

## **Alternative Strategies towards Monetary Union in Europe**

The Maastricht Treaty defined a strategy for moving towards monetary union in Europe. This strategy has now come under increasing criticism. In this lecture I first review the problems with this strategy. I then describe a different approach that in my view could define an alternative road to monetary union in Europe.

### **1. The Maastricht Strategy**

The Maastricht Treaty defines a strategy for moving towards monetary union based on two principles. One is the idea that the transition to monetary union in Europe should be a gradual one. This contrasts with most approaches to monetary unification in history which have been introduced following a shock therapy approach. The most recent example of such a quick transition to monetary union is the German monetary unification of 1990.

The second principle of the Maastricht strategy is that entry in the monetary union by individual member countries is conditional on achieving a sufficient degree of convergence. These convergence criteria are well-known: Countries should have a sufficient degree of inflation and interest rate convergence; no devaluation should have occurred two years prior to entry, and budgetary policies should converge (3% rule for the government budget deficits, 60% rule for the level of the government debt).

Here also the contrast with most monetary unification processes in history is strong. As far as I can see not a single monetary union in history was organized by first imposing on potential candidates a long and protracted period of slow convergence of inflation, interest rates and budgetary policies. Prior convergence in these macroeconomic variables has never been imposed as conditions to join a monetary union. Again the recent German monetary unification provided the example. Monetary union was not only organized very quickly. There were no prior convergence criteria imposed on East-Germany. Certainly if these conditions had been imposed, the monetary union between East and West Germany would not exist today.

How stringent are these convergence criteria? Today, in 1994, not a single country (except possibly Luxembourg) satisfies all these conditions. Is it likely that this will change

dramatically before 1996 or even 1999? I want to argue that the stringency of the convergence requirements is such that, if maintained, these requirements will have the effect of keeping the monetary union small. In addition, they carry the risk of making the monetary union impossible.

First, and foremost, the fixity of the exchange rates cannot be maintained for a sufficiently long period of time. Conflicts about the stance of monetary policy in the system will continue to undermine the credibility of the fixed exchange rate arrangement. In addition, diverging fundamentals will add pressure on the fixed exchange rates.

The lack of credibility in the fixed exchange rates during the transition process will not diminish as we approach the final phase. On the contrary the more we approach the final phase the greater the problem. Expectations of a final realignment will inevitably lead to speculative crises much before the final date.

The lack of credibility of the fixed exchange rates during the transition process also has implications for the interest rates. Interest rates can only converge if there is increasing confidence that the exchange rates will remain fixed. The lack of credibility in the fixed exchange rates necessarily implies different interest rates. Put differently, in order to ward off speculative crises that inevitably will arise, interest rates will have to diverge. This is in fact a necessary condition to allow exchange rates to remain fixed during the approach phase to the final union.

The convergence of inflation rates is equally problematic. During the transition, the national monetary authorities continue to issue their own currencies. Each monetary authority carries its own reputation. This influences inflationary expectations, and thus actual inflation rates. These reputational differences will not disappear during the transition process, so that inflation differences will not easily decline to 1.5 percent a year as required by the Maastricht Treaty.

What about budgetary policies? Although with the present recovery, the conditions for budgetary consolidation may appear to be improving, new shocks on the road to monetary union are likely to occur leading to renewed divergence.

The whole of the Maastricht approach seems to be conditioned by the requirement that no major shocks in the world economy will occur. The rest of the world will sit still so as to allow Europe to converge quietly. This is very unlikely to be the scenario for the future. The probability of major shocks occurring, e.g. an oil shock, is great, thereby jeopardizing whatever level of convergence has been achieved. As a result, it is very likely that a significant number of countries will not satisfy these conditions.

Why were these severe entry conditions made the cornerstone of the Maastricht strategy? Is there a strong economic reason to impose such prior convergence requirements? We have a very large literature, called the theory of optimum currency areas which identifies the conditions that countries have to satisfy to make a monetary union possible. These conditions are that real wages should be flexible, or in the absence of sufficient wage flexibility labour should be willing to move across national borders.

The most striking aspect of all this is that the theory of optimum currency areas is silent on the need for prior convergence in inflation rates, interest rates, budget deficits or the levels of government debt. In contrast, this theory stresses the need for real wage flexibility and mobility of labour, as preconditions for a successful monetary union. Thus, the imposition of the Maastricht convergence criteria does not seem to have been based on much economic analysis.

If there is no economic case to be made for imposing prior convergence conditions, why were they then imposed. Those who drafted the Maastricht Treaty were not stupid. In order to understand the nature of the Maastricht convergence criteria it is necessary to analyze the political economy of monetary union in Europe. Two elements stand out in such an analysis. One has to do with the hegemonic position of Germany in European monetary affairs, the other with the possible inflation bias of the future monetary union.

## **2. The political economy of monetary union in Europe**

Today, Germany takes a dominant position in European monetary affairs. It is no exaggeration to state that Germany determines the monetary conditions in Europe. This has been made obvious especially during the recession of 1991-93, when the EMS-countries were forced to contract the money stock and raise interest rates, because of the need felt in Germany to reduce inflation. This acceleration of inflation in Germany led the Bundesbank to restrict the growth rate of the money stock. This German monetary restriction was then transmitted to the other countries who were forced to reduce their money stocks. Thus, the EMS forced the other countries to engage in monetary restriction so as to reduce the German inflation rate. This happened at a time when the inflation rates in these other EMS-countries had declined significantly and when the main policy problem was the recession.

The episode of the recession of 1992-93 illustrates the dominant position taken by Germany in Europe's monetary affairs. In a monetary union with twelve members Germany would certainly lose its ability to impose monetary policies on the others based on purely domestic objectives. In the future European central bank, comprising twelve directors, Germany will easily be put in a minority position, thereby losing control over its own monetary affairs and those of Europe. This loss of monetary hegemony of Germany in a future monetary union can be limited, however, if membership in the union can be restricted. In a relatively small monetary club Germany will be able to wield sufficient influence to maintain a significant hold on monetary affairs. It is in this context that the Maastricht convergence criteria should be understood: These serve the purpose of restricting membership in the monetary club and keeping it small.

The second factor explaining the Maastricht approach of restricting membership to the union can be explained as follows. German monetary policies of the past have been quite successful in creating a brand name for the mark as the low inflation currency in Europe. A European monetary union implies that the mark will be abolished and replaced by a new, untested European currency. In this process Germany is certain to lose its brand name. The new currency that will take over will have to establish a new reputation from scratch. This adds to the German reluctance to move into a monetary union, and creates the conditions for Germany to impose conditions for the access of EU-countries into the union. The convergence requirements again serve Germany's interests in restricting the size of the union so that the process of creating a new brand name for the European currency is made easier.

Note that in all this I do not want to blame Germany or its monetary authorities. Germany is pursuing what it feels is its national interest. Other countries in the same position would do exactly the same.

### **3. Risks of the Maastricht Strategy**

The Maastricht strategy carries great risks. It will lead to a prolonged exclusion of EU-members from the European monetary union. The problem for Germany is that even if some countries satisfy the convergence criteria, their representatives in the future ECB in no way will be bound to follow monetary policies that are agreeable to Germany. As a result, the incentive for Germany to postpone an irreversible step into the union will be strong.

There is a second risk in the Maastricht strategy. It could lead to a situation where the union does not even get off the ground. The risk here is that in 1999 only a minority of countries satisfy the entry requirements. According to the wording of the Treaty they should then start the union. It is also clear, however, that the process of deciding which countries are fit to start the union will be a highly political decision. The risk therefore exists that the majority of countries will be asked to give their consent in starting the union from which they themselves will be excluded. Such a situation will certainly lead to major political conflicts.

In this connection it should be stressed that the fact that the convergence criteria as formulated in the Maastricht Treaty allow for a flexible interpretation will not reduce the political conflicts. On the contrary. This flexibility may become a source of additional political tensions, as it will pit against each other those countries that want to exclude others and those countries that are excluded. The latter will almost certainly find arguments for a flexible approach, while the former will want to interpret the Treaty in a more rigid way.

Finally, as these conflicts will be fought out, it will be uncertain up to the last moment before the deadline of 1999 which country will be part of the union and which country will be excluded. As the step into the union necessitates a lot of preparation (technical and institutional) it is difficult to see how this can be done when one of the major questions, i.e. who will be member will remain unsettled until the last moment.

We conclude that the Maastricht strategy for monetary unification in Europe is fraught with difficulties. Not only does it risk creating a situation where a significant number of EU-countries are denied access for a long period of time. More importantly, the start of the monetary union is likely to be accompanied by major political tensions concerning the question who should be in and who should be out of the union. The uncertainty about these basic issues is likely to leak into the foreign exchange markets thereby creating a lot of turbulence. The Maastricht road to monetary union is likely to be a very bumpy one.

Do there exist alternative transition strategies? Let me now present an alternative approach to monetary unification, and discuss its advantages and disadvantages compared to the Maastricht one.

#### **4. An alternative strategy**

As I argued before, the problem of the Maastricht strategy is that it does not help to overcome the German reluctance for entering a monetary union with countries that have experienced more inflation in the past. Therefore, one has to devise a scheme that shows to Germany that a non-inflationary monetary union can work, before Germany is forced to abandon its own currency. How can this be accomplished? Let me first describe the scheme, and I then argue that this scheme meets our test.

The alternative strategy is based on three principles:

- a. All EU-members qualify to join. Those who are willing to join should make a commitment to join at a date which is set in advance.
- b. All convergence requirements are dropped, i.e. they are not considered as preconditions for entering the union.
- c. All the other rules defined in the Maastricht Treaty remain in force. This means that countries surrender their monetary sovereignty to the European Central Bank which will issue the new European currency and which will displace the national currencies. It also means that this European Central Bank will be politically independent and will be forbidden to finance government budget deficits.

The philosophy underlying this alternative strategy is that membership in the union will be determined by the free choice of each EU-member. Those members that believe it is in their interest to join can do so freely. They cannot be excluded by the others (as is the case in the Maastricht Treaty). Those that believe it is not in their interest to join are free to stay out of the union.

Let us analyze the advantages and the disadvantages of this strategy compared to the Maastricht one. The first advantage of the alternative strategy, proposed here, is that it avoids the occurrence of political conflicts, inherent in the Maastricht Treaty, about the question of membership. It will be clear long in advance who will be in the club and who will be out. All the necessary preparations can be made. This contrasts with the Maastricht Treaty where the membership question will remain unsettled until the last moment, producing great turbulence. In the alternative approach I propose here one can be sure the union can start in 1999 (one could even have it started in 1996). An important source of uncertainty that will hang over the European Union will be eliminated.

A second advantage of the strategy I propose here is that it recognises explicitly the low incentives Germany has in joining a monetary union and that it creates better incentives for Germany to join the union. This may seem paradoxical because the first objection that comes to mind against my proposal, is that Germany most likely will refuse to join a union in which countries with a history of relatively high inflation tend to dominate. Is it conceivable that a monetary union gets off the ground without its major partner participating? Up to now, the general response in Europe has been to think that this is inconceivable. It may be good to reconsider this widespread opinion.

So let us assume that Germany refuses to join and that the others decide to start the union without Germany. How does this give better incentives to Germany to accept the reality of a monetary union? Two things happen when such a union starts. First, since Germany will be outside a monetary area with which it has a major share of its trade, the variability of the real effective exchange rate of the mark is likely to increase. This creates a cost for Germany of staying outside the union. Second, the other countries forming the monetary union now have the opportunity to show to Germany that a non-inflationary monetary union is possible. Many observers today may doubt that this will be possible. These doubts are probably unfounded. For by adhering to the Maastricht Treaty the participants also introduce drastic institutional changes, including an independent central bank which will be prevented from financing budget deficits by creating money. For many countries this is a formidable institutional change. There is some reason to be confident that in this new regime these countries can produce an environment of low inflation. This conclusion is corroborated by a large body of empirical evidence indicating that the political independence of central banks tends to produce a low inflationary environment. Put differently, the monetary institutions created by the Maastricht Treaty (political independence, no monetary financing) are a reasonable guarantee for the maintenance of low inflation in Europe, whether or not Germany is part of the union.

What about fiscal policies in this monetary union without Germany? Much of the resistance of Germany against a monetary union finds its origin in a fear that large budget deficits will jeopardize sound monetary policies and therefore will make it impossible to achieve low inflation. Can the monetary union I propose here escape the need to put tight conditions on national fiscal policies? This is certainly a difficult question. Let me first point out that there is some evidence indicating that countries whose central banks are politically independent also tend to have lower government budget deficits (on average). The main reason is that in

those countries the government budget constraint is "hard". Here again the new monetary regime that will prevail in Europe in which the ECB will be politically independent, is likely to produce an environment of harder budget constraints than the ones that prevail in many individual countries. Thus, the future European monetary union is likely to constrain national governments much more than the monetary regime that prevails today in, at least, some of these countries. This being said there will be a need for mutual control and peer pressure in the budgetary field.

Once it becomes clear that a low inflation monetary union is possible, the incentives for Germany to join the union will be large. Instead of being forced to jump into the dark as the Maastricht Treaty requires, Germany will have a guarantee that while it abandons the mark, it will obtain a new currency that has the same low inflation characteristics. Thus, this strategy circumvents the major problem with the Maastricht approach. Despite the tightness of the convergence criteria, the Maastricht strategy will not give sufficient guarantees to Germany. The fact that countries satisfy these convergence criteria does not bind future national representatives in the ECB. The alternative approach suggested here does not ask Germany to leap into the dark. It can make the step when it is convinced by the evidence that the European Central Bank is committed to low inflation.

The strategy proposed here of course also faces formidable problems. The major one is probably political. Some countries, in particular France, but also smaller ones like the Netherlands, may not be interested in a monetary union in which Germany is not a member, even if this absence is only temporary. If too many countries refuse to join such a union it will not get off the ground. The challenge consists in convincing the governments of these other countries that the easiest way to have Germany in the European monetary union is to let it wait outside for a while.



## **6. Conclusion**

In this lecture I have argued that the Maastricht Treaty does not deal with the German reluctance to join a monetary union. In fact, the Maastricht Treaty will make Germany the final arbiter of who will be in the union and who will be out. This approach carries the risk of great political conflicts and of the postponement of the union. The alternative proposed in this paper consists in allowing each country to be his own arbiter about the membership question. This approach, of course, could lead Germany to decide to stay out. I argued that this may be a better approach, however, because it better recognizes Germany's problem. In this alternative approach Germany can wait and see and be convinced by the facts that a non-inflationary Europe is possible.

I realize, of course, that the alternative strategy proposed here faces formidable problems of its own. As a result, I have no illusions. I certainly do not view the proposals formulated here as realistic. They are to be interpreted as a 'spielerei' of an academic who feels completely free from political constraints.