

EUROPEAN MONETARY UNION: WILL IT REALLY CONTRIBUTE TO STABILITY?

C. Richard Neu
RAND

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[The views expressed in these comments are those of the author and do not necessarily reflect the views of RAND or its sponsors.]

The first almost year of the almost common European currency has gone generally smoothly. We have seen some minor--and probably predictable--miscues and crossed wires as new officials operating in new institutional settings made uncoordinated and sometimes contradictory comments. Markets have been briefly unsettled by this confusion, but no serious instability has resulted. For the most part, businesses, governments, and financial markets are adapting to operations in a new currency. Impassioned debates about the pros and cons of a common currency have been replaced by calmer discussion of just when it will be appropriate for the "outs" to become "ins."

Neither has anything transpired in the last 10 months to shake the widespread view that, from a political point of view, monetary union is a positive development. In both symbolic and practical terms, monetary union has been an important addition to the collection of institutions and arrangements that contribute to the creation of a unified, cooperating, and democratic Europe where national differences are resolved peacefully and constructively, and within which goods, investment, and people can move freely. By removing the possibility of competitive currency devaluations, monetary union has also eliminated a potentially troublesome threat to the long-run sustainability of the single European market.

In economic terms, too, monetary union promises some real--although initially modest--advantages. Within Europe, cross-border transactions have become simpler and less risky. In the longer run, this may result in more efficient patterns of investment and perhaps in deeper and more liquid financial markets, which in turn will lower the cost of capital. Overall, I see no reason to question the conventional wisdom that monetary union is already a Good Thing and that the benefits of monetary union will grow over time.

But this conference is about risk. Our task is to consider how monetary union has altered the risks faced by American and European businesses. What sorts of risks have been mitigated by monetary union? And what risks have been accentuated? In this regard, my assessment of monetary union is not so positive. I don't doubt the long-term benefits of monetary union. I will argue, however, that at least for the remainder of my professional life--the next ten or fifteen years, say--monetary

union has created some new risks to doing business with, from, and in Europe.

THE GOOD NEWS

Let me begin by giving credit where it is due.

I've already noted the elimination of exchange-rate risk in cross-border European transactions and the benefits that are likely to flow from this.

We must also credit monetary union with some reduction in the risks arising from misguided or whimsical national macroeconomic policies. Responsible policy among nations is a lot like greatness among individuals. Some are born with it. Some achieve it. And others have it thrust upon them. Europe has long had its examples in the first two categories. The arrival of monetary union has created some in the last category as well. By taking monetary policy out of the hands of national authorities, monetary union has almost certainly eliminated the worst and the most uncertain of European monetary policies. To a lesser but still important degree, the Stability Pact that has accompanied monetary union has accomplished something similar for fiscal policy. It would be impolite to name names. I can leave it to each of you to identify the countries that likely have been saved from their own policymakers and political processes by monetary union. This should be counted as an unambiguous benefit.

THE BAD NEWS

Against these reduced risks, however, we must set three other kinds of risks that I think have been exacerbated by monetary union. The first category of increased risks are those that arise from the reduced predictability, coherence, and quality of overall macroeconomic policymaking in Europe. Monetary union may have eliminated the worst of European policymaking, but I will argue that it has also compromised the best. The second set of increased risks are those that arise from increased variability and volatility in local real economic conditions within Europe. And finally, I think that monetary union will lead to increased uncertainty about--and maybe even increased strife over--social policies. Let me consider each of these in turn.

An Uncertain Common Monetary Policy

Whatever the political advantages of a single European currency, most economists concluded long ago that Europe just does not make the grade as an optimal currency zone. Basically, a one-size-fits-all monetary policy will not be reliably flattering for the very varied European figures. The three objections usually advanced are these:

- The various European economies will not be similarly or equally affected by external shocks. Consequently, all European economies

may not need the same monetary policies at any particular time. The Asian economic crisis cut deeply into manufactured exports from industrialized northern Europe, but not so deeply into the agricultural exports of southern Europe. Reform and growth in Eastern Europe will bring increased demands for exports of machinery from Germany, the Netherlands, and France but more competition for the lower-skilled workers of Italy, Spain, and Portugal. Changing oil prices will affect oil-exporting Britain very differently than oil-importing continental Europe. (This is perhaps the best reason for Britain's staying out of monetary union, at least for a while.)

- Labor mobility in Europe is low. Because of linguistic and cultural constraints, European workers do not move readily out of a depressed region to other places where jobs are more plentiful. (European workers are notoriously immobile even within countries, when language is not a barrier.) Thus, stimulus somewhere is not sufficient to combat unemployment and its political consequences. Stimulus has to be delivered where the unemployment is. This, of course, is precisely what a currency devaluation can accomplish. But currency devaluations, of course, are impossible after monetary union.
- Lack of fiscal federalism. In the United States, the federal budget --taxes and transfer payments--offset something like 35 cents of every dollar of disposable income lost in an individual state. To an important extent, Americans "are all in this together." When one region suffers, we all--to a significant degree--suffer. And thus to some extent, policy that is right for one state is right for others as well. But the entire EU budget is only one-and-a-quarter percent of GDP, much too small to allow any meaningful redistribution from temporary winners to temporary losers. When the business cycle or external events turn against them, individual European countries are pretty much on their own. Monetary union and the stability pact take away the main policy tools for smoothing out bumps in national income, and no other shock absorbers have been created to replace them. In the absence of national equilibrating mechanisms, national economic conditions will differ and so will national demands for policy.

The consequence of all of these is that macroeconomic policy in Europe is likely to be contentious. National differences--perhaps sometimes quite sharp--will arise over what constitutes appropriate monetary policy. Much less frequently than in the United States will there be consensus about the right course of monetary policy. And because fiscal policy is constrained--both nationally and in the aggregate--by the Stability Pact, monetary policy will have to carry that much more of the burden.

The European Central Bank is supposed to be immune from political pressure. Maybe it will be. But it cannot be and of course will not be indifferent to economic conditions. But how will it respond to these conditions? Even a highly independent Bank will be pulled in different directions, and probably just when its decisions matter the most. How

should the Bank respond when labor markets are tight in one part of Euroland and unemployment is high somewhere else? (Without labor mobility, this situation can easily arise and may persist for some time.) Will it be enough to set monetary policy so that inflation rates or employment are right on average? Or should the Bank seek to insure that unemployment is not too high in any single country? Or is it only economic conditions in the some subset of "core" countries that have to be right?

And what if the Bank cannot be immunized against competing demands from national governments? Even strong supporters of an independent European Central Bank seem to have doubts about whether this independence is possible. What justification is there for a Stability Pact that limits national fiscal policies if a strong and independent central bank can adjust monetary policy to guarantee price stability? Indeed, a Stability Pact is necessary only if there is reason to doubt that the central bank will have the stomach to raise interest rates high enough to combat the inflationary consequences of overly expansive fiscal policy. That is, a Stability Pact makes sense only if you doubt the efficacy of the central bank. There is a certain irony in the fact that an independent European Central Bank embodying the so-called neo-liberal philosophy of the conservative governments that dominated Europe in the late 1980s should finally come to life when eleven of the fifteen European governments are controlled by social democrats. It's hard to see how a collision between the ECB and Ecofin can be avoided over the next few years.

Put all this together and what you get, I think, is considerable uncertainty about the course of monetary policy in Euroland. For some time to come, we will all be guessing about how the ECB will react to new situations. And as we second-guess the ECB, we will all contribute to financial instability. Making monetary policy is a tricky business, even when there is rough consensus about the desired outcomes. How much harder will it be when there are multiple and potentially divergent interests--some of which will have potent political backers--about just what is supposed to be accomplished? I suspect that the ECB Governing Council does not know--CANNOT know--how it will react to situations it has not yet encountered. How it will react to the next Europe-wide slump or the next foreign financial crisis is not just a secret; it is a true mystery. You may not have liked the Bundesbank much, but at least you understood it. We will not be able to say the same thing about the ECB for many years to come.

Increased Volatility on the Real Side

Because one size of monetary policy will have to fit all countries in the monetary union, I think we must also expect more variation in real economic conditions around the edges of Euroland. With monetary union, the real economy of Euroland becomes something like a schoolyard game of crack-the-whip. For countries near the front of the line--call them Germany, France, the Netherlands, Austria--moving more or less in synch with each other, the common monetary policy will probably be just fine.

Indeed, policy will probably be designed with particular attention to these countries' needs. But for the smaller countries nearer the end of the line and moving sometimes in different directions from the bigger countries at the head of the line, the business cycle could provide a wild ride. Deprived of key tools for macroeconomic stabilization, these countries at the end of the line will see both positive and negative shocks amplified. Out on the metaphorical edges of Euroland, the main result of monetary union may have been a trade-off: less monetary and exchange-rate instability for more real-side volatility. This will suit sectors of these economies that are interest- and exchange-rate sensitive like construction or trade, but complicate life for those like retail or other services whose business depends primarily on real economic conditions.

Uncertainty about Social Policy

It is always easy to think of reasons why any particular time is not the right time to undertake a major institutional shift like monetary union. That said, European monetary union seems to have come at a particularly awkward time, with European unemployment at near record levels. The good news is that monetary union will make it much harder for countries to resort to the temporarily easy way out of high unemployment with stimulative macroeconomic policies. Pressure will grow to get on with structural reform. The bad news is that this reform is bound to be politically difficult and socially divisive. Most problematic perhaps is that reform will not proceed at the same pace in all countries, and this is likely to lead to squabbles, accusations of social dumping, and long harangues about a headlong "rush to the bottom." The result may well be a resurrected "social charter" or some other straitjacket to make sure that structural reform proceeds nowhere faster than it can in the most ossified polities. Before monetary union, we could always hope that a few of the countries would take the necessary steps, and we could place our bets accordingly. I fear that monetary union will make it more difficult for right-thinking countries to do the right thing. And if social policy goes bad, it is now more likely to go bad for all of Europe.

WINNERS AND LOSERS

So who wins and who loses as a result of monetary union?

Among the clear winners, I think, are firms for which financial and trade flows among European countries are important. These firms will no longer have to worry about exchange-rate movements or wide swings in national interest rates necessary to maintain some kind of currency peg. Not so favored are businesses engaging in substantial transatlantic flows. Our old friend the Bundesbank is gone, replaced by a new entity for which we have high hopes but which remains untried and which will inevitably face some very tough decisions. The course of the dollar/euro exchange is likely to be more volatile than was the dollar/DM rate. Perhaps the biggest losers will be firms whose fortunes

are tied to real conditions in particular national economies, especially in the figuratively peripheral Euroland economies. The way I see it, monetary union is a good deal for folks interested in building, say, Europe-wide banking or financial services empires. Folks trying to straddle the Atlantic, though, and folks outside the core of the EU who produce and sell locally, without much interest in or opportunity for diversifying across European borders, are going to take on some significant new risks.

Maybe this is the real political dynamic set in motion by monetary union: Monetary union favors pan-European economic undertakings and penalizes the purely national. This, more than a lot of political idealism and inspiring rhetoric, may be what ultimately produces a unified Europe.