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Patrick Holly Jr. '99
*Illinois Wesleyan University*

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# Politics, Economics and the European Union

## Abstract

The development of what is now termed the European Union (EU) into an unparalleled world trading bloc is a powerful case study in the trials and tribulations of achieving economic harmony among many countries. It is also a testament to the amount of time and work involved in achieving this economic oneness, for we have seen this kind of effort in the formation of another cohesive economic unit, —the United States.

## Keywords

history of the European Union, transition to national currency

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# Politics, Economics and the European Union

*Patrick Holly, Jr.*

Ever since Winston Churchill called for a United States of Europe in 1946, European political and governmental figures have been enamored with the idea of living on common economic ground. The end of World War II, the Marshall Plan for European reconstruction of 1947, and the ensuing Organization for European Economic Cooperation (OEEC) gave them a preliminary opportunity and opened the door for further collaboration. But it was the creation of the European Coal and Steel Community in 1951 and the Treaty of Rome establishing a full fledged European Economic Community (EEC) in 1957 that virtually guaranteed the opportunity for an eventual economic and monetary union. These events lie at the beginning of what has become a grand scheme to create a single European economic machine. For certain, the development of what is now termed the European Union (EU) into an unparalleled world trading bloc is a powerful case study in the trials and tribulations of achieving economic harmony among many countries. It is also a testament to the amount of time and work involved in achieving this economic oneness, for we have seen this kind of effort in the formation of another cohesive economic unit—the United States. Indeed, our own *economic* beginnings as a group of thirteen colonies can be equated to those of the EU, as both groups have gone through similar problems and now share many economic characteristics.[1]

The signing of the treaty of Rome in 1957 laid the groundwork for a new era in European economics by formally declaring a European Economic Community (EEC) that would work together to harmonize the various economies of Europe. Among others, its goals included: (a) The elimination of customs duties and quantitative restrictions on the import and export of goods among Member States; (b) a common commercial policy; and (c) an internal market characterized by the abolition...of obstacles to the free movement of goods, persons, services, and capital.[2] (We shall see later that these goals have been expanded to include a single currency.) These goals and others were to be achieved through a governing body not all that different from the United States in terms of structure. Provisions for a Parliament, a Council, a Commission, a Court of Justice, and a Court of Auditors were made to separate the duties of the EEC. These bodies still exist today.

The European Parliament's primary responsibility is similar to that of the U.S. Congress—it is the lawmaking body of the Union and oversees the construction and adoption of Union acts. The European Council oversees and aids in the coordination of the general economic policies of member states. The European Commission ensures that the provisions of the treaty are applied and formulates recommendations on matters within the Treaty. It has no equal in the world. The Court of Justice is present to ensure that the correct interpretation and application of the Treaty is observed. Finally, the Court of Auditors regulates Member States by researching their actions to assure compliance with the Treaty and its goals. It does this primarily through observations of revenues and expenditures of the EEC and of the individual Member States. (The U.S. structural equivalents, barring the Commission, would be Congress, the Presidency, the Judicial System, and the IRS respectively.)

As you can see, the Treaty of Rome designed a governmental structure similar to the U.S., complete with a clearly defined separation of powers amid a centralized body. It is no surprise that the framers of the Treaty chose a more centralized body. While there is no doubt that most of the countries in Europe are more socialistic than the U.S., history has also shown through the failure of the Articles of Confederation (the first U.S. government) that a severely decentralized system fails to adequately aid in the allocation of funds, the managing of interest rates, and the creation of a common commercial and tariff policy for a large group of independent states.[3]

One of the primary mechanisms through which the Treaty of Rome chose to manage transition toward an intertwined European economy was the European

Investment Bank (EIB). "The task of the European Investment Bank, the European Union's financing institution, is to contribute towards the integration, balanced development and economic and social cohesion of the Member Countries. To this end, it raises on the markets substantial volumes of funds which it directs...towards financing capital projects according with the objectives of the Union."[4] In other words, the EIB was created to balance the economies of the Member States by encouraging investment in the poorer countries.

As time wore on after the Treaty of Rome was signed, there grew a desire and a need for a common monetary policy complete with monetary integration. "As early as 1962, the Marjolin memorandum pointed out that, whereas the Treaty of Rome had foreseen a common trade policy, it had not envisaged a common monetary policy; it was felt that this lacuna should be filled."[5] Since the Treaty of Rome subjected exchange rates for Member States to narrow fluctuation margins, this memorandum revealed that after a period of transition, it would be necessary to fix exchange rates and head towards a single currency before the management of the various currencies became too difficult.[6] A similar sentiment spread across the U.S. when the Articles of Confederation was still law. Every state having its own currency was becoming cumbersome, leading to a difficulty in maintaining the "exchange rates" between states for lengthened periods of time. It also made intrastate trade more difficult than it needed to be.[7] This movement, however, lost momentum in the mid-1970s in Europe due to divergent policy responses to the economic shocks of the period (ie: OPEC, Fall of Bretton Woods, etc).

*Europe lasted longer than the U.S. without economic harmony and a single currency because its countries were never under one government.*

January of 1979 saw the revival of the movement towards a single currency with the creation of the European Monetary System (EMS) and the European Currency Unit (ECU). Then, in June of 1988, the European Council confirmed monetary and economic union as an EEC objective and appointed the president of the European Commission, Jaques Delors, to study and propose stages leading to this union. Their research proposed that complete economic and monetary union should be achieved in three evolutionary steps:

**Stage One** represents the initiation of the process of creating an economic and monetary union.
**Stage Two** is the period of transition to the third and final stage, during which the basic organs of the union will be set up, most notably the European System of Central Banks (ESCB).
**Stage Three** commences with the move to irrevocably locked exchange rates and the introduction of a single currency. The ESCB becomes responsible for monetary policy and exchange rate management, among other things.

As of 1994, the EU has been in Stage Two of this process. Stage Three is slated to begin no later than 1999 and is to be in full force with the euro as a single currency by the year 2002.

The proposition of these stages and the declaration of monetary union created the necessity to revise the Treaty of Rome. The resulting negotiations formed the Treaty on European Union, signed in Maastricht on February 7, 1992. This treaty expanded the role of the Treaty of Rome to include provisions for monetary union and effectively renamed the EEC the European Union (EU). It outlined goals to: (a) fix exchange rates on the way to common currency; (b) develop close coordination among Member State economic policies; and (c) coordinate a single monetary and fiscal policy for the entire EU.

The Treaty on European Union also establishes protocol on the European Monetary Institute (EMI) and the ESCB. The former (which is now in force) is primarily a buffer between Stages One and Three, and is to be liquidated at the onset of Stage Three—the start of the ESCB and the introduction of the euro as a currency. Thus, the EMI and the ESCB will never coexist. The EMI is present as an advisor for policy coordination, but does not have any active involvement in monetary policy operations. It carries

out its tasks primarily through persuasion. Its other primary responsibility is outlining the framework for carrying out a single monetary policy in Stage Three. It is this duty that will allow a smooth transition to the ESCB. The ESCB will assume powers comparable to those of the Federal Reserve System of the United States.

As the EEC became more stable and mature, its popularity among non-member states grew substantially. This was the reason the Treaty on European Union also established several conditions that were to be met before a nation could join the Monetary Union: (a) The inflation rate must not exceed by more than 1.5 percentage points the average rate of the three community nations with the lowest rate; (b) its budget deficit must not exceed 3 percent of its GDP and its overall government debt 60 percent of its GDP; (c) long-term interest rates must not exceed by more than two points the average interest rate of the three countries with the lowest inflation rates; and (d) its average exchange rate must not fall by more than 2.25 percent of the average of the EMS for the two years before joining.[8]

After continued interest in membership and continued growth in scope, it was determined that the Treaty on European Union needed further revision. These revisions combined to produce the Treaty of Amsterdam. Basically, this treaty, signed on June 17, 1997, makes minor amendments to the Treaty on European Union, updating it for the 21st century and preparing it for the allowance of a wealth of new members. Included in the revisions are the following: (a) A clear statement of intent towards a single currency; (b) a declaration of intent for a common defense policy; (c) declaration of a common foreign and security policy for the entire EU; (d) declaration of political solidarity; and (e) declaration of the need for the necessary social security programs to provide freedom of movement for workers.[9] This fine tuning affords the EU a greater means by which to achieve economic cohesiveness. It is interesting to point out that when the U.S. Constitution was framed, all of these goals and expectations were present[10], with the exception of the necessity of social programs. (Although that difference has more to do with politics than with economics.)

Coinciding with the provisions of the Treaty of Amsterdam was a separate doctrine called Agenda 2000. Revealed on July 16, 1997, it promoted extensive expansion and rigorous monitoring of the policies of the EU. According to European Commission president Jacques Santer, "It is a strategy for strengthening growth, competitiveness and employment...and for extending the Union's borders through enlargement eastward toward the Ukraine, Belarus and Moldava."[11] The doctrine recommends, among other things, that accession negotiations start with Hungary, Poland, Estonia, the Czech Republic and Slovenia. Bulgaria, Romania, Latvia, Lithuania, and Slovakia will be invited to join soon. The Agenda plans to maintain its strength amidst this aggressive expansion through further institutional reform and a review of the Commission's organization and operation, development of internal policies for growth, employment, and quality of life, and maintaining economic and social cohesion through more effective structural funds. As a sidenote, this doctrine could be seen as a quasi-European version of the Monroe Doctrine and Manifest Destiny, although these American declarations were motivated more by greed than by economic virtue.

The EU of today is the largest free-trade association in the world. It boasts 15 Member States with more on the way, and is well prepared to face the next century. The comparisons of its growth to that of the early U.S. are substantial, if not perfect. The economic plight of the original thirteen colonies under the Articles of Confederation mirrored that of Europe before W.W.II. Europe lasted longer without economic harmony and a single currency, however, because the separate countries were never under a single government. Regardless, the similarities in their "exchange rate" problems, their common commercial policy yearnings, their tariff problems, and their governmental structural design (among others) forces a notable comparison. The question that remains is whether Europe will take that extra step in a few decades towards a single government to compliment its strong, unified economy. But that is beyond the scope of economics.

**PART TWO**

> *The different regions of the European Union are a patchwork of distinct cultures, languages, histories and traditions. They are also characterized by different levels of income, and therefore cannot offer all citizens equivalent opportunities—the 10 most prosperous regions in the EU are three times as rich, and they invest three times as much in their economic fabrics as the 10 poorest.*[12]

It was asserted previously that the structural development of the European Union was very similar to that of the United States, both economically and politically. But this comparison ends when observing the economic climates in which these two have developed. Whereas the economic environment under which the U.S. grew was secluded from the rest of the world, the respective environment that the EU has grown under has been open and global. As a result, it can be said that the closed economy of the U.S. made it easier to coordinate the various currencies that existed at the time when the move to a single currency took place. Coupled with the fact that the technology of the time didn't allow for as rapid a transfer of money, the states of the Union and the U.S. Federal government didn't have to worry significantly about speculative attacks throughout the process. The EU, however, is influenced greatly by the technology-ridden, open and global economy that persists today. Consequently, its development plans for the move to a single currency have been made more complex, both in terms of politics and economic theory. The fine line between economics and politics has become considerably blurred to a much larger extent than that of the U.S. in the early 1800s. It will be seen that the decisions reached on the provisions of monetary union have been based on large political compromise just as much as economic theory, and that these decisions are still being debated.

Because of the volatile nature of today's market, a move to a single currency is very risky and complicated. This complication led to the previously mentioned "Delors Report," which proposed in 1988 that economic and monetary union should be achieved in these three steps, explained in further detail here:

**Stage One** represents the initiation of the process of creating a monetary union. It would aim at a greater convergence of economic performance through the strengthening of economic and monetary co-ordination. It began on 1 July 1990 and terminated at the onset of Stage Two on 1 January 1994
**Stage Two** is the period of transition to the third and final stage, during which the basic organs and structure of the union will be established and prepared by the European Monetary Institute (EMI). This stage will end on 1 January 1999 at the onset of Stage Three and the liquidation of the EMI.
**Stage Three** commences with the move to irrevocably locked exchange rates and the introduction of a single currency to replace all EU member national currencies. Simultaneously, the European System of Central Banks (ESCB) assumes control for formulation and implementation of monetary policy, exchange rate management, and the maintenance of a properly functioning payment system. More will be mentioned about the EMI and the ESCB later.

At the onset of Stage Three, the national currencies and the euro will become different expressions of what is essentially the same currency. In other words, national currencies and the euro will coexist interchangeably for a period of three years. At the end of these three years (1 January 2002) the ESCB will begin the process of overtaking the national currencies. At the latest, six months after the onset of the national currency buyout, national banknotes and coins will lose their legal tender status.

There is still much debate concerning this approach to monetary union, for many believe that it should not be gradual, but instead instantaneous. "There are very few successful processes of monetary unification that (have) proceeded gradually...Some economists have argued that this strategy of slow convergence of the inflation rate in the high inflation countries to those of the low inflation countries is risky, and in the end may fail to bring inflation rates to equality."[13] The reasoning behind this is as follows. It is unlikely that the authorities of high inflation countries can convince speculators and other economic agents that they are as mindful of inflation as the authorities of low inflation countries. Speculators'

power makes this assertion more concrete. The high-inflation country that is attempting to converge will face high nominal interest rates because their inflation expectations decline slowly.[14] Since the exchange rate is fixed, this creates an opportunity for speculators to take advantage of short term capital inflows (i.e.. high inflation country's currency is cheap and attractive to other countries). "This capital inflow...tends to increase the domestic currency money supply stock of the high inflation country, making it all the more difficult to follow an anti-inflationary policy."[15] This reasoning is also used to assert that it would be easier for member countries to satisfy the convergence criteria set by the Maastricht Treaty *after* monetary union has taken place. The convergence criteria will be outlined later.

These arguments could lead one to believe that it is better to converge economies immediately in order to avoid a loss of credibility. But this is where the politics of the situation enter. "It is conceivable that governments might use an extra year or two to deregulate, free up sclerotic labour markets and make their economies more competitive; but they are just as likely to seize the excuse to slow down politically painful measures."[16] Because governments and constituencies might not respond well to the potential shocks of an immediate changeover—whether because they will not be popular politically or they will not be easy to overcome economically—most have demanded a transition over time. Indeed, many European countries have been plagued with high unemployment as of late. An immediate change could temporarily make situations worse for the voting constituency of these countries, whereas a gradual transition could allow governments to ease their pain. As a result, politics has won over what may be a better economic plan.

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The role of the EMI and the ensuing ESCB will be all important to this political decision. The EMI will be acting as a bridge between Stage One and Stage Three, and has two main tasks: (a) to contribute towards the convergence of the main macroeconomic indicators; and (b) to make required preparations for the establishment of the ESCB and the conduct of a single monetary policy under a single currency. The EMI is not a central bank and cannot conduct monetary policy, but it has considerable power in that it will largely research and define the role of the ESCB and its duties. To this end it is the perfect political tool for the gradual formation of a single monetary unit—it buys a lot of time for the various member governments. Because the EMI reports regularly to the Commission of the EU, those governments are given constant updates on what to expect from the ESCB, so as to be given enough time to prepare. When all is said and done, the ESCB will be dictating monetary policy and monitoring exchange rates, among other duties, while maintaining a status similar to that of the Federal Reserve System of the U.S. The ESCB will also oversee and conduct the currency changeover to the euro. As we can see, the EMI will be an incredibly useful buffer between Stage One and Stage Three, and will assure a gradual institutional transition to coincide with its gradual monetary transition.

Again, it can be mentioned here that this is where the similarities between the economic development of the U.S. and the EU differ. The U.S., as a result of its closed economy, did not concern itself with building a "time bridge" between the individual state policies and one national policy, because the opportunity for speculation was small—the closed economy eliminated the political intuition for a gradual change. As a result, the first National Bank of the U.S. was formed and took over almost overnight. Granted the first National Bank failed, but that was more because of political opposition to the idea of a national bank than a transition failure.[17] Thus, we can see that the EU's exposure to large amounts of potential speculation at the hands of a currency change has created the political (although some would probably

add economic) environment for a gradual changeover—legislators in the EU and its member countries are more concerned about pleasing constituents because the potential for transition problems is greater with an open economy.

To further assure that a gradual transition does occur, the EU has established various convergence criteria that potential and current member countries must adhere to in order to participate in the monetary union. Those criteria are defined and explained here:

**Price stability**—defined as a rate of inflation that lies within 1.5 percentage points of the three best performing EU countries—will be necessary for the onset of Stage Three and the move to irrevocably fixed exchange rates, especially during the three-year transition when both national currencies and the euro will co-exist. If a country has wild fluctuations in inflation, it will disrupt the fixed exchange rate equilibrium and force the rest of the EU to experience the same fluctuations.

**Low long-term interest rates**—defined as within two percentage points of the three lowest scoring EU countries—are also a key criteria. The previously mentioned argument relating to capital inflows and how they make it difficult for a high-inflation country to follow anti-inflationary policy explains why this criterion is present.

**Exchange rate stability**—defined as a country keeping within the "normal" fluctuation margins of Europe's exchange rate mechanism for at least two years—is also required. It remains obvious that the move to an irrevocably fixed exchange rate will require the stable exchange rates of potential and current members. If exchange rates fluctuate wildly during transition when the euro and national currencies co-exist, that means that price levels are changing [$Q=(P^*/P)S$]. This leads us back to the inflation criteria explanation above.

**A sustainable government financial position**—which is defined as either a budget deficit no higher than 3% of that country's GDP, or a ratio of public debt to GDP of no more than a "reference value" of 60%—is the final criterion. It can be reasoned that a cap on government spending will largely help to prevent inflation, which again leads us back to the first criterion. Indeed, German finance minister Theo Waigel felt that "a country might qualify to join the euro only to revert, once inside, to its former profligate borrowing." [18] Waigel said that this phenomenon would undermine a single currency and concluded that government spending and borrowing limits are proper for admittance into the EU.

The current member countries of the EU must satisfy these conditions by the start of Stage Three on 1 January 1999. Any other countries satisfying these criteria by this date may also apply for EU membership and for participation in the monetary union. Also implicit within this set of criteria is the principle that not all potential members have to join the monetary union at the same time. Thus, it is further stressed that these criteria are flexible within a reasonable margin.

It is the third and final criterion that has created the most controversy, largely because some assert that budgetary norms are not related to the workings of a monetary union. "Countries have to follow sustainable fiscal policies irrespective of the monetary regime. The sustainability of deficits and debt is required whether a country has a floating exchange rate or a fixed one, whether it is in a monetary union or not."[19] The primary argument here is that the separate governments of the EU have agendas aside from the EU that they have freedom and the necessity to pursue. It can be interpreted that this final criterion infringes upon the individual government's rights and abilities to pursue other fiscal agendas that may or may not be related to the EU and that country's own economic policy. Again, we see here that politics have entered the arena and threatened to inhibit what may be a sound economic criterion, assuming of course that the convergence criteria are economically sound. And let us not forget that the convergence criteria in general were created for political reasons just as much as they were for economic reasons. It is certain that Mr. Waigel's statements about "profligate spending" by poorer countries of the EU were just as much political as they were economical, for the big, stable countries of the union such as Germany are also looking out for the economic well-being of their constituents.

The economic and political development of the EU has made for an interesting case study in the differences between the two. It can certainly be seen here that what may be practical economically is not always practical politically and vice versa. This is a debate that has plagued the EU for decades and will

continue to do so in the years to come. Indeed, what will be interesting to observe as the EU progresses forward is how much one wins over the other, and what effect that will have on not just economic advances, but on advances in the governmental structure and the possible expansion of the EU's sphere of influence.

### Endnotes and References

[1] For the purposes of part one, when I compare the development of the early United States to that of the European Union, it will be in terms of economic development and structure only. The political developments of the two, while also similar and certainly intertwined, do not concern us at this point.


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[14] **Ibid**

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[18] **—, "European Union"**, The Economist, pp. 7

[19] **DeGrauwe, Paul**, The Economics of Monetary Integration, pp. 159.