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The European Union Monetary Integration

Tom Purl '99
Illinois Wesleyan University

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Abstract

The date is 1 January 1999, and for the first time in history the nations of Europe will combine their economic might to form a monetary union of unparalleled size, diversity, and power. Starting in 1952 with the European Coal and Steel Community (ECSC) and then progressing towards the recently signed Treaty of Amsterdam, the process of European economic unity has produced two stunning results: constant economic growth and lasting European peace. With the introduction of the euro as legal tender in 2002, the final piece of the EU puzzle is in place. The new era of the EU is set to begin characterized by increased economic development and cooperation within the continent.

Keywords

economic development, monetary union monetary union

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Of course, this is a prediction, one that most leaders of the EU would probably like the average European citizen to believe. However, after researching the subject, one could not say that this prediction is very accurate. Today, as the EU is moving closer to the dates specified for monetary union by the Maastricht Treaty, we can clearly see that the EU is still very far away from accomplishing their vision of constant economic growth and peace. Forty-five years after the birth of the ECSC, the EU has weathered economic disasters, high unemployment, popular skepticism, enlargement problems and fiscal irresponsibility by member states. However, even with these numerous problems, the EU member states will attain their goal of European Monetary Union (EMU) which will eventually include additional Eastern European states.

To first analyze the future of the EU, the single currency, and enlargement, we must look at the theories of optimal currency areas developed by Robert Mundell and Ronald McKinnon. The theory of optimal currency areas describes whether a group of territories are suitable to share a single currency, whether that group be a federation like the United States or independent nations such as in the EU. By analyzing the monetary unit's size and makeup, these two economists developed two nearly opposite theories to prescribe the best possible area for a single currency.

Mundell believes that a monetary union should not be so big that it cannot have a common economic base throughout. This theory follows the idea that if a region were too big and had greatly varying industries, one area could be experiencing an economic boom while another may be in a recession. In such a situation, the monetary union's central bank would have great difficulty trying to devise a single monetary policy that would benefit the entire region. An EU example of this would be if the UK was experiencing an economic boom due to an increased demand for steel and coal while Germany was experiencing a recession due to a sharp increase in Albanian refugees coupled with a taste shift from German to Japanese automobiles. The European Central Bank (ECB) would not be able to raise interest rates to avoid inflation (resulting from the UK's boom) because that would only augment the economic problems in Germany, nor could they lower interest rates to help Germany for the opposite reason.

This problem does not mean that an economic union as large as the proposed EMU with its widely varying industries cannot survive, however. The US economic union does not shut down every time there is a recession in New England and a boom in the Pacific Northwest. For a region such as the proposed EU to run efficiently, it needs internal adjustment mechanisms to compensate for the varying economic shocks it will experience.

One of the necessary adjustment mechanisms is ease of labor mobility. If a resident in Missouri loses her job as a defense contractor, she should be able to move to another area of the economic union to get a similar job with a minimum of obstacles, such as having to change citizenship. This free flow of labor would result in an outflow of labor from the area that is losing jobs and an inflow to the area that is offering new jobs, providing a way of balancing out varying economic shocks within an economic union.

Today, the EU does not offer the same level of labor mobility that is found in the US. For starters, there are ten different official languages within the EU.

A doctor in Missouri could move over 1500 miles away and still not have to worry about learning a new language, yet a doctor in France would have to learn German if he moved just 100 miles to work in Germany. This would then lead to other cultural barriers that inhibit labor mobility. No matter where you are from and want to go in America, cultural differences would not be as varied compared to say, Greece and Finland.

Also, there are strong professional boundaries towards a freer flow of labor in the EU. Although similar circumstances do exist within the US, an accountant that received his diploma in Wisconsin is able to work in Illinois. However, even though the EU is a common market, their accounting system varies from member to member. While the EU is striving towards common standards for such professions as accounting, many guidelines will still be decided by "local guidance", meaning that internal differences will still exist (Gallagher and Andrew 57-58). These professional and cultural boundaries could seriously restrict the free flow of labor needed to make the EU more efficient and to minimize regional inequalities.

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Another necessary internal adjustment mechanism within the frame of Mundell's model is centralized fiscal transfers. If Italy is experiencing a recession while France has a booming economy, labor mobility may not be sufficiently quick or large enough to cause an equilibrium in the region. Centralized fiscal transfers would then aid the poorer region by using some of the increased tax revenues from France and apply them towards projects such as welfare for Italy.

Once again, however, the structure in place for this internal adjustment mechanism is not as strong as its US counterpart. Called 'cohesion funds' in the EU, they are not "as large as those in the U.S. federal fiscal system" (Caves et al. 604). Even though no plans for increasing these funds exist, these cohesion funds should be augmented in the future to help the EU run more efficiently, especially considering that the EU heads have a lot more control over fiscal transfers than they do labor mobility.

McKinnon's theory of optimum currency areas is quite different from Mundell's. Whereas Mundell's motto might have been "go small", McKinnon's ideal optimum currency area would have to be big to protect its standard of living. He believed that if the industrial base of an economic union were too small, that area would have to import too much, meaning that their purchasing power for most necessities would rely greatly on how much the value of their currency fluctuates in relation to their trading partners.

For example, say St. Louis was an economic union with its own currency. Domestically, they produce military aircraft, beer, and miscellaneous machine equipment for industrial plants. Within a reasonable range, fluctuations of the value of St. Louis currency would not have a very large impact on the price of its domestic products. However, if the St. Louis currency was fluctuating wildly with the central Illinois currency where they bought all of their corn and milk, consumers would witness their purchasing power fluctuate every time they got paid. Such price level instability might result in a loss of confidence regarding the St. Louis dollar, which could lead to it losing its function as a "stable store of value" (Dunn and Ingram 523). In this example, there would be a clear advantage in having an economic union large enough to produce most of its own goods that it uses.

So which theory is the right one? Obviously the EU cannot be big enough to produce nearly everything it would need while simultaneously being small enough to ensure optimum labor mobility. And there may even be debate over which option is more desirable within the EU power structure itself. Germany has made their case repeatedly for strict adherence to the Maastricht convergence criteria while making, "no secret of their desire for a 'small' euro (EMU) in the first instance" (Peet 7). Meanwhile, smaller EMU members such as Portugal are eager

exploit the trade and price level advantages of belonging to a full fifteen member EU (Portugal 1997).

So which vision is 'right' for the EU? This question is hard enough if we were only looking at the situation economically, but the EU is a unique case. Politically, the right EU is a large, inclusive EU. As I have already mentioned, the ECSC was the forefather of the EU, being the first multi-state European organization to use a federal governing body (the ECSC High Authority) which was composed of representatives from the member countries (France, West Germany, Italy, Belgium, Netherlands, and Luxembourg). Although one of the goals associated with the creation of the ECSC was more efficient trade, President Jean Monet and French Foreign Minister Robert Schuman's long term goal was to create a structure that uses economic integration to eventually accomplish the political unification of Europe (European Community: 95, 1997). Freer trade was a plus, but European leaders were also trying to prevent Germany and France from igniting another world war. Therefore, the EU has always had the two clear goals: increasing the standard of living through freer trade and forcing member states to be peaceful with one another due to economic integration.

EU leaders will need to consider making enlargement a chief priority to ever fully realize the political potential of an economically unified, truly 'European' union.

To improve Europe as a whole, however, the EU needs to grow so it can be more representative, more accurately 'European'. In its history, the EU has grown from six members to fifteen, enlarging on four separate occasions. This enlargement has been difficult, usually resulting in long negotiations and bitter debates over the EU's role. The UK had to wait over ten years to join the EU because of various disagreements over the validity of agreements, such as the Common Agricultural Policy (CAP), which was advantageous for France but increased the average British grocery bill. Disagreements over this policy led to the vetoing of Britain's EU application by President de Gaulle of France in 1963 and the ceasing of renewed negotiations in 1967 (History of UK Membership of the EU, 1997). However, the recent accession negotiations for Finland, Austria, and Sweden only took sixteen months and, unlike previous enlargements, there were no transitional periods. The EU officially views enlargement as, "an investment in our own future," removing trade barriers which therefore creates wealth and jobs (Brittan 1997).

It is, however, much easier for the EU to accept wealthy, highly developed nations such as Finland and Austria than it is to accept poor, former soviet satellites such as Poland or Hungary. For example, the three recent EU additions had either "belonged to, or been associated with, EFTA (European Free Trade Association) since 1960; and all had developed progressively closer relations with the EU over many years" (Brittan 1997). In contrast, many eastern European nations are just now beginning to adjust to free-market capitalism, an idea that in some regions is still very new and foreign. To add to the difficulties incurred by eastern European nations who seek membership in the EU, there are strict Maastricht criteria for EMU, which seem barely attainable to many current EU members and impossible to non-members.

Also, as witnessed by the recent civil wars in the former Yugoslavia and Albania, the EU is not delivering on its original vision of uniting Europe politically through economic integration. Traditional enemies, such as Germany and France may now be friends, but Baltic nations like Serbia, the 'powder keg' for W.W.I, are reliving the same wars they participated in over a century ago. EU leaders will need to consider making enlargement a chief priority to ever fully realize the political potential of an economically unified, truly 'European' union.

Finally, the last topic discussed here will be the viability of an EU composed of full-fledged EMU members or 'ins' and non-euro using 'outs'. Clearly, if EMU is to proceed according to the benchmark dates established by the Maastricht Treaty, some current EU members will be left out of the first wave of EMU acceptance (Brittan 1997). This inequality may foster an environment within the two-tiered EU that would

produce two problems: competitive devaluations between 'ins' and 'outs' and increased speculative attacks on outs.

It has already been stated that being a member of the EU certainly has its advantages. However, many 'out' members may feel that they are at a disadvantage compared to the EMU's trading strength, which could possibly be hurting 'out' industries. In an effort to achieve an economic advantage, an 'out' country may decrease the value of its currency against the euro even though its inflation is no higher than that of the EMU, resulting in a competitive devaluation. These actions would hurt 'in' industries because it would make their goods more expensive relative to the goods of the country that devalued.

The other problem facing 'outs' in a two-tiered EU world is speculative attacks. Although speculative attacks already occur to EU members, the creation of the EMU will cause new reasons for them to occur. For example, even after all of the economic and political sacrifices that have been made by an EU member, failure to attain EMU status on 1 January 1999 may cause the financial market to believe that all 'outs' will lose their monetary discipline. For example, these 'out' nations may believe that since they don't have to worry about joining the EU for a while, they can run a bigger deficit to stimulate growth and be more politically popular. Just the possibility of this occurrence could launch a speculative attack on any 'out' country, which would be worsened by the fact that the ECB has vowed not to bail out any those countries. These problems may introduce some added volatility to the future EU.

When analyzing the EU's position as an optimal currency area, it is important to remember that no one area is ever going to fit both theories exactly. No economic union in the world is small enough to have perfect labor mobility coupled with ability to produce most of its own products. It is, therefore, important to look at the EU as a unique case, examining how well it fits the theories and what policy changes are planned.

To analyze the EU from McKinnon's perspective, it would make a great optimal currency area. The members of this large economic union already receive most of their goods from each other. Even from Mundell's perspective, economic unity is still a possibility. Labor mobility may look difficult today, but it is important to remember that economically integrated international blocs are fairly new. This new climate may cause many Europeans to learn skills that would be valuable all over the continent and most Europeans already know more than one language. If EU officials enact more laws to promote mobility while also increasing fiscal transfers amongst members, the economic union as a whole could adjust efficiently enough to minimize certain asymmetric economic shocks.

Next there is the question of enlargement. In a 1996 speech by Sir Leon Brittan, the vice-president of the European Commission, he referred to enlargement as the "moral responsibility which history has challenged us to accept." Officially, the EU wants to be as "Enlargement-friendly" as possible, viewing Maastricht convergence criteria as sound policies that should be aspired to, rather than "hurdles which they have to jump" (Brittan 1997). EU leaders realize the necessity to enlarge eventually, and there is no reason to doubt that they will continue to admit qualified nations well into the next century.

Finally, once again we look at the problems associated with a two-tiered EU. As far as possible competitive devaluations taken by 'outs' against the EMU, there are deterrents already planned for such actions. For example, if a country participates in such devaluation, they would receive EU aid in the form of their native currency, which would be worth less due to the devaluation. Also, as nations negotiated to become part of the EU, the all "signed up to the broad economic guidelines, which will ensure that we are all pursuing the same complementary macroeconomic policies" (Brittan). Regarding speculative attacks, if an 'out' shows that they are rejecting the EMU and might participate in competitive devaluations, they will be ripe for such an attack. In order to defend themselves, an 'out' will have to continue to run a sound monetary policy, defending its currency behind the strength of the euro.

Today, the question is not whether the European Union will use a single currency. Rather, it is who will be the first to participate, and where will it go, and when will others join. Although the process of European economic integration has lasted over forty years, it still has plenty of room to grow and change. Adjustments to the union will need to be made constantly, striving to maintain peace while steadily

increasing the standard of living.

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