



4-1997

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### **Recommended Citation**

Beaird '97, Tina (1997) "Europe Will Form a Momentary Union ... Eventually," *The Park Place Economist*: Vol. 5

Available at: <https://digitalcommons.iwu.edu/parkplace/vol5/iss1/15>

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## Europe Will Form a Momentary Union ... Eventually

### Abstract

While I have just shown many problems along the EC's path to integration, I still feel positively about the formation of monetary union. Germany has continued to remain strong in its backing of the union and its support of it. France has even endured significant unemployment and social unrest due to its policy decisions aimed at being able to meet the convergence criteria. France and Germany have also shown cooperation in forming the union.

# Europe Will Form a Monetary Union . . . Eventually

Tina Beaird

The issue has been discussed almost to exhaustion: Will the European Community (EC) ever achieve monetary union? To address this issue we need to look at the political and economic reasons for integration as well as the many obstacles that the countries must face as they aim for monetary union. It is my opinion that monetary union in the EC will be achieved. However, I am not sure whether or not it will actually take place by 1999, the date set in the Maastricht Treaty. This treaty lays the guidelines the countries are to follow in order to join the union. It is also not possible to tell how many of the current EC member countries will join the European Monetary Union (EMU) when it does form because it is likely that many will not be close enough to meeting the requirements. There are many reasons why the countries should integrate and there have been many steps taken towards the unification. But the countries are not without their fears and frictions, and to this day full monetary union seems distant.

By integrating, it is hoped the countries will have political, economic, and social progress without restrictions on the movement of goods, services, capital, and people. The countries are expected to be strengthened by unity. Fair and effective competition will raise the standard of living. As a monetary union, there will be less uncertainty of exchange rates, thus trade and investment in the countries should increase as business there will be easier and less costly. The societies will also save in the way of transaction costs, information costs (incurred when one has to develop a sense of what a reasonable price for an item is in another currency), and social cohesion costs. This final cost will be eliminated by the fact that with a single currency countries may lose some of their

national identity or unity. By doing so their purchasing decisions will not be based on their desire to see only their country's economy succeed, but rather the decisions will be made based on the benefit of the union as a whole. A single currency will make it easier to manage common EC institutions as well as create a more stable internal price level for the union. In addition, the countries will have a single inflation rate which is expected to be relatively low.

While these advantages of forming the EMS exist, the transition towards unionization has not been without its troubles and doubts. On a political level, the countries fear giving up much of their power to supranational governing institutions. These institutions act independently of the national governments so that decisions made will be implemented by all the member nations without their individual say in the matter. But, in laying out the groundwork for these institutions, it seems the countries really do not have much to fear. The actions the European Council can take when a country's economic situation may be jeopardizing the operation of the monetary union are weak. The Council is expected to make recommendations to the country, but does not have any certain strict rules to make the country follow. Another example of the weak response of the Council is when a country runs a high budget deficit. There are numerous steps that could take years to follow through with before any fine is actually demanded of the country. I think that the weak actions the supranational institutions can take against individual countries should not be too much of a worry for the individual countries and I do not see this as a hindrance towards union.

There are also many real economic fears.

As a monetary union the countries will not have the ability to make independent monetary policies to boost their economies. They also will have very little fiscal policy freedom. These policy decisions will be left up to the Central Bank and other governing institutions of the EMS. Countries fear that the decisions made by these institutions may not always be beneficial to them and may hurt their economy. They fear that the decisions may be made by the dominant country at the time, and in that country's best interests, instead of for the benefit of the union as a whole.

Currently, the countries fear a "German Europe." They fear that because of Germany's strength and influence in Europe right now, the political and economic decisions would be made in Germany's interest and at the expense of the other countries. This might mean that other countries would continue to suffer with recessions and unemployment while Germany suffers little economic troubles. This fear is strengthened by the past actions of Germany such as when it raised its interest rates in the early 1990s because of its increased spending in East Germany. Since Germany was the anchor of the fixed exchange rate system at the time, the other countries were forced to increase their interest rates as well, leading to deeper recessions for them and also making their goods less competitive.

There have also been other frictions on the path to monetary integration. The Italian and Spanish crises in 1992 caused these two countries' currencies to lose their competitiveness. Since their price levels diverged so much from Germany's, speculators bet against the countries' ability to keep their currencies at their current values and forced devaluations that were much greater than they would have needed to be to remain in the fixed exchange rate system. With a common currency, though, the value of the currency would be the same in all the countries, hence a crisis like this would not occur. Another crisis occurred in France and

Britain due to their high unemployment rates. While the monetary authorities widened the exchange rate bands so that speculators would not be able to have a significant impact on the currencies, the countries were still suffering very high unemployment. Britain gave up and dropped out of the EMS. This has definitely added to the friction of monetary integration because it shows the little faith or will some countries have in forming the monetary union.

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**"Many countries are forced to make economic choices that are causing severe unrest and unemployment."**

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The Maastricht Treaty also creates frictions in countries because of its stated convergence criteria that countries must meet in order to join the EMU. The "policy paradox" it presents forces countries to suffer at the expense of trying to meet the convergence criteria. The countries do not have monetary policy powers and are constrained in their use of fiscal policies. They cannot implement fiscal policies to stimulate their economy in order to get output and unemployment levels where they want them because in order to meet the criteria their debt and deficit must not be more than 60% and 3% of their GDP, respectively. The Treaty also sets criteria regarding the inflation rate and the long-term interest rate of a country. Also, a country cannot have devalued its currency in the two years prior to joining the EMU. This means that many countries are forced to make economic choices that are causing severe unrest and unemployment for their citizens.

Whether the convergence criteria will actually be met by many of the countries by the date required (January 1, 1999) is questionable. Currently the deficit to GDP ratio requirement is only met by Luxembourg,

although Germany and the Netherlands are close to meeting it. Greece and Italy, on the other hand, are far from the requirements. The debt to GDP ratio is currently met by France, Germany, Luxembourg, Britain, and Spain. Portugal and Denmark are not far from reaching the goal. Others are quite far from the criteria. There is still time for more countries to converge in more of the criteria areas. As the date approaches I think more and more of them will come closer to meeting the criteria.

Germany remains strong in its stance that it will not allow members to enter the union without meeting the criteria. However, I believe that when the time comes, Germany will decide to be more loose on its demands. Right now Germany must remain tough. If it didn't, then the other countries would have no reason to continue trying to meet the criteria. It is true that the closer the countries are to the convergence criteria the better the union would function and the more effective the implementation of various policies would be for the overall welfare of the union.

"The criteria are intended to guarantee the convergence of inflation rates and the imposition of a measure of fiscal rectitude prior to monetary unification. As such, they are not prerequisites for currency union, only of a currency union that works in the way those who specified the conditions hope it will" (Copeland, 1994). So, if all the countries do not meet the Maastricht convergence criteria then it does not necessarily mean that the EMS will not be able to be successful. It merely means that right now the criteria are considered to be the characteristics that will make the union work best. I think the countries should try to be as close to the requirements as possible. However, there must be some leniency allowed in deciding acceptance to the EMS. Otherwise, it may never form. It is also possible that it could allow 'associate membership' for non-qualifiers. These members would have more

lax criteria but the benefits and aid would probably also be less than if they were full members. This would not be as sound an economic decision but would be less risky than if they were full members ("EMU," 1996).

While I have just shown many problems along the EC's path to integration, I still feel positively about the formation of monetary union. Germany has continued to remain strong in its backing of the union and its support of it. France has even endured significant unemployment and social unrest due to its policy decisions aimed at being able to meet the convergence criteria. France and Germany have also shown cooperation in forming the union.

Other positive steps for monetary union are the Schengen Agreements reached between France, Germany, and the Benelux countries. Due to the implementation of these agreements in 1995, there are presently no border checks between these countries. There exists much more cooperation between the countries and an overall increased ease of dealings between them. Countries that are not a part of this group still face the same treatment as they always have. "And let this be food for thought in some capitals, London and elsewhere, as Schengen is proving that one cannot prevent one group of countries from moving forward, if they really wish to do so" (Reuter, 1995). This shows the seriousness of these countries in working together and forming a union. It is a definite step in the right direction.

It is also a good sign to know that plans are in the works for the new currency to be used in the union. The currency has a name, the euro, and designs of it are being drafted. Work is being put into managing the transition and looking into the costs of rewriting computer programs ("Virtual," 1995). These too, are signs that Europe is on its way to monetary union.

Another important issue that has arisen recently is the two-tier approach to monetary

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union. In this approach some countries, the stronger ones, would form the first tier and would operate with a single currency. The second-tier countries would not be so tightly held to the first tier's currency but would also be a union of sorts. This can be seen as positive because the first-tier countries are the ones with the most similarities in economic cycles and fiscal policy positions. It is important that the countries be similar in these ways so that monetary and fiscal policies are beneficial for more than one country. These countries also tend to be closer to meeting the convergence criteria. When the second-tier countries come closer to meeting the requirements then they too could join the core group. This arrangement would allow some of the EU countries to move forward and benefit from unionization. Their strength could then make it easier for other countries to join later.

I feel that the benefits outweigh the costs in the formation of monetary union in the EU. I also think that the majority of EU countries believe the same. It is difficult, however, for them to make the necessary sacrifices in their countries to meet the criteria. Not every country is as economically healthy as Germany. I expect that the stronger countries (Germany, France, Luxembourg, the Netherlands, Belgium, Denmark, and Austria) will be able to, and will find it in their best interests, to form a monetary union possibly by 1999. Once these countries take the big step forward I expect that the other countries will not want to be left behind and will also find it in their best interest to strengthen their economies so they too can join. With a powerful Germany leading the way, I feel that monetary union will occur.

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**Tina Beaird ('97)** is a major in International Business with minors in Spanish and Japanese. This paper comes from the International Finance course she took with Dr. Lowry. Though her plans after graduation are not yet definite, she hopes to find a job in business and eventually study for her MBA.

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