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ASPECTS OF EUROPEAN ECONOMIC AND MONETARY UNION

As expected, the heads of government who met on the first weekend in May decided that eleven member states (all EU countries with the exception of the U.K., Denmark, Sweden and Greece) would enter the third stage of economic and Monetary Union (EMU) on 1 January 1999 and would convert, with no effect on the purchasing power, their national currency to a single European currency: the Euro.

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With a population of 290 million and a gross domestic product of ATS 84,000 billion (approximately 6,000 billion Euro), EMU will become the second-largest single currency area in the world, initially representing some 80 percent of the EU's economic activities. Euro-denominated circulation for internal payment transactions will immediately equal that of the dollar as the national currency of the USA. As an international reserve currency, the Euro will similarly gain importance, although in this respect it will, at least initially, lag behind the dollar.

OBJECTIVES OF EMU

The Austrian business community will soon have a major global currency for use as its own currency. The Euro will go a long way towards bolstering international transactions against exchange rate fluctuations – turbulent developments in recent years provide a strong argument in favor of the single currency, which is aimed towards improving the efficiency and thus the stability of the internal market.

Companies and consumers alike will benefit: the costs and uncertainties of exchange rate fluctuations will be a thing of the past, as will be the expenses associated with conversions between national currencies. On the other hand, banks will be hit directly by EMU, suffering losses in their foreign exchange business.

Within the single currency area, these factors, as much as the greater price transparency, will boost competition and in this way keep price levels low. Given the sheer size of the currency area, the cost of financing will tend to decline, as capital markets are expected to become more efficient. Added to this is the expectation that the Euro will give European businesses more influence on the global economy. In terms of economic policy, the establishment of EMU will provide a strong impetus for tackling harmonization also in other areas (state finances, taxation).

Next to these objectives of a primarily economic nature, political motives have been a major driving force in implementing the single currency project. The Euro can be interpreted as an expression and symbol of the intent to achieve ever closer integration. And for some member states, EMU means that the factual dominance of the German Bundesbank will be replaced by Federal power exerted through the European System of Central Banks (ESCB).

OBJECTIONS RAISED BY ECONOMISTS

Economists continue to disagree in their assessments of the venture. Their objections can be grouped around the following issues:

1. The Euro zone about to be established does not constitute an optimal currency area, given the great cyclical and structural differences among participating EU economies, in spite of having met the Maastricht criteria. It will no longer be possible for them to employ national interest and exchange rate policies to compensate for gross divergencies ("asymmetric shocks") in the economic development of some countries.
2. There is some doubt whether the criteria, and in particular those of a fiscal nature (net deficit and government debt in terms of GDP) can be sustained in the long run, considering the temporary measures and creative accounting efforts used to achieve them, especially since the unsatisfactory labor market situation has forced all participating states to accord higher priority to employment issues, a course of action which was incidentally agreed between EU member states (Council resolutions in Luxembourg, November 1997).
3. The introduction of a common currency rather restricts the scope of action available to national budgets in their monetary policy responses. In the interest of fostering confidence in the Euro, overly expansive national budget policies need to be restrained in order to avoid possible detrimental effects on the other partners. Yet this means that two of the main traditional control instruments are no longer available to national governments or at least greatly reduced in their effectiveness.
4. Other economic mechanisms to adjust to asymmetric economic conditions appear to be less effective in western Europe than, e.g., in the USA, the consequence of a social model based on the welfare state and the strongly localized linguistic and cultural roots. Among the economic adjustment mechanisms typically referred to in the literature are flexibility of real wages and other labor market adjustments, including labor mobility.
5. Past experience has shown that currency unions usually fail when no common political institutions are available to restrain special national interests. Within the European Union, EMU has not been provided with central bodies which could efficiently harmonize and settle divergent political and economic interests. The ESCB must pursue its currency policy based solely and exclusively on the goal of monetary stability. The bodies of the European Central Bank are entirely independent politically. Member states differ substantially with regard to issues of political control and considerations of other economic interests than price stability. The search for a solution to these issues will be greatly hampered by the simultaneous need to reform the EU institutions and negotiate the next enlargement round.

Arguments along these lines are voiced primarily by German economists and several noted colleagues in the USA. Some even go as far as to describe the current framework of EMU as a "gamble"[1] or suggest that the single currency could lead to conflict and even war (*Feldstein,* 1997).

Most of these arguments are based on the theory of an "optimal currency area", developed by Robert Mundell in 1961 (*Mundell,* 1961). According to this theory, a single currency area promises to deliver greater efficiency for participating national economies and greater stability provided that economic conditions and responses are approximately parallel.

When economic conditions differ greatly between participating economies (asymmetric shock), these would need to have at their disposal at least the following responses, as they have lost the instrument of devaluating their currency:

- mobility of the production factors, especially of labor, which would have to move to places where employment conditions are better,
- flexible response by wages and prices, in order to re-establish competitiveness,
- a high degree of fiscal policy integration within the currency area, which would have provisions for transferring fiscal resources between countries or regions, which in turn appears to require a strong central political power.

In terms of the movement towards integration, the optimal currency area theory spawned the "crowning theory", according to which Monetary Union is feasible only as the

[1] *Obstfeld* (1997), with contributions by Alberto Alesina, Richard N. Cooper et al., and *Jacquet* (1998).

crowning conclusion of a long and comprehensive process of political and economic harmonization.

Various empirical proofs have been forwarded to show that while the Euro's core zone – Germany and its neighbors France, Belgium, the Netherlands, Luxembourg and Austria, which have already linked their currencies[2] – will come close to the theory's stipulation of similar economic and structural conditions, both mobility and compensatory transfers are non-existent in this zone. And as to the peripheral states of Italy, Spain, Portugal, Ireland and Finland, none of the theory's criteria will apply.

ANALYZING THE CRITICISM VOICED AGAINST EMU

While it is a fact that the national economies about to join in EMU have so far failed to acquire the required measure of congruity, this need not be a structural constant. It might indeed be argued that they will achieve convergence only under the influence of EMU. In contrast to the "crowning" theory, such a line of argument reflects a dynamic view:

Economic interpenetration of the national economies will increase, and thus the risk of asynchronous business cycles will decrease – quite a few of the asymmetric shocks of the past were due to exchange rate fluctuations, which will become impossible under the Euro –, and differences in financing structures, especially with regard to responses to changes in the central bank discount rates, will level off, influenced by relatively uniform interest rates. Eventually, wages and prices, faced with a degree of unemployment that can no longer be alleviated by devaluation, will respond with greater competitiveness and progress in productivity[3].

Efforts by some participants to reduce their extremely high government debt, which might even endanger Monetary Union, will be greatly facilitated by the lower interest rates prevailing in EMU. The direct influence of a large public debt on common monetary policy has been rather exaggerated in the political interpretation of the fiscal criteria of Maastricht. A low debt level certainly provides for sounder foundations for EMU, but the debt policy of some governments would have to be consistently excessive in order to place an undue burden on their partners.

Austria has some experience in adjusting its national economic policy to external factors, which derives from the time when it pursued a hard currency policy, linking its schilling unilaterally to the DM (since the late 1970s) and practically foregoing the devaluation option. At the time, political decision-makers may not have been fully aware of the consequences that would be required in terms of budget and income policies. But confronted with the danger of slanted current accounts and loss of market shares, incomes policy in particular quickly learned to orient itself on the fixed exchange rate.

An additional factor neglected by the optimal currency area theory is the margin left to national policy, which is by no means to be depreciated: by offering itself as a suitable business location, a member state can design the supply-side conditions for its economy, at least in the medium term, so that its price and cost development – and thus its employment situation – can be improved. Key elements of such a strategy would be to reduce supra-plant costs, raise efficiency and, most of all, reform the public sector.

Active employment policy and stability with the EMU need not necessarily be a contradiction in terms: provided that the labor market situation is improved by the elimination of structurally caused obstacles to employment and provided that the misallocation of resources is alleviated, this will put a damper on prices and costs and stabilize the national economy in economic and political terms.

The second group of objections concerns the limits placed on the budgetary leeway. Critics feel that the agreed ceilings for state deficits are too low in the event of a downswing, especially as there is serious doubt as to whether national households will have been sustainably consolidated upon their joining EMU.

There is no doubt that many EMU countries need to continue their efforts to improve state finances, especially in view of their future financial needs to cover items such as old-age provision.

The margin allowed for automatic stabilizers to be effective in the event of a downswing certainly needs to be increased everywhere, and particularly in Austria. Varying the state deficit by ±2 to ±3 percent of GDP to reflect cyclical variations nevertheless appears sufficient when judging recent experience[4]. In addition we can assume that asynchronous setbacks will become rare and less marked under the EMU regime. And if a synchronous crisis should occur, the ECB could adjust its monetary policy accordingly.

There is some justification to the criticism that EMU has no effective central institutions that can be used to adjust

[2] *Bofinger* (1994), *Gros* (1996), *Bayoumi – Eichengreen* (1996).

[3] The empirical evidence furnished to prove that flexibility in real wages has so far been inadequate is unconvincing because it neglects the change to EMU which will create effective incentives (*Obstfeld,* 1997, p. 274).

[4] *Url* (1997) estimates the cyclical component of the state deficit in Austria to be less than 1.75 percent of GDP in most cases.

other economic policies, so that special national interests could run counter to its monetary policy. We need to understand that the European Union won't have the constitutional structure of a federation for a long time to come. It is therefore necessary to develop political institutions that reflect this type of a closely linked group of states which has no equivalent in human history.

The economic provisions of the Union Treaty, especially those relating to household discipline (art. 104c) and the definition of economic policy as a matter of common interest (art. 103), together with decisions to improve the standing of Ecofin, the Economic and Financial Affairs Council, certainly provide the building stones to achieve effective co-ordination of economic policy in the Union.

The objection that the Union has no fully established system in place which might facilitate transfers of fiscal resources in order to cope with national, regional and sectoral specificities is certainly true, especially when we compare the rather meager means available to the EU with the amount of internal transfers used elsewhere, especially in Federal states. The Union's structural funds and the provisions of art. 103a par. 2 with regard to exceptional problems of a member state nevertheless should not be disregarded as a point of departure in that direction. If and when a situation arises that calls for appropriate action, more far-reaching arrangements are conceivable within EMU. Monetary Union will certainly provide an impetus to reconsider fiscal federalism in the Union beyond its current standing.

To summarize, there is little doubt that some participants in EMU are still lacking adequately homogeneous structures, and that institutional facilities to ensure proper operation of Monetary Union could be found wanting in an extremity. The EMU venture certainly has its measure of inbuilt risks. Yet there is a chance that participants will learn and become more flexible under the influence and with the help of Monetary Union – a prospect that will necessarily be overlooked by econometric research based on historical data due to its inherent systemic approach. The degree of convergence achieved within a short period already before the start of EMU is unexpected and encouraging, in spite of some doubt as to the measuring parameters.

There is one factor which is ignored in many comments, especially and typically those furnished by economists: if it is true that the creation of EMU harbors risks, then it is even truer that for the EU to continue in its current ways would be expensive, inefficient and risky. Protectionist responses to devaluations by member states would threaten the continued existence of the single market at least as much as tensions and rigidity would endanger EMU. From a national viewpoint, devaluation might be the instrument of choice in some cases – and it certainly is presented as such by many economists; but from the EMU's viewpoint, it is an instrument that certainly impairs the Union's and thus the partners' welfare. Any attempts towards "beggar my neighbor" policies should be systematically suppressed in a single market.

CONSEQUENCES FOR ECONOMIC POLICIES

From an economic point of view, it is both desirable and probable that EMU will be a success, yet there is no guarantee that it will be so. EMU will improve key framework terms for its participants, yet it needs to be accompanied by sustained reforms in the area of economic policies. It may well trigger another wave of harmonization within the EU. Within its scope, there are several major tasks in which economic policy needs to become active:

Participants will have to keep their budgetary restrictions in place for some years to come, in order to get back their maneuvering capacity in the face of cyclical developments. Budgetary reforms will now have to extend to areas that were set aside during the first stages of consolidation. These include mainly the public sector and should be aimed at improving efficiency and reducing the cost burden carried by the economy. If western European states wish to remain credible in their expressed desire to preserve welfare state facilities, they need to be flexible and innovative at the detail level.

Monetary Union will have hardly any directly alleviating effect on unemployment. Although EMU holds out the promise of added value and thus added jobs in the long run, and although some of the former high-interest countries appear to be favored by a convergence of interest levels, EMU simply does not create jobs in the short run.

Quite the contrary: if, as expected, the ECB does a credible job of fighting inflation, and in view of the EMU-induced merger mania, labor market pressure could initially be further increased. Participants are thus urgently called upon to implement without delay at the institutional and structural levels those labor market policies outlined in their national action plans (active labor market policy, education policy, R&D organizations, etc.) which are only marginally dependent on increased state spending.

Budgetary restrictions furthermore mean that there is little willingness at national level to raise more funds for federal transfer payments at Union level. This attitude is further hardened by the burden that the next round of enlargement is expected to involve. Nevertheless, EMU might well widen the scope of Union financing, to enable it to respond effectively to Community concerns (e.g., trans-European infrastructure) and economic imbalances.

EMU will also provide some momentum towards further harmonization of the tax system. This will affect primarily taxation of investment income (withholding taxes) and of capital earnings, and subsequently taxation of sales and consumption. If no agreement is reached along the lines of the new code of conduct directed against unfair competition in corporate income taxation (which aims to fight corporate tax tourism), then Monetary Union will practically force its members to harmonize taxes, which could make it difficult to balance state households and fulfill the duties of governance.

EMU will heat up competition between business locations in Europe. National promotion policies will thus be of even greater importance. In spite of the trend towards tax harmonization, tax rates themselves are not expected to be harmonized. Improving the efficiency of the public sector is

Aspects of European Economic and Monetary Union – Summary

European economic and Monetary Union (EMU), due to start in 1999, is expected primarily to improve the effectiveness of the internal market because it should eliminate most of the uncertainties surrounding exchange rates and their costs. EMU will strengthen competition and put the risks of foreign trade and international investment on a more calculable basis. There are also grounds to assume that the single currency, being a viable alternative to the dollar, will provide more weight and influence for the European Union as a player in the global economy.

Eurosceptics, which count quite a few economists among their ranks, raise a number of objections to EMU: they doubt that the eleven countries are an "optimal currency area"; they fear that further budget consolidation, a necessary condition for stability, will not continue, that there is insufficient margin to compensate for asymmetric shocks, that there could be situations in which devaluation is the instrument of choice; they expect the strained labor market to exert heavy pressure on governments and the European Central Bank, and that national emotions will run high; and they feel that a central monetary policy would need to be accompanied by similar common institutions to co-ordinate other economic policies.

All these objections are true in principle and they certainly constitute risks for the working of EMU. Yet they overlook several provisions and mechanisms put in place to ensure that EMU will become and remain functional. Establishing Monetary Union will help states faced with massive budgetary problems because it reduces expenditure on interest and invigorates the economy. EMU will bring transparency to inconsistent wages and price policies, thereby fostering efforts to put them on a basis of productivity. Employment initiatives are not necessarily inconsistent with budgetary consolidation – indeed in many cases what is needed most is organizational improvements that have little impact on the budget. And the institutional provisions to co-ordinate economic policies and ensure independence of the European Central Bank are designed to perform efficiently and inspire confidence.

Ultimately, we need to consider that the European Union's political structure constitutes integration sui generis, which cannot be compared with any historical predecessors.

Many critics also tend to overlook that there is no alternative to EMU that does not include at least some level of risk. Loose co-operation within the European Exchange Rate Mechanism clearly demonstrated the limits and enormous risks involved in that structure. In the long run, the system has been putting a major strain on Europe's position in the global economy.

Austria in particular has sound reasons to participate in EMU: For many years now Austria has designed its economic policies in a way that anticipated EMU conditions by fixing the ATS/DM exchange rate. This unilateral link has made the Austrian economy stronger and more dynamic in general. Austria has very close ties to the Euro core zone, which can with some justification be seen as an "optimal currency area". If Austria were to stand apart, this would deprive its economy of the advantage of using a global currency as its own currency and would have it fall back on a schilling currency that is prone to marginalization and speculation.

Yet the creation of EMU also constitutes a new challenge to economic policies and corporate competitiveness. A major concern is ensuring that budget consolidation will continue in Austria in order to have an effective response in the event of a downturn or other crisis. The chief item on the government agenda will need to be stringent cuts in the costs and structure of the public sector. Austrian businesses will have to live with more competition, which will nevertheless bring new opportunities. The acceleration of merger activities in Europe will have to be countered by specialization in niches as much as by building partnerships on a European scale.

thus a prerequisite for attractive tax rates and an argument in favour of a location. Other incentives will be provided by a public service that is business-friendly and by some measure of flexibility in trade and labor laws.

The Austrian economy will be in urgent need of such locational advantages – or rather of the elimination of current disadvantages. Faced with a Europe-wide trend towards concentrating locations and merging companies, which will be further accelerated, at least partially, by EMU (financial services, trade, transport, consumer goods producers), many SMEs will have to opt for specialization rather than cost leadership in mass production. But specialization requires not just excellent performances by the tangible and intangible infrastructure, but also flexibility and innovation of the legal framework set up by the state.

There is no need to exaggerate the divergent opinions and adaptation problems which are likely to emerge in the common currency area. If the venture were to fail, it would cost all its participants more than they need to spend on compromises to adjust themselves to a single monetary policy. The Euro needs to be a success because if it fails then European integration itself could be at stake.

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