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The EU 6 or the EU 15+?

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Abstract

The countdown to form a “united Europe” continues. The first phase of the Economic and Monetary Union will form in early 1998. At this time, the European Council will name those countries that are eligible to form an EMU (due to their compliance with the five economic criteria). This decision of allowing the “in” countries to proceed in an EMU will affect the future decisions of the EMU. Three conditions are crucial to insure the existence of an Economic and Monetary Union in Europe: a single currency, the euro; a single exchange rate; and central bank authority. Several benefits and costs are associated with the formation of an EMU. The size of the EMU will also influence these costs and benefits of an EMU-6 of Germany, France, the Netherlands, Belgium, Luxembourg and Italy, for example, versus an EMU of all 15 member nations. By using the theory of optimal currency areas, one can examine the costs and benefits of an EMU, especially in relation to Eastern European enlargement.

Keywords

Economic Monetary Union (EMU), costs and benefits, transition

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The countdown to form a "united Europe" continues. The first phase of the Economic and Monetary Union will form in early 1998. At this time, the European Council will name those countries that are eligible to form an EMU (due to their compliance with the five economic criteria). This decision of allowing the "in" countries to proceed in an EMU will affect the future decisions of the EMU. Three conditions are crucial to insure the existence of an Economic and Monetary Union in Europe: a single currency, the euro; a single exchange rate; and central bank authority. Several benefits and costs are associated with the formation of an EMU. The size of the EMU will also influence these costs and benefits of an EMU-6 of Germany, France, the Netherlands, Belgium, Luxembourg and Italy, for example, versus an EMU of all 15 member nations. By using the theory of optimal currency areas, one can examine the costs and benefits of an EMU, especially in relation to Eastern European enlargement. Separate European cultural identities that have developed over the last millenium and individual economic situations in these nations will provide the biggest challenges of the formation of a single European Monetary Union in the next century.

In approaching the theory of an optimal currency area, a good place to begin is with a definition. According to Copeland, a "Single Currency Zone is one where the accepted means of payment consists either of a single, homogeneous currency, or of two or more currencies linked by an exchange rate which is fixed (at one-for-one) irrevocably."[1] He also refers to this Single Currency Zone as a Monetary Union, referring to the European Union project. The EU is currently at the second stage of 15 different currencies aiming to link with one fixed exchange rate. During the third stage of the EMU, the European System of Central Banks will administer the common currency, the euro. Thus, a Monetary Union, like that of the EU or the USA does not necessarily imply an optimal currency area. As a unit of account, the euro, or the dollar, economically unites the areas where each is circulated, but does not make these optimal currency areas. To illustrate, more than seventeen small countries have pegged their exchange rate to the US dollar, but this does not necessarily imply that Hong Kong and the USA are optimal currency areas.[2] There must be certain characteristics then that foster an optimal currency area such as high internal trade, high mobility of labor, a correlation of economic shocks and a "federal fiscal system to transfer funds to the regions that suffer adverse shocks".[3] One helpful characteristic that allows the US to be in a more likely position to form an optimal currency area is a common language and a relatively homogenous culture. When these characteristics are present, the benefits of a Monetary Union are feasible for the regions or countries involved in the union.

Several benefits will exist for the EU nations now forming an Economic and Monetary Union. With a fixed exchange rate mechanism, and an eventual single currency, several costs will be reduced. With a high level of internal trade, transaction costs of goods and services from one nation to another will be reduced due to the elimination of an exchange rate. The bid-ask spread (or the price difference in buying and selling a currency) involved in exchange transactions will disappear, facilitating freer trade, higher efficiency and a reduction in information costs. With one euro circulating in Europe, prices will become more transparent. For example, citizens in Spain and Germany will have the same notion of the worth of a good or service. A freely floating exchange rate mechanism allows for the constant fluctuation of such prices, resulting in menu costs (such as the reprinting of information like prices) as well as the need to constantly monitor the exchange rates. In addition, travelers will avoid confusion and collecting pockets full of "expensive" souvenirs as they move from country to country.

A single currency in a monetary union decreases the uncertainty of trade involving several currencies. There will be no need to buy futures contracts in order to hedge against exchange rate risks.

In terms of exchange rate fluctuations, prices of Italian goods, for example, will remain constant and understandable for a Dutch importer wanting to buy the Italian goods. A single currency will free up those dedicated to constantly monitoring the changes and uncertainty of exchange rates to other, more productive tasks within the EU. Less economic uncertainty will increase the volume of trade, providing comparative advantages for the countries involved and ultimately raising the standards of living for all participating nations.

Additional benefits will be derived from a single currency and an EMU. Whether or not the euro unites the participating countries with a shared sense of economic identity, the euro will be demanded as a world currency. The use of the euro will allow nations to have more of an economic influence in the world markets compared to the use of just their national currencies. To clarify, the euro will be a much stronger currency than the peseta or escudo could ever be alone.

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The Economic and Monetary Union also has the chance to reduce inefficient economic behavior as organizational changes shift some power from each country to the central authority. Stagnant high unemployment in nations like Spain and Italy may change with increased economic development. Many college students in Spain are in no rush to complete their studies, often time dragging them out for 8 years. The job market is so bleak, even for graduates that are practically specialists in their fields, that there is little opportunity to immediately enter the labor market. The high Spanish unemployment level is affecting society in that competition is extremely high for relatively few available positions. Powerful trade unions, like those in France, will have to possibly restructure or combine with other European trade unions in order to maintain their influence not just in France, but in all of Europe. Regardless, these possibilities offer the chance to change conditions like labor rigidity and the lack of job opportunities for college graduates.

The absence of essential characteristics (labor mobility, a federal fiscal system that accommodates its member nations and a shared sense of economic identity, etc.) that form an Economic and Monetary Union translates to higher costs for forming such an EMU. Small internal adjustment mechanisms like low labor mobility, a federal fiscal system that reduces economic shocks in certain areas and cultural differences only provide additional barriers toward forming an EMU. The completion of the five convergence criteria will permit the nations of the EMU to be more economically united to face these challenges. Briefly, the convergence criteria involve target inflation, exchange and long term interest rates as well as specified levels of budget deficit and government debt of each nation. With more than 15 languages spoken in the EU and large economic and cultural differences existing between Denmark and Greece, for example, labor mobility remains quite limited. Danes may vacation in Greece due to the pleasant climate and rich culture yet may not chose to live there. Likewise, from a Greek perspective, although the Danish standard of living is much higher in economic terms than that in Greece, a mass exodus of workers from Greece to Denmark may not necessarily occur. An extremely large economic difference in the wage level and opportunities for employment must exist in order to initiate the movement of labor across borders. Due to the large economic differences in Germany and Turkey, there is a large presence of Turkish *Gästarbeiter* ("guest workers") in Germany. Labor mobility is an internal adjustment mechanism that transfers human capital from an area in an economic downturn to one where rapid growth leads to a high demand for labor. Although many Europeans are at least bilingual if not polyglots, many speak only dialects and their national language and may have little experience with other European cultures. With southern Italians now unlikely to move to northern Italy to find work due to regional and "national" differences, such individuals are not very likely to cross international borders in order to find employment. Europeans are prouder than ever of not only their national, but regional identities, which only decreases the likelihood of high labor mobility and a sense of common identity within the European Union.

With the use of a single currency and a "one size fits all monetary policy"[4], one major drawback to the EMU is the loss of control over Monetary Policy. Central banks of member nations must give up domestic control of conducting open market operations, setting reserve requirements, making discount loans, enforcing capital controls and intervening in foreign exchange markets.[5] When multiple, unrelated problems arise in the EU, the challenge will be to accommodate the needs of each situation without sacrificing or prioritizing one problem for another. The EU will not want to anger an entire region or industry while ameliorating the economic problems in another area. This issue is extremely pertinent in that the economic effects of one area are bound to affect other areas of the EU in some way.

The size of the EMU is an important concept in the success of its functioning. Robert Mundell holds that a small economically based union is in the best interests of the EU. For the previously stated reasons, he argues that a smaller, tighter economic base throughout a common currency area is necessary for monetary policy. His argument follows that "an optimal currency area should be no larger than the region over which labor is mobile, so that regional recessions could be eased through labor moving to where jobs are more plentiful."[6] If this common economic base does not exist, then either a mechanism for fiscal transfers and/or labor mobility must exist. Therefore, Mundell would probably be in favor of a European Union consisting of 5 members over a European Union of 15 nations, when the "ins" and "pre-ins" are determined early next year.

Next year will be a time to establish a large currency area, according to the view of Ronald McKinnon. McKinnon proposes that the EU is a more stable currency area than any individual country, just as the USA is a better currency area than New York. If the economic base of the EMU is too small, the purchasing power will fluctuate too much as the Exchange Rate changes. Fluctuations in the Exchange Rate with other countries would place the price levels of goods and services produced outside of the area or country on a constant shifting state. Fluctuations would especially increase if there is a lot of trade between two countries. If two countries trade a lot, a common currency may be optimal.[7]

These different theories bring several questions to the forefront. Once an EMU forms, will some of the economic differences decrease or diminish, regardless of its present size? Likewise, with the 15 member nations joining, will a larger Union become more optimal, according to McKinnon's premise? Additionally, one must consider the effects of a future expansion of the EU, encompassing Eastern Europe and its effect on the Economic and Monetary Union.

Historically, the EU has grown into its present state from four previous enlargements in 1973(Ireland and Denmark), 1981(Greece), 1986(Spain and Portugal) and 1995(Austria, Sweden and Finland). Additional enlargements from the former Eastern Bloc countries will provide challenges for both the EU and those countries anxiously applying. One must examine the individual situations of each country, since economic levels and progress differ in this zone. Additionally, both the EU and applicant country must weigh the pros and cons of enlargement in the short and long runs. In this sense, an effective enlargement should involve timetables with goals and deadlines in order for it to be effective for all of Europe. Ultimately, "the issue is each country's health, not its wealth."[8]

An application process is handling the 10 Eastern European applications. In 1994, both Hungary and Poland submitted their applications to the European Council. Six nations addressed their applications to the Council: Romania, Slovakia, Latvia, Estonia, Lithuania and Bulgaria in 1995. The Czech Republic and Slovenia applied in 1996. The European Council responds to these requests with a published "opinion". This opinion includes a description of economic and political conditions in each applicant country, an evaluation of the country's ability to successfully adapt to the goals and regulations of the EU, possible difficulties the nation may have in the EU and a recommendation that initiates a negotiating procedure. These criteria also require the stability of democracy, human rights, the protection of minorities, etc. Additionally, the country must have a functioning market economy that can cope with the requirements and pace of the EU.

After studies are completed, negotiation procedures follow. *Article O* of the Amsterdam Treaty handles these issues of enlargement; the European Council emphasizes that all applicants will be treated separately and fairly. The length of the negotiations will vary from country to country. Given the variation in the transition periods of the current EU nations, it is difficult to make a general statement about how long the future enlargements will take. It took Spain over a decade of negotiations and transitional periods to finally join in 1986. On the other hand, Austria, Finland and Sweden "received all of the rights of membership from day one" without passing through a transitional period in1996.[9]

Agreements were established with Poland, the Czech Republic, Hungary, Slovakia, Romania and Bulgaria. The three Baltic countries (Estonia, Latvia and Lithuania) along with Slovenia are waiting for their agreements to be ratified. In the meantime, these nations are preparing by strengthening both their short experiences with democracy and capitalism. The recent resignation of the Czech Prime Minister Vaclav Klaus is one example of the changing political climate in Eastern Europe. As a result of this political event, the Czech koruna plunged, experiencing a significant depreciation (requiring more Czech korunas to purchase foreign goods).

The EU's financial support program for the applicant members, or Phare, is providing assistance for these nations to improve their infrastructures and participate in Community programs.[10] Enlargement will signify an increase in the EU's budget, implying short run costs for the present EU countries. The Community Agricultural Policy and Structural Funds will have to be reallocated, possibly drawing funds away from nations like Greece, that as a member since 1981, should have priority to these funds. This will no doubt be a very sensitive time for those citizens that do not have confidence in the EU in the first place. These decisions and possible additions may increase the EU from 370 million to 480 million citizens.[11] Such a shift may have a huge impact on the internal structure of EU organizations, including the number of votes in the European Council, for example.

Such a large Union provides a large economic base, ideal for McKinnon's theory. In light of the present economic goals and challenges, will the EU be ready to take on enlargement now, or in the near future? Perhaps, it is better to wait, at least after the "ins" have established an EMU. The "pre-ins" should later join a small, established EMU when they have proven that they can maintain the five previously mentioned convergence criteria with relative ease. Then, after the present 15 member nations have established an EMU-15, the "possible-ins" (the applicant Eastern European countries) should become a priority of the EU. Eventually, the EU may be able to address the applications of Turkey, Cyprus and Malta. Political conditions and economic forces may strengthen or weaken their cases for entry.

These goals will be achieved when the time is right. To turn back on a project that will soon be 40 years in the making would be foolish, as well as very difficult to accomplish. The EU must carry on as it has, but with reasonable timetables, especially for the young market economies of the applicant countries. Certainly, if a rapid and financially sound EMU could evolve in a short amount of time, all European nations would benefit. However, expectations must be realistic. The "ins", "pre-ins" and "possible-ins" will work simultaneously and independently to achieve their goals. Different challenges will influence each nation's progress. By aiming for an EMU-6 of Germany, France, the Netherlands, Belgium, Luxembourg and Italy, for example, these members may proceed ahead in a small EMU, while the other nations push ahead at their own pace. As long as deadlines are not pushed further and further back, the EMU will grow eventually, accepting one or a few new members at a time, so that both the EMU and each individual country has time to adjust harmoniously. Like a class of students, each student may be learning at a different level and have different difficulties with certain subject material. Similarly, the economies of European nations are at different stages aiming toward the formation of an Economic and Monetary Union. Nonetheless, countries, like individuals in a classroom, should be allowed to progress and be challenged in a way that they are productive and working harmoniously with the rest of the class.

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