

EUROPEAN MONETARY UNION (EMU) AND THE MAASTRICHT TREATY

Dr. J.B. Kelegama

The desire for a united Europe geared to peace in place of a divided Europe prone to war was shared by both the victors and the vanquished who emerged from the devastation of the Second World War with one conviction — to avoid by whatever means another war arising out of the clash of national interests among European states. This was to be achieved by means of integrating Western Europe through common institutions and common rules so as to weaken national sovereignty and to strengthen the spirit of Europeanism. Perhaps the most difficult problem at the beginning was to overcome the general distrust in Europe of Germany which caused the two World Wars. The new leaders in Germany realised that the most effective way of earning the trust of its neighbours was by surrendering its sovereignty to common European institutions and by binding itself economically and politically to Europe. German leaders believed that a Germany anchored in a strong European Union was unlikely to act irresponsibly to disturb peace, and this belief was also shared by other European countries. Thus, Germany became the most enthusiastic advocate of European integration, making the task easier than expected.

Economic Integration

European unification was to be launched not by complex and controversial political means but by economic measures. It was believed that an economically integrated Europe in which European states gain experience in working together in common institutions and under common rules would facilitate political unification at a later stage. The foundation was laid by the linking of the coal and steel industries of France and Germany under a common authority on a plan formulated by Jean Monnet and Robert Schuman. Thereafter, ties were strengthened gradually in stages through the establishment of a European Common Market with free trade among members and a common external tariff against other countries and thereafter through the transformation of the Common Market into the European Economic Community or Union with free movement of capital, people and services in addition to goods. These measures

linked the economies of Western Europe as never before and the free flow of goods, services, capital and people across national boundaries overcame insularity and economic nationalism.

Economic integration was accompanied by attempts to maintain stable national currencies. The depegging of the U.S. dollar from gold and the abandonment by U.S. of its role of preserving stability in world money markets in 1971 made Western European countries realise that they had to work together to achieve by their own efforts some degree of stability for their currencies. They attempted to do so by limiting the fluctuations between their currencies by different devices. The first was described as "the snake in the tunnel" where the fluctuations between Western European currencies were kept within a band or 'tun-

This article covers the economic situation in Europe prior to Euro came into operation in 01st January 1999. This background information facilitates the understanding of the subsequent behaviour of the Euro.

nel' of 4.5 per cent; when this failed, the second scheme described as "the snake without the tunnel" or combined floating in which agreed upon exchange rates were adjusted according to the market was substituted. This scheme was modified to establish Europe's exchange rate mechanism (ERM) under the European Monetary System with fixed but flexible exchange rates with a European currency unit — a purely accounting device — as the reference unit. This too met with limited success; exchange rates had to be realigned about 18 times and UK, Italy, Spain and Portugal left the European exchange rate mechanism when they failed to keep their currency fluctuations within the fixed limits. This resulted in allowing exchange rate fluctuations to as high as 15 per cent and the system worked satisfactorily from 1993. These schemes, despite their shortcomings, provided the experience needed for the Monetary Union.

Common Currency

The European Monetary Union (EMU) is the culmination of four decades of efforts to integrate the economies of Western Europe to form a cohesive regional economic unit. The crux of the Monetary Union is the use of a common currency by all countries and the adoption of a common

monetary policy. The first stage is the transfer of monetary policy and interest rates from sovereign nations to a fully independent European Central Bank to be established in January 1999. The second stage to be launched in 2002 is the replacement of all national currencies such as the Deutsche Mark, Franc and Guilder by a single European currency called "Euro". Benefits accruing from a common currency are several. A common currency will reduce the "transactions costs" — costs of currency conversions and currency hedges — for buyers and sellers of goods and services in Europe. It will also eliminate exchange rate fluctuations which hinder business. A stable Euro will allow European business to plan investments, set prices and sign contracts on a reliable long-term basis. It will curb inflation, and promote harmonization of national fiscal policies; it will tend to make travelling and shopping easier for Europeans.

An economic community can hardly operate efficiently if

monetary and exchange rate policies are determined on a national level. Thus, it is logical for a single market to have a single currency as it facilitates the free movement of goods, services, capital and people within the community. It has also been pointed out that the larger and more efficient regional financial market brought about by a common currency will tend to lower the cost of capital, increase the supply of savings and increase the demand for investment capital to stimulate economic growth. A single currency is also expected to help multinational corporations to consolidate some units such as distribution into a single location instead of having them scattered in separate countries. In addition, it will prompt manufacturers to move production facilities to other countries of the Union in order to lower costs and increase productivity; this process is also expected to result in increasing mergers and acquisitions. Price transparency and greater competition resulting from a single currency will tend to lower prices as well as profits in many companies; banks in particular are likely to have reduced earnings from currency transactions.

The common currency is not free from political considerations. Chancellor Helmut Kohl of Germany for instance wants to make a united

Europe irreversible and regards the common currency as the best means of ensuring it. France on the other hand, believes that a common currency would bring Germany close to Europe and also reduce its hegemony in the region. Almost all European leaders believe that by living in an economic union, following common rules and using a common currency, their people will tend to become more European and less nationalistic in their thinking and consequently more favourably disposed to a political union which is the ultimate guarantor of peace, their common decision making in domestic policies paving the way for common decision making in foreign and defence affairs.

Maastricht Treaty

Although almost all European countries other than UK, Denmark, and Sweden want to join the European Monetary Union, they can be admitted only if they satisfy the strict criteria for entry laid down by the stability pact of the Maastricht Treaty of 1992. The crucial requirement of the Treaty is that a member country's budget deficit should not exceed 3 per cent of its GDP and defaults carry automatic fines. The second requirement is that a country's public debt should be below 60 per cent of its GDP. In addition, a country is required to have low inflation, low interest rates and stable exchange rates. It was Germany that was instrumental in introducing the 3 per cent budget deficit criterion mainly because it wants a strong and stable common currency in the image of the strong Deutsche Mark. With 5 trillion Deutsche marks in liquid assets in Germany, private German households are expected to lose 50 billion marks with each percentage point of inflation. Germany is still haunted by the memory of the hyper-inflation of 1923 which wiped out the country's savings. This explains why Germany is so obsessed by the fear of inflation.

There is no doubt that a sound monetary policy at the regional level needs to be accompanied by sound fiscal policies at national levels if the monetary union is to be a success. Lower budget deficits normally mean lower interest rates and higher investment, growth and employment. It was Germany's belief that it could use the Monetary Union to impose strict macroeconomic discipline *a la* Germany on its neighbours so as to have a strong and stable common currency. The strict economic criteria for membership of the Maastricht Treaty, however, have come up against three major problems. The first is that the budget deficits in 1997 of all countries of the European Community, including, strangely enough, Germany, are estimated by OECD to exceed 3 per cent of GDP: Germany 3.4 per cent, France 3.2 per cent, Italy 3.7 per cent and Spain 3.4 per cent. This means that all these countries will be required to prune their public spending and increase taxation to reduce their budget deficits — in short, implement austerity measures. The second problem is that it is not easy to make cuts in public spending, particularly in welfare ben-

efits people have got used to. This was clearly demonstrated in France where the public not only protested violently against welfare cuts but also voted out of power the government which initiated such austerity measures.

The third problem is the existence of a relatively high level of unemployment in Western Europe: Spain 22.9 per cent, Belgium 13.0 per cent, France 12.3 per cent, Italy 11.9 per cent and Germany 10.2 per cent in June 1997. People fear that cuts in public spending are likely to increase unemployment further. Thus, the common currency — Euro — does not appear to be very popular in Europe at present. According to the latest Eurobarometer opinion polls in May 1997, a third of the respondents in the European Union as a whole are against the common currency. In six countries — Germany, Austria, Denmark, Sweden, Finland and UK — the balance of opinion is negative; in France the balance is positive but the margin in favour is shrinking. This does not augur well for Euro's future.

Faced with difficulties in pruning public expenditure, both French and German governments have resorted to other devices which many describe as "fudging" to reduce their budget deficits. The French government has transferred the entire pension fund of the State-owned France-Telecom to the treasury so as to increase revenue. The German government attempted to revalue its large gold reserves closer to current market prices in order to add a windfall profit of around \$ 10 billion to government revenue — for reducing both the budget deficit and the public debt resulting from massive subsidies to eastern Germany, but it was fiercely resisted by the Bundesbank (German central bank) as an unacceptable accounting trick and had to be abandoned for the time being.

Flexible Rules

Partly because of the difficulties in satisfying the Maastricht Treaty criteria and partly because of the representations made by the new socialist government in France, entry to the EMU is likely to be determined on less rigid criteria and on political considerations. The Maastricht Treaty rules are expected to be revised or interpreted liberally so as to provide greater flexibility. The consensus of opinion is in favour of this course of action in order to stick to the set time-table rather than postpone the monetary union to allow countries adequate time to meet the rigid Maastricht criteria but with no guarantee that they will be able to do so. Further, the countries have advanced too far along the road to turn back now.

France had argued for some time that there should be a political dimension to the EMU and that the European Central Bank should not be given overall control and that it should be watched over by an "economic government". In response to this suggestion, the European Commission has agreed to set up a "Stability Council" consisting of finance ministers of the EMU countries to operate as a political counterweight to the European Central

Bank. Whether the Stability Council will undermine the Central Bank's independence in monetary policy is not clear, but there is potential for conflict here for while the Germans want a narrow "economic" Euro, the French desire a wider "political" Euro. Second, the Stability Pact has also been revised to meet the French objections and any fines on defaulters will be subjected to approval by governments and not automatic. Third, the other members are not opposed to including a growth pact to stimulate employment in the Treaty and to preventing an overvaluation of the euro against the US dollar, as proposed by France. Although France has requested that both Italy and Spain should be admitted to the EMU in the first round itself, Germany has strong reservations on Italy's eligibility, particularly its ability to follow sound fiscal policies. Italy on the other hand, is expected to reduce its budget deficit and public debt by "accounting fudges" to satisfy the criteria for entry and is optimistic that it will be admitted.

In view of the difficulties in reducing the budget deficits below 3 per cent of GDP, it is expected that the 3 per cent ceiling on budget deficits will be allowed to be infringed so long as the budget deficits have been brought down somewhere close to 3 per cent or so long as any excess is temporary or exceptional. Of course, Germany will be most embarrassed as it was vehemently opposed previously to any flexible interpretation of the Maastricht criteria. Greater flexibility in the interpretation and application of the Maastricht Treaty may result in a Euro somewhat less strong than that envisaged by Germany, but the German exporters may prefer a Euro weaker than the Deutsche Mark to stimulate their exports.

If the EMU reduces the cost of doing business to stimulate economic growth, the people become satisfied with the way the European Central Bank conducts monetary policy, the European governments refrain from reducing welfare benefits as the French government has vowed, and the general public accept the Euro, the European countries may overcome their reluctance to give up sovereignty in political affairs to pave the way for a United States of Europe. If on the other hand, Europe's high level of unemployment persists with jobless growth and relocation of industries in low cost developing countries, welfare benefits are cut to reduce budget deficits and deflationary policies are pursued to make the Euro strong, the European Monetary Union and the common currency — Euro — are likely to have a rough passage at least at the beginning.