The Desirability of a European Monetary Union: A German Perspective

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While the member states of the European Union (EU) are currently engaged in comprehensive constitutional negotiations aimed at augmenting the Treaties of Rome and Maastricht, the public debate in Europe focuses on the planned introduction of a common currency for the Union in 1999, a subject that is largely unrelated to the discussions at the Intergovernmental Conference. Whether in London, Paris, Bonn, Vienna or Rome, economic and political discussions among friends will almost unavoidably result in a lengthy discourse about the monetary union and the state of the EU.

Opposition to EMU

The current administration in London invariably attempts to water down the EU through a speedy enlargement eastward. It endeavours to have the Union regress to a simple free-trade zone—at minimum, to prevent the UK from joining the European Monetary Union (EMU). By May of 1997, Britons will have cast their votes in a general election, presumably in favour of a Blair administration. A Labour government might act in accordance with the current moderately pro-European statements by Tony Blair.

In France, President Jacques Chirac and his Prime Minister Alain Juppé have stuck to the EMU-related provisions of the Maastricht Treaty. Both have refrained from any discrediting or critical statements. The same applies to Germany's Chancellor Helmut Kohl who nonetheless was incapable of preventing his finance minister from publicly questioning the performance of the Treaty and from making additional clauses conditional for its implementation. Nor did Mr Kohl intercede when his finance minister and the Governor of the Bundesbank helped—through their *de facto* destruction of the successful European Monetary System (EMS) in 1993—to withdraw one of the cornerstones of the Treaty: Article 109(j), Section 1. In Germany, the Governor of the Bundesbank is the most powerful opponent of EMU.

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Prospects for Convergence

Article 109(j) of the EC-Treaty (augmented by Maastricht) and the two associated Maastricht Protocols regulate the start of the third stage of EMU—the actual introduction of the common currency. For this process, the Maastricht Treaty delineates two principles. First, on January 1 1999, the currency union will begin and the European Central Bank (ECB) will start its full-scale operations. Second, only those countries that comply with the five so-called convergence criteria are to participate. In practical terms this means that, from early 1999 on, the Union comprises two categories of members, the "ins" and the "outs".

One of the five convergence criteria has now become almost completely irrelevant. It dealt with devaluations of national currencies within the pre-1993 EMS, a system which linked the member currencies through fixed exchange rates with permissible fluctuations of ±2.25%. Since August 1993—after the Maastricht Treaty had been signed—the fluctuation band has been widened to allow for exchange-rate movements of up to ±15%, an arrangement that has rendered this criterion largely meaningless.

Of the remaining four convergence criteria (long-term interest rates, inflation rates, public debts, and budget deficits) the former two do not play any significant role in the current discussion. With the exception of Greece, Italy, Spain, and Portugal, all of the EU member states fulfil the interest-rate criterion. Even less critical is the one regarding the inflation rate. Again, with the exception of Greece, Italy, Spain, and Portugal, this criterion is met by every member state. Moreover, it seems possible that, by 1997, inflation rates in Italy, Spain, and Portugal may be below the maximum level allowed.

Public attention will therefore shift toward the criteria evaluating public debts and deficits. In 1996, it appears that only the Netherlands, Belgium, Denmark, Finland, and Luxembourg will be able to keep their deficit-to-GDP ratios below the upper limit of 3%. France and Germany, the two core countries in the future currency union, currently exceed (and will likely do so in 1997 as well) the 3% budget-deficit criterion. Both countries will strive to reduce their deficits for 1997. In order to reach this goal, they have two options: either they decrease public expenditures or they increase taxes. Both alternatives naturally meet with considerable opposition.

Deficits Must be Addressed…

Even without the stability provisions of the Maastricht Treaty, an increased degree of fiscal discipline has become nec-

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essary, in France and Germany as much as in most other European countries. Almost everywhere, fiscal control has become too lax. In late 1994 and early 1995, the social democratic government in Sweden was the first one to react to this budgetary development—despite the resistance of some of its voters. In Germany, unification with East Germany made additional expenditures necessary which, until now, have largely been financed by tax increases on lower-income German households.

Unacceptably high and steadily increasing unemployment is on the political centre-stage almost everywhere in Europe. In this economic environment, additional tax increases are no political solution. Many European politicians continue to believe—in a misguided reference to John Maynard Keynes—that additional, deficit-financed expenditures can stimulate the economy. None of the major EU member states, however, have so far acted on that belief.

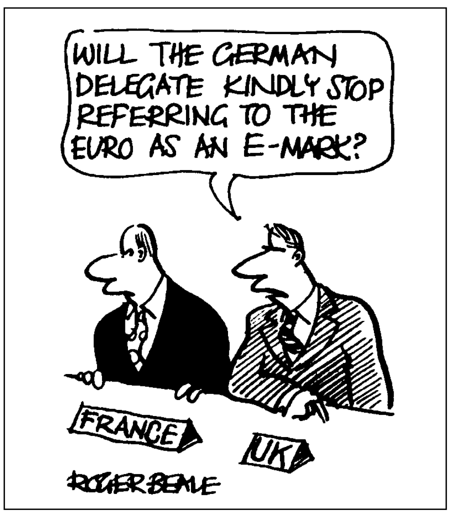
Such a Keynesian response would be ill-guided, since current unemployment is primarily structural rather than cyclical. In Europe, labour markets are too rigid and companies are overly burdened with additional labour costs and too high a degree of regulation. In the international arena, many of them have lost their competitive edge. Increased subsidies are able to secure jobs only temporarily; they cannot create new ones. To eliminate structural unemployment, comprehensive reforms are required: reforms to the labour market and to the systems of social security; reforms to the paralysing complexity of tax laws and tax exemptions; and reforms to laws and rules that no entrepreneur or taxpayer is able to understand. Furthermore, solutions to the insufficient support of basic scientific research and to a highly inefficient university system have to be found.

In Germany, attempts by the finance minister to reduce the budget deficit are blamed on the Maastricht Treaty. Incidentally, this is also the case in France, Italy and elsewhere in Europe. Maastricht is even blamed for the existence of unemployment. In the current economic context, the 3% budget-deficit criterion seems questionable altogether. In a case of another oil price shock, every EU member state except the UK, which has its own oil, would be forced to increase expenditures and thus budget deficits. If, on the other hand, there were an economic recovery in Europe tomorrow, most of the member states would easily remain below the 3% threshold. This criterion only makes sense within a "normal" economic landscape. A budget, exactly calculated at the 3% budget-deficit level, implies an easy clearing of this hurdle during upswings and a default during downturns.

Nevertheless, this criterion was ratified as an integral part of the Maastricht Treaty. Consequently, it has to be honoured: *pacta sunt servanda*. It must not be overlooked, though, that the same Treaty allows for a significant amount of interpretive flexibility regarding permissible budget deficits. Article 104(c) stipulates that, as long as the ratio between budget deficits and GDP is surpassed only exceptionally and temporarily and as long as it remains in the vicinity of the reference value, the Council decides with a qualified majority after examining the overall economic situation whether there actually is an "excessive" deficit.

...and Debt Too

An analogous argument can be made for the other criterion evaluating the fiscal situation of a member state. The Treaty states that the overall level of debt in relation to GDP is not to exceed 60%. Currently, only France, the UK and Luxembourg meet



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with this condition. Germany is trying to do the same for 1997 but it is doubtful that the finance minister will be successful. The dubious logic of the 60% debt criterion as a basis for EMU participation can be highlighted by examining the situation in Belgium and Luxembourg. In 1995, Belgium's public debt was 135% of GDP, Luxembourg's was 8%. This, despite the fact that both countries have been using the same currency (the Belgian franc) for a considerable amount of time.

This criterion is also an integral part of the entire Treaty and therefore needs to be honoured. But a similar amount of flexibility exists. In regards to both fiscal criteria, Article 104(c), Section 3, applies in cases in which a member state complies with neither or only one of these criteria. In these instances, the Council will take into consideration whether the deficit exceeds public investment. It will also take into account every additional factor deemed relevant, including the medium-term economic and budgetary situation. What matters, in the end, is the qualified majority of the Council—that is, the political will of the heads of government.

Why EMU is Important

This leads to the question of why the heads of government agreed on EMU, the most important and only concrete part of the Treaty of February 1992. The reason is that, without it, the so-called "common market" would remain a torso to atrophy into a mere free-trade zone, after which the political will to strive toward an increasing degree of political and economic integration would likely dissipate as well. If France and Germany were not integrated, Europe at the beginning of the 21st century would find itself exactly where it had been during the 19th and first half of the 20th century.

Helmut Kohl knows this. Germany has a pivotal strategic interest in preventing a return to a situation in which many of its neighbours form an alliance against the menacing strength of Germany, both perceived and actual, in an attempt to control the Germans. When, in this context, the Chancellor talks about peace and war, he is, though overly dramatic, correct in his interpretation.

Many opponents of EMU behave in a rather opportunistic fashion, attempting to ride the wave of popularity that they themselves created. With their expert studies they have been wrong so frequently that they want to be right at least once by supporting their self-fulfilling prophecy. And once EMU has been prevented, nobody can show any more that their "sacrifice" theory—the surrender of the D-Mark in exchange for the inferior Euro—was complete nonsense.

Convergence is Sufficient, but Unnecessary

Over a prolonged period of time, the Bundesbank Governor and some of his colleagues have accumulated a variety of anti-EMU arguments. According to the weakest of these arguments, EMU has to fail without some form of European statehood spanning over the common currency, as if the common international gold standard (prior to World War I) had not functioned wonderfully without a common political authority. Since the European Central Bank has been designed as a highly independent political institution (including a one-term limit for council members that prevents any conflicts of interest on their parts), a central European government, if established along the lines of the Bundesbank's demands, would be powerless towards ECB decision-making, just as the German government is prevented from influencing Bundesbank policies. This reasoning behind the Bundesbank's demand for a European government that, in any event, would not have any monetary authority is puzzling. But take the arguments where you can find them!

The Bundesbankers, who have become even more powerful since the introduction of quasi-flexible exchange rates following the 1993 currency crisis in Europe, have a very fundamental motivation for their objections to EMU. They do not want to become merely a dependent branch of a central bank that is even more independent than they are.

The political independence enjoyed by the Council of the ECB, firmly embedded in the Maastricht Treaty, will secure monetary policies that are aimed only at one target—price stability. No budget deficit in any member state will deter them from that goal. Quite the opposite: should one member state borrow excessively, it will have to offer higher rates of interest in order to sell its bonds to the capital market. The ECB must not buy them. Should unions and management in one member state sign overly generous collective bargaining agreements, higher liquidity will be required. Without any accommodation from the ECB, higher rates of unemployment will be the result. Clearly, a country that acts in violation of its economic interest would only hurt itself.

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Those who insist that the convergence of the EMU participants remains insufficient for a successful monetary union should analyse the saving, inflation and unemployment rates, as well as productivity figures and per capita GDP of the potential member countries. The differences among France, Germany, the Netherlands, Belgium, Denmark or Austria are much smaller than, for instance, the differences between the German states of Mecklenburg-Vorpommern and Bavaria, between Luxembourg and Brussels, or between Ile de France and Languedoc. Nevertheless, in all three of the aforementioned cases, the same currency is used and thus the same monetary policy is pursued.

In the public debate, the convergence argument is highly overrated. If economic convergence were a prerequisite for a common currency, imperial Germany could not have used the same Mark in Pommerania and the industrial Ruhr area; the United States could not use the same dollar for the New England States and Louisiana; the old Russia could not have used the same rouble for the Ukraine and Siberia; and Japan could not use the same yen for Hokkaido and Honshu. Despite a common currency, no economic convergence took place in any of the above countries. It is just not necessary.

Why EMU is Good for Germany

Economic anti-EMU arguments are unconvincing. By analysing the economic consequences of either a postponement or a complete abandonment of the EMU project (a postponement of the introduction of the Euro beyond 1999 would likely result in the abandonment of the entire EMU venture), the advantages of the currency union for Germany's economy become immediately evident. Without EMU, the trend appreciation of the D-Mark would continue. The increased external value of our currency has threatened Germany's economic stability: it has reduced import prices (and increased export prices) to an extent that hundreds of thousands of jobs were eliminated in the process. Since 1991, the D-Mark has appreciated by about 12%, inducing companies to invest abroad. That way, hundreds of thousands more jobs disappeared. Our world market share in the engineering industry, in electronics, automobile and chemistry has—due to the high value of the D-Mark—steadily been falling, with massive job losses as a result. Who imparts these facts to the Bundesbank? Preventing the currency union means taking responsibility for even more lost jobs.

But there are other less immediate reasons why the abandonment of EMU would be bad for Germany. First, the abandonment or just the postponement of EMU would undermine public confidence in continuing European integration so severely that the entire process of integration, both politically and psychologically, would be threatened.

Second, the European countries and their currencies would continue to be exposed to the erratic fluctuations of the US dollar and the passion for speculation that exists in the globalised financial markets. Germany alone would be too weak—and the volume of the D-Mark too small—to protect us effectively, not only from fluctuations vis-à-vis the US dollar but also from those against the Japanese yen (and, in the foreseeable future, the Chinese renminbi).

Third, within the torso of the oddity that is euphemistically called the "common market" (never in world history has there been a common market with a dozen fluctuating currencies), powerful protectionist tendencies would likely re-surface. Once on that slope, the free movement of capital, goods and services might be endangered as well, a development that would potentially culminate in the demise of the European free-trade zone.

The Last Opportunity?

A change in the Maastricht Treaty, or even a mere prolongation of its implementation period, puts Europe's integration process in disarray and her future in jeopardy. It was bad enough in the summer of 1993 when Paris and Bonn/Frankfurt suspended the EMS for pointless reasons of political prestige rather than follow the rules and change the central rates. In the end, the markets did the latter. The ECU, well-introduced and widely accepted in international capital markets, died along the way.

It appears that the Maastricht Treaty is not only the second but also the last opportunity for Europe to create a common currency. It is about time that our provincially-minded foreign politicians and economists realise that, if they talk this opportunity to death, they play on the appalling instrument of populist angst. When the first human beings started to walk on two legs—according to the words of Johannes Gross—one German immediately joined in to warn that it would be dangerous, they would collapse, with particular danger to children and old people. A mean, yet realistic satire. EMU must not be endangered by Germans. If we destroy the common currency project, we will isolate ourselves and thereby act against our own interest. ◆