Can The EMU Fly?

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By the year 2000 consumers could be paying for their purchases in ECUs; interest rate levels could be set by an EC central bank; and the Minister for Finance could find that his annual budget is drawn up within guidelines set at EC level. But is EMU just a Delorian dream that will utimately be watered down? In this paper I will describe the 'irreversible course' towards European Monetary Union (EMU) and its much proclaimed benefits, as a background to a discussion of the risks, reforms and threats that need to be addressed if EMU is to live up to the expectations of both Eurocrats and Europeans.

The Road to EMU

Post-Maastricht, the road to Economic and Monetary Union has been clearly mapped out, and, if Ireland meets the rules for membership, the punt will be replaced by a single EC currency by 1999 at the latest and possibly as early as 1997.

The first stage of EMU is already under way and entails the tying together of currencies in the European Monetary System band, with as many countries as possible to be in the narrow band of the system by the end of this stage. The narrow band allows a 2.25% variation of currencies from a central point, while the wider band, in which British and Spanish currencies lie, allows a 6% swing. The Greek and Portuguese currencies are not in either band.

In 1994 the second stage of the process will get under way. A European Monetary Institute (EMI) will be established and will replace the existing Council of Central Bank Governors. Member states will appoint a president on the basis of a recommendation from the central bankers. The EMI will have limited powers, its main role being to prepare the way for final union, act to coordinate monetary policy, and promote the use of the ECU. During this transitional stage the Community member states will be directed not to run large budget deficits, to reduce high debt levels, and generally to conduct policy within set criteria for moving to the final stage of Union.

By the end of 1996 the EMI and the European Commission will assess whether the member states are ready to move ahead to a single currency. A move will only be made if a majority, seven member states, meet the rules on inflation, interest rates, and government finances set for those moving to final Union. If the decision is not taken in 1996, then by mid-1998 the member states must decide which countries are ready to move ahead to final currency union. Who can join will be decided by a qualified majority vote on the basis of

financial criteria. One way or another, the final stage will commence on January 1st, 1999.

At this stage the EMI will be replaced by a European central bank. The central banks of the member states will continue to exist, but their power to set interest and exchange rate policy will be transferred to the European central bank. A mechanism will be set up to ensure that member states keep their budget positions in order, and do not run large deficits. This will involve financial penalties for errant states.

The Hopes .....

EMU was conceived as the next logical step beyond the creation of the single market. The 1992 programme involves free movement of labour, goods, services and capital. A single currency would increase the benefits of the single market, lowering the cost of business transactions and eliminating currency uncertainty. For member states, full economic and monetary integration carries hopes of lower interest rates, lower inflation, financial stability, and membership of a dynamic economic bloc, thus boosting investment and employment. In addition, financial market integration can only be perfected with single currency. The ECU should provide the benefits of price stability and central bank independence. As a single currency, the ECU would become a major international currency, providing several second order benefits.

The Risks.......

The ambitions of politicians can sometimes run ahead of economic realities. This may be true of their enthusiastic push to establish a single currency for Europe. Convergence of inflationary expectations is a necessary condition for EMU to work successfully - but not a sufficient condition. Irrevocably fixing the exchange rates of the potential member countries could be destabilising for the European economy, unless the individual national economies are sufficiently well integrated. A single currency means that individual countries can no longer use changes in exchange rates as a tool of economic policy. This loss of autonomy may be no bad thing when it prevents governments from devaluing to boost output today at the expense of higher inflation later. Yet fixing of exchange rates brings costs too. It means that governments can no longer use exchange rates to offset the effects of surprise economic events which affect economies differently. Events such as diverse swings in oil prices or one-offs like German re-unification can quickly push relative prices between countries out of line. Unless relative wages and prices are flexible and adjust quickly, the result will be lost output and higher European unemployment.

The potential costs of EMU therefore depend on the extent to which individual European economies behave as one economy, the extent to which they suffer from different shocks, and the speed with which relative prices adjust. Many economists argue that the Exchange Rate Mechanism (ERM) and the prospect of the single market have already increased the degree of integration between EC member states. At first sight the evidence suggests

they may be right. The scale and timing of economic shocks can be measured, albeit imperfectly, using stock price movements. If two economies are affected in the same way by the same economic shocks the share prices in the two countries should move together. The average correlation between changes in the stock price indices of the main European economies has been rising constantly since the early 1980's.

First impressions can be misleading. Sushil Wadhani of Goldman Sachs has studied this increase in European stock market correlations and has found that stock market correlations between the US and Europe have risen by as much as those between European markets since 1985. A closer analysis shows a rise in intra-European correlations has occurred largely because the individual European markets move more closely with the US. The ERM and the 1992 programme had only a modest effect.

Furthermore, the main determinants of movements in individual company equity are national rather than European in origin. The more integrated European economies become, the less national influences should matter relative to factors that affect all European companies in the same industry. Yet individual stock prices remain considerably more responsive to the performance of national share prices than to European sector share prices. Only in the UK do the national and European influences appear equal.

Further analysis also shows that the positive returns of certain industrial sectors compared to the national average are poorly correlated across countries. The UK and German electronics sectors, for instance, do not appear to outperform or underperform their national markets at the same time. The evidence suggests that the main European economies are far from being fully integrated. I would draw two conclusions at this stage: first, that the lack of European stock market integration still makes it profitable for investors to spread their risks by diversifying their portfolios across countries, and second, that investment companies should continue to employ individual country analysts.

Thus it would seem that EMU remains a somewhat risky venture. The European economy is not highly integrated, and country-specific economic shocks do occur. With exchange rates fixed, relative prices can only be realigned through changes in relative wages and prices. As labour mobility in the community is low, these adjustments could prove to be long and painful.

Will Ireland be eligible to join the club ?

The Irish football team may only have been seeded in the second group in the draw for the World Cup, but the economy should have little trouble qualifying for the first division in the move to the final stage of EC economic and monetary union. The Maastricht Treaty sets a target for debt to Gross Domestic Product ratio of 60%, compared to the current Irish rate of 97%. It is crucial to note that it makes

it quite clear that a state will be allowed to join once its debt position is moving fast enough in the correct direction. The same applies to the budget deficit target of 3%. With freedom to alter exchange rates removed, some flexibility of budget deficits will be allowed so as not to put national policy makers in a complete strait-jacket. In other words, the final decision on deficits, as on debt ratios, will be political; only major offenders will be excluded. Much will obviously depend on how the rules are interpreted. Those wishing to move ahead with the first group will also have to have inflation rates and interest rates close to the lowest in the EC, and a stable EMS link.

While the Irish government is confident that the rules, as set now, will allow this State to move ahead with the first group to EMU, it will require a much tighter budgetary policy to bring this about. NCB, in a study published last December, point out that the need to continue reduction of the debt ratio will mean a succession of tight Budgets. If borrowing is reduced to 1.5% of GNP by 1993, in line with the Government targets, then it would need to reduce the debt to within 10 to 15 points of the 60% target by 1997. Whether an economic upturn arrives in time to assist the government in honouring the already partly postponed pay increases agreed under the PESP will be a crucial factor.

The Irish authorities have little choice but to try to move with the first group to EMU. Not doing so would not stop the economy suffering from the disadvantages of EMU - the risk of activity moving to the richer central EC members - and would deal a serious blow to confidence in the Irish market from overseas investors.

Current Threats to the Creation of EMU

* The difficulties surrounding German re-unification. Until the German inflationary danger is put to rest, the prospects for EMU are dim. EMU is an extension and consolidation of the ERM. Germany is the anchor of the ERM, to which other countries are tied, despite the polite fiction that currency parities are fixed to ECUs. Thus if Germany goes through an inflationary phase, the attraction of a new single currency will wane, at least temporarily . The German public will not want to risk currency experiments and other countries will be less keen to sacrifice their monetary sovereignty to what they view as a German system.

* More fundamental, however, is the threat of forced budgetary transfers between member countries. Both the opponents of EMU and some of its more misguided supporters are insisting on the need for increased transfers to an ever growing list of poorer countries and regions. This is claimed to be necessary to compensate for the freezing of exchange rates and the eventual elimination of national currencies. This whole line of thought represents a failure to understand the type of convergence required for monetary union, which is the convergence of inflation rates or, more strictly, of cost levels for internationally traded products. Provided comparative

pay reflects prevailing productivity, rich and poor countries can engage in harmonious trade under a single currency, as they did under the 19th century gold standard. It is because such market-based ideas are neither accepted nor widely understood that the pressures for budgetary transfers are mounting.

* The so called 'social dimension' will hurt the very people it is designed to help. The Social Charter is not technically part of EMU, but it is part of the total package of which EMU is part. The Charter aims to improve benefits such as holidays, maximum hours, social security and so on. This will help existing employees, but will add to costs and discourage firms from taking on new workers. Moreover, because it will become more costly to lay off existing personnel, the bargaining power of the latter will be increased. The Social Charter amounts to a tax on jobs, and to an especially heavy tax on taking on new workers in conditions of uncertainty.

Conclusion

This essay has set out the path ahead for European Monetary Union. While the many potential benefits are widely known, I chose to view these benefits in the light of the real risks EMU holds for member economies, the ability of the Irish economy to meet the required criterion on time, and the current threats facing the flight of EMU. EMU will eventually find its wings but unless the costs, reforms and threats I have discussed in this essay are addressed before take-off it could prove to be a bumpy flight.

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