Trade Currency

In the long term, Europe with a strong euro, could also challenge the so far uncontested position of the dollar as the major currency in the world. In the past, this dominant position had a positive effect on U.S. foreign trade. Furthermore, the U.S. has been able to have a direct influence on the level of international interest rates. U.S. concerns that a stable euro could become a dominant reserve currency in certain areas, such as eastern Europe, are justified. The euro could play a greater role in the international currency system than the DM.

A weak euro is not a likely scenario and therefore U.S. fears that Europe will use the exchange rate as a weapon in trade policies seem to be ill-founded.

Euro as Investment Currency

EMU will continue to have a decisive influence on the financial markets. There has been a remarkable convergence of economic fundamentals and, consequently, of interest rates in Europe among those countries which are likely to participate in EMU.

Dependent on the steadiness and credibility of future European monetary policy, various scenarios are possible (“run on the dollar” or “run on the euro”). Since it will initially not have built up a reputation, the ECB could pursue a very restrictive monetary policy at the start of EMU. This could prompt international investors to switch from dollars into euro capital investments.

Among the participating countries, exchange rate and inflation risks will be eliminated as reasons for yield spreads. Euroland will be based only on credit risk and different market conditions. Yield differentials of several hundred basis points will be a thing of the past. The start of monetary union will have considerable effects on the ratings of European issues by rating agencies. Governments have no possibility whatsoever to print money for debt redemption. Printing money, and thus inflation as a means of debt reduction, is no longer possible as the ECB is

responsible for European monetary and interest rate policy. Only the strengths of the fiscal and financial policies of a country will be assessed for the repayment of debt.

The common euro bond market will have a more pronounced market breadth and depth than the still existing individual markets. The market volume of the EMU core countries accounts for roughly one-fourth of the international bond market and is equivalent to almost half the U.S. bond market. As a result of the weight of the new capital market alone, the euro could reduce dependence on the dollar policy. International borrowing in euros would also help to strengthen the international role of the euro as a global investment instrument.

What matters is not the formal status of the euro, but the currency's actual performance. If performance is strong, the markets will ensure that the international use and role of the euro will be strong as well.

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