The Single European Currency: Prospects and an Alternative Proposal

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Abstract: This paper appraises the current position of the European Union (EU) countries, which could potentially become members of the Economic and Monetary Union (EMU) which is now likely to materialise in January, 1999, in an attempt to argue that the current EMU criteria should be revised. The paper discusses briefly and critically the Maastricht Treaty arrangements and convergence criteria for the single currency, reviews the current position of all the members of the EU, and presents a proposal for a new Maastricht. This alternative proposal seeks to overcome the deflationary biases in the Maastricht proposals, and suggests for low unemployment rates to be included in the convergence criteria.

Introduction

This paper pursues a number of themes related to the proposals for a single European currency: in particular we critically review the Maastricht Treaty arrangements and convergence criteria for the single currency, review the current position and present proposals for a new Maastricht. We begin by a brief review of the convergence

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criteria and of some key elements of the institutional arrangements which would underpin the single currency. The following three sections discuss in more detail the exchange rate and the budget deficit criterion and the proposals for an independent central bank. We report on the present position relating to the convergence criteria (which broadly shows that there would have to be a considerable degree of 'fudge' if the criteria are deemed to have been met), and argue that the criteria are of limited benefits. The last draws up an alternative proposal which seeks to overcome the deflationary biases in the Maastricht proposals.

Maastricht And All That

The convergence criteria under the Maastricht Treaty for a country's membership of the single currency and, by implication, membership of the Independent European System of Central Banks (IESCB) are (1) a high degree of price stability, with an inflation rate within 1.5 per cent of the three-best performing member states; (2) 'healthy' government finance, defined as a maximum ratio of 3 percent government deficit to GDP at market prices, and a maximum ratio of 60 percent of government debt to GDP at market prices; (3) observance of the normal ERM fluctuation margins for at least two years without any devaluation among the member state currencies; and (4) long-term interest rate levels that do not exceed two percentage points from the nominal long-term government bond rates of the three best-performing member states in terms of price stability.

The proposed IESCB comprises two important institutions: the national central banks and the European Central Bank (ECB). National central banks will not be abolished; they will become operating arms of the IESCB and have to be independent from the national governments. It is envisaged that such an institution would be accountable to the European Parliament through regular monitoring of the performance of the ECB, and in that way some degree of democratic accountability would be retained. The key points in the IESCB mandate are the following. First, to maintain price stability, using whatever monetary policy will be necessary regardless of the costs involved in unemployment and lost output. Second, to support the general economic policies of the EC, provided that it does not interfere with the objective of price stability. Third, to act in accordance with the free market economy principles. Fourth, to set interest rates, to conduct foreign exchange operations and to manage member states foreign exchange reserves. Fifth, to ensure smooth functioning of the payment system which links banks across the EU.[1]

Thus, the institutional arrangements involve the creation of an 'independent' (of political control) Central Bank at the European level, given the sole policy objective of zero inflation, which is to be achieved via the movement of interest rates,

presumably through its influence on the demand and supply of money and hence ultimately the rate of inflation. There is a complete separation between the monetary authorities (in the form of the Central Bank) and the fiscal authorities (in the form of national governments). There are EU-level expenditures, but there are no EU-level taxes, though member government make payments to the EU based on the yield of value added tax. The contributions from member governments are intended to cover the expenditure, and any budget deficit or surplus which arises does so from miscalculation and not for reasons of fiscal management. There is some degree of redistribution across countries involved in the EU budget but much of the redistribution is not of egalitarian direction and is linked to the vagaries of the Common Agricultural Policy ; but the EU-level expenditures are relatively small (of the order of 1.25 per cent of EU GDP). This separation between monetary and fiscal authorities is more than the one with which we are familiar with, namely the Central Bank/Federal Reserve operating monetary policy and the Treasury/Finance Ministry fiscal policy. This separation is between different tiers of government, and places the monetary authorities at the EU level in a much stronger position than the fiscal authorities at the national level, who in any case are limited to budget deficits of 3 per cent of GDP or less.

The monetarist theory which underlies much of the advocacy of the independent central bank (see Arestis and Sawyer, 1997) believes in the classical dichotomy, so that whilst monetary policy can guide the rate of inflation, the levels of output and employment are set on the supply-side of the economy (at the 'natural rate' or at the NAIRU) leaving no role for fiscal policy. The national budget deficits would be constrained by the threats of fines on any country which exceeds the 3 per cent of GDP norm. A country which fails to keep its budget deficit within the 3 per cent limit will have to pay in the first instance a penalty equivalent to the payment of a non-interest bearing deposit. If the situation persists the penalty becomes a fine equivalent to between 0.2 and 0.5 per cent of GDP, depending on the size of the 'excess' deficit. We would assume that any fine would be levied in respect of the *ex post* budget deficit since budget deficit forecasts are subject to both error and to manipulation (though this would also apply to deficit outcomes). But if the prospect of fines impact on national government decision making, then a government would aim for deficits substantially below 3 per cent of GDP in each year, regardless of the stage of the business cycle, to avoid unforeseen events pushing the actual deficit over 3 per cent of GDP. The *Stability and Growth Pact* 'sets out fines for deficits in excess of 3 per cent of GDP, unless corrective action is put in place to bring the deficit back down below 3 per cent. The stability pact incorporates a let-out for severe downturns' (Currie, 1997, p. 13). There are further problems with the penalty clause. As Goodhart (1996) observes,

'It immediately adds to the fiscal deficit it is meant to prevent. It will encourage accounting stratagems to reduce the estimated fine. Worst of all, the.....tax would inevitably have the effect of raising anti-European venom among the public. And would national parliaments willingly vote for such a tax? And what would happen if they refused?' (Goodhart, 1996, p. 246).

This constraint on the budget deficit clearly limits the use of national fiscal policy for demand management purposes, and also places some constraints on national governments to respond to disasters.[2] If a government is running a budget deficit near to the 3 per cent of GDP margin, then a degree of approval would have be obtained from the EU for any actions involving expenditure which would take the deficit over 3 per cent. Any budget deficit which does occur would have to be financed by borrowing, and the rationale for the limits on the national budget deficits is the externality effects of one country's budget deficit on the general level of interest rates within the European Union.[3] This non-monetisation of deficits is an (almost) inevitable corollary of the different tiers of government responsible for fiscal matters and for monetary ones.

The 3 per cent of GDP rule for budget deficits may well mean that over the business cycle the budget position is balanced or in surplus.

'National governments will need to aim at a balanced budget or surplus, or the deficit limit of 3 per cent could well prevent the proper working of fiscal stabilisers over the economic cycle. This means that governments could be required to raise taxes, or cut government spending, as the economy moves into recession, thereby exacerbating the downturn' (Currie, 1997, p. 13).

In the past decade, the budget position in the UK has swung from a surplus of 3 per cent of GDP to a deficit of 7 per cent. If a comparable swing in the budget position occurred in the future, with the largest deficit constrained to 3 per cent, then the surplus would be 7 per cent, with an overall surplus averaging around 1 per cent of GDP. A more cautious government which aimed for say a maximum deficit of 2 per cent to provide a margin of error would clearly run a somewhat larger surplus. This simple calculation points to two important likely consequences of the budget deficit rule. First, if there is a surplus of this magnitude, then government debt is being retired and the outstanding debt would fall to zero within a few decades, eliminating the bond market and the possibilities of open market operations. Second, it can be observed that the other side of a budget surplus would be some combination of private investment exceeding private savings and a foreign trade surplus. There is little reason to think that full employment is compatible with the requirements of either high investment relative to savings or a trade surplus. Any requirement of on an

average balanced budget is that the sum of net private domestic savings (savings minus investment) and foreign trade deficit (equal to overseas borrowing) is, on average, zero. It has yet to be established that such a requirement is compatible with full employment with the prevailing propensity to save and investment behaviour.

Exchange Rate Considerations

The criterion concerning exchange rates requires that observance of the normal ERM fluctuation margins for at least two years without any devaluation. When the Maastricht Treaty was agreed in December 1991, the normal ERM band was 2.25 per cent either side of a currency's central exchange rate against the Deutschemark (though some currencies were observing a 6 per cent margin). The ERM crisis of 1992-93, however, introduced the 15 per cent band for all currencies, with the exception of the Deutschemark and the Guilder which remained in the 2.25 per cent band. The 'letter' of the Treaty suggests that the 15 per cent band is the relevant one, though it could well be argued that the 'spirit' is the 2 per cent band. Whatever it may be, however, it is the case that what is meant by 'normal fluctuation' margins is vague. What is crystal clear, though, is the EMI (1995) statements, that 'Under current circumstances, it is not advisable to give a precise operational content to the Treaty provisions regarding exchange rates which could be mechanically applied also to forthcoming periods' (p. X), and that 'the requirement to be a member of the ERM remains an element of the Treaty' (p. 33). But however the Treaty is interpreted, we would argue that the relevant criteria would be low variability of the exchange rate (relative to other EU currencies) akin to the 2 per cent band. We would argue this for two reasons. First, since the single currency is the ultimate fixed exchange rate, preparations in the broadest sense for the single currency are much enhanced by stability of exchange rates in the period leading to the introduction of the single currency. Second, it enables a judgement to be made as to whether the exchange rate is at the 'right' level. Any judgement on the appropriate rate would be clouded by variations in the exchange rate, given the lagged effects of the exchange rate and the general finding that temporary fluctuations in the exchange rate do not feed through fully into prices.

However, a considerable degree of prior stability of the exchange rate (against relevant currencies) is a basic requirement for entry. The entry into a single currency obviously involves accepting a rate of exchange between each of the member currencies and the ECU, and it is a decision which is almost irreversible. If the exchange rate is in some relevant sense set incorrectly then it would have enormous and long lasting ramifications for the economy. The British experience over the return to the Gold Standard in 1925 with an overvaluation of around 10 per cent and

the entry into the ERM in 1990 at an overvaluation of around 15 per cent show the dangers of an incorrectly set exchange rate. Overvaluation raises the question of what is the correct value of the currency: our benchmark is an exchange rate which is compatible with a sustainable trade position and full employment. The question arises as to whether there is a mutually consistent set of exchange rates which would be compatible with full employment in each of the member countries. For the UK, the prevailing exchange rate is clearly not consistent with full employment given the current levels of demand in other European countries, though it may be if all EU countries achieved full employment. The calculation of the appropriate level of the exchange rate is fraught with difficulties and the advantage of a substantial period of stable exchange rates is that it would help to establish whether the prevailing exchange rate is the right one. We would stress that we are arguing here for both a stable exchange rate prior to any entry into a single currency and one which has been consistent with a healthy foreign trade position and high employment levels.

Budget Deficits

The criteria for a budget deficit of 3 per cent of GDP and a government debt of 60 per cent of GDP are given as 'reference values' and their precise status is a matter of considerable debate, especially since there is no prospect of many countries meeting the debt ratio requirement and there is considerable doubts over whether some of the major countries really meet the deficit criteria. Whilst the other criteria have a clear rationale in terms of a single currency (in the sense that, following the introduction of a single currency, there would be a fixed exchange rate and near equality of inflation rates, interest rates) that cannot be said for the budget deficit and government debt criteria. The particular figures chosen are quite arbitrary, but a justification appears to have been given. It is reflected in the following statement:

> 'The Commission say that if the Treaty conditions did not exist there would still be strong need for budgetary adjustment, and that the budget criterion is about sustainability: *The targets of 3 per cent deficit and a 60 per cent debt/GDP ratio would result in a stable debt/GDP ratio in a steady state economy with 2 per cent inflation and 3 per cent real growth*' (TUC Report on European Common Currency: the italicised part is a quote from a paper by Chris Boyd, a member of the cabinet of Jacques Delors then President of the European Commission, presented to the 1993 TUC Congress).

This statement is misleading in two crucial respects. First, a 3 per cent deficit and a 60 per cent debt/GDP ratio are consistent with any combination of inflation and

growth which adds up to 5 per cent per annum.[4] Similarly any size of deficit is consistent with a twenty fold larger stable debt/GDP ratio when the nominal rate of growth is 5 per cent per annum. The 3 per cent and 60 per cent figures have effectively been plucked out of the air, and there is no reason why, say, 4 per cent and 80 per cent could not be chosen. Second, there is some suggestion that the attainment of the 3 per cent and 60 per cent figures would lead to the attainment of a steady state economy which would not be the case. But there is little reason to think that the future will provide 5 per cent nominal growth divided into 2 per cent inflation and 3 per cent real growth. It is interesting to note that a 2 per cent rate of inflation is assumed here when the convergence criteria only refer to a country's inflation rate being close to the lowest inflation rates being experienced within the EU.

Concern over the government budget deficit should arise from the possibility that it will lead to mounting national debt, and that will be the case (for a constant primary deficit, that is excluding interest payments, relative to GDP) when the (post tax) rate of interest exceeds the rate of growth. This condition mask a basic problem namely that if it is not met then the 3 per cent overall deficit (including interest payments) can only be maintained by a growing surplus on the government budget excluding interest payments on the national debt.

The Independent European System of Central Bank

The proposition that IESCB should operate according to 'free-market principles' in the conduct of monetary policy means that the control of the money stock is to be achieved via the influence of the central bank on market interest rates, rather than through direct controls (Bain, 1995). But it is pointless to demand that the IESCB attempt to control the money stock when that is essentially endogenous and not controllable by the Central Bank (for example, Arestis, 1997, ch. 3). This raises the question of how price stability is to be achieved in the absence of any other policy instrument, other than using unemployment deliberately to achieve lower inflation rates (and that may well be ineffectual and/or costly). Central bankers, with their heavy emphasis on 'sound' money, are prone to pursuing deflationary policies without giving sufficient attention, if any, to full employment and growth targets. The justification for this focus on money and inflation has come from appeal to the classical dichotomy, and the declaration that monetary restraint has no effects on the supply-side potential of the economy.

We would see another problem with these proposals arising from the crucial assumption that appointed central bankers are to be trusted more than elected governments. But since central bankers see themselves the custodians of international capital, the formation of monetary policy will be geared more to the interests of

international financial capital rather than to those of the EU (see Coakley and Harris, 1983).

It is difficult to think of any precedent for the type of monetary arrangements which would arise under the single currency. The European single currency (euro) will only be legal tender in a part of the EU, and presumably it will only circulate to any great extent in those countries which accept the euro as legal tender. Whilst the euro will be underpinned by the tax raising powers of participating member governments (that is taxes in those countries will have to be paid in euros), nevertheless there will be a separation between tiers of government regarding taxation and money. The non-monetisation of the deficit would appear to mean that high-powered money would not increase, even when there is an expansion of economic activity. The consequence of this would be that there would be severe restraints on the ability of banks to increase their reserves (of high powered money): in effect they could only do so if the non-bank public are willing to reduce their holdings of cash. Then there could be corresponding restraints on the ability of banks to increase lending and the stock of money if there was a reserve ratio constraint. Alternatively, the stock of money can grow in the face of a declining required reserve ratio. The ability of banks to grant loans and to generate a growing stock of money is a necessary component of an expanding economy. A declining reserve position could undermine the ability of banks to grant loans and thus the stability of the financial system. The other possibility is that the European central bank engages in open market operations and provides reserves to the banking system. In effect, this would be a 'backdoor' monetisation of budget deficits. This, however, need not be an awkward problem if commercial banks can create reserves endogenously, especially so in view of liability management and securitisation. A potentially more serious problem is that changes in the common monetary policy are likely to have asymmetric effects across the Union in view of differences in the timing and amplitude of cycles, as well as in the institutional and behavioural characteristics of the member countries. So that 'Differences in the responsiveness of other financial markets to changes in money market interest rates and differences in the net financial positions and interest sensitivities of personal, corporate or financial sectors will mean that the burden of adjustment will not be evenly distributed' (Arrowsmith, 1995, p. 84).

Current Prospects

According to the Maastricht Treaty, the European Commission and the European Monetary Institute, forerunner of the proposed European Central Bank, will be reporting in March 1998 the participants to the EMU and to the single European currency. To qualify for EMU membership on 1 January, 1999, countries should

meet the Maastricht criteria as explained above. EU finance ministers will decide sometime in 1998 on how to interpret the ERM criterion, that is whether a 'normal' band is 2.25 per cent or 15 per cent. This decision will no doubt affect the number of countries meeting the ERM-Band criterion.

Table 1 cites the convergence situation of potential EMU members for the three years 1996-8. If we concentrate on the 1997 position to begin with, it would appear that 93 per cent of the EU member states meet the inflation criterion. This percentage was lower in 1996 (66 per cent), which represents a vast and significant jump within a twelve-month period. Changes of this magnitude pose a number of questions, the most important being the sustainability of the changes (suffice to note here that the percentage of countries expected to qualify on this criterion in 1998 is not expected to change in comparison to 1997) and the implied costs of doing so, an issue we touch upon later. The record of achieving the government finance criteria is interesting. Whilst 73 per cent of the countries meet the budget deficit criterion in 1997, a similar percentage fails the debt criterion. 87 per cent of the member states meet the long-term interest rate criterion. The comments made above on the ERM criterion not withstanding, 80 per cent of the EU countries manage to meet the ERM-participation criterion. The latter is particularly interesting, of course, in that it had to be relaxed substantially following the ERM turmoil in the early 1990s.

There are a few further observations that can be made. If we examine the convergence criteria through time, say over the three years reported in Table 1, there is significant improvement from 1996 to 1997 in two of the criteria reported in Table 1. The inflation rate criterion was met by 67 per cent of the EU countries in 1996 which went up in 1997 to 93 per cent and expected to remain at the same level in 1998. The budget deficit criterion was met by only 33 per cent in 1996; the 'success' rate shot up to 73 per cent in 1997 and in 1998 it is expected to increase to 87 per cent. The percentage of countries that meet the debt criterion does not change at all through time. It is met by only 27 per cent of the EU countries throughout the 1996-8 period. In terms of which member countries meet all criteria, the news is not very good for the proponents. It is only Luxembourg and Finland that meet all criteria comfortably in 1997 and 1998. By contrast, Greece is the only country that meets none of them. Belgium, Denmark, Ireland (which, however, is expected to fail in 1998 on the inflation rate also), Italy, Netherlands, Portugal and Spain fail on the debt criterion only. The UK also belongs to the category of only one failing criterion, but this is on the ERM band. Countries which fail on two criteria are: Austria and Germany failing on the budget deficit, (but both are expected to meet this criterion by 1998), and on the debt criterion. Sweden fails both the debt criterion as well as the ERM band one. It clearly follows that two members will meet the criteria, one will not, with the remaining 12 struggling with various degrees. The UK and Denmark negotiated the

right to abstain from any move to the EMU and the single currency; Sweden will also exclude herself from the first round.

There is also a question of the sustainability of outcomes which appear to satisfy the convergence criteria. One aspect of this is that there are business cycles and the extent to which the convergence criteria are met may depend on the state of the business cycles in the member countries. In particular, it would be expect that recession would make the budget deficit condition more difficult to achieve than boom conditions. Another aspect is the degree to which measures have been taken with the specific aim of ensuring that the convergence criteria are met. This appears to have been particularly the case in a number of major countries (France, Germany and Italy) with respect to the deficit position.

Whilst it is important to acknowledge that some 'success' is being achieved this year, and in some cases further improvements are expected in 1998, the point ought to be made that such success has been achieved at a high cost in terms of unemployment. As Table 2 shows, the picture is really bleak when the unemployment experience is taken on board. Unemployment rates well above the 10 per cent rate still exist in a number of EU members, and with the exception of Luxembourg, all EU unemployment rates are well above 5 per cent. Countries which managed to improve on meeting the convergence criteria over the 1996-8 period have experienced high and rising unemployment rates. We may refer to Austria, Finland, France, Italy, Spain and Sweden to make the point. In the case of all these countries, improvement in terms of meeting the convergence criteria did take place, but at significantly high costs in terms of their unemployment rates. Furthermore, the countries outside the EU do not appear to have been experiencing the same high unemployment rates, as the EU members. If we take the average unemployment rates for the EU countries and the non-EU countries, as reported in Table 2, the point is made clearly. But what is more important is that as we move from 1992 to 1997 the difference in the averages of the two sets of countries widens, and indeed after 1995 the gap remains the same. Indeed countries which are comparable to the EU countries, Canada and the US in particular, have actually been enjoying falling unemployment rates continuously since 1992. Norway is another good example of a country which has chosen to remain outside the EU and her unemployment rate has been falling steadily since 1993. Similarly, we may even refer to the UK case where since 1992, when the UK left the ERM mechanism, unemployment has been falling steadily with the exception of 1993 when it increased slightly.

Even if countries met the criteria and joined the single currency, they would have to abide by the above mentioned *Stability and Growth Pact*. This system of financial penalties for member countries which breach the budget deficit criterion, imply that deflationary policies and high unemployment rates would not disappear by the mere fact of qualifying to join the EMU. As suggested earlier, the current convergence

such as it is, may very well be unsustainable which implies that further costs in terms of unemployment are likely to ensue in view of the *Stability and Growth Pact*. There are thus potentially very high costs in terms of both attempting to meet the Maastricht criteria and maintaining the imposed discipline once within the EU. The clear implication is that the introduction and use of euro under these conditions would have severe deflationary consequences. Table 2 is a vivid reminder that countries like Germany, France, Italy, Spain, Sweden, have savaged their economies in their attempts to meet the single currency criteria. Even more seriously, they will have to go on doing so, thus increasing further their unemployment rates.

A potentially serious situation may develop if the EMU includes countries which meet the Maastricht criteria only marginally. This may very well mean that fiscal deficits and inflation rates are higher than if the membership of EMU were narrower, and especially so if the *Stability and Growth Pact* is implemented rather weakly. Under these circumstances the ECB is likely to offset this fiscal laxity by being more deflationary, than otherwise, in its attempt to achieve price stability. Erratic movements in interest rates may ensue which could imply a volatile euro. All in all, this could easily lead to an overvalued euro thus deteriorating even more the unemployment situation.

Limited Maastricht Benefits

It is generally recognised that the direct benefits of a single currency are rather limited, and arise from the reduction in transactions costs involved in EU trade. 'The likely amounts are not however very large, and once the one-off costs of converting to the euro are taken into account as well, the net transactions savings do not provide a strong reason for moving to the euro' (Currie, 1997, p.6). Estimates of the transition costs to the euro are of the order of $30 billion (Financial Times, 24 November, 1997). The major effects, for good or ill, of a single currency will arise from the institutional and policy framework within which the euro is embedded. We would see the current proposals for that institutional and policy framework as derived from a 'new monetarist' perspective. This is based on the classical dichotomy with a separation between the real and the monetary sides of the economy with the (equilibrium) level of unemployment (effectively the NAIRU) and output determined on the supply-side of the economy and the level of prices (and hence the rate of inflation) set by the rate of expansion of the money supply. The monetary and financial sector is viewed as essentially stable and, of course, the classical dichotomy serves to, in effect, insulate the real side of the economy from the monetary side. The stock of money cannot be directly controlled, but the Central Bank can use its discount rate (or equivalent) to influence monetary conditions, which thereby influence the rate of inflation. The

general level of interest rates is seen, by the financial markets at any rate, to depend on the credibility of the monetary authorities of the country concerned. Those with anti-inflationary credentials are rewarded with lower interest rates.[5] An independent central bank is seen as one device for securing these credentials.

A New Maastricht

We start from a rather more Keynesian perspective. The prevalence of unemployment is an unfortunate stylised fact of most peacetime industrialised economies during most of this century. We do not propose a mono-causal explanation of unemployment but rather see an inadequacy of aggregate demand, a financial system which has deflationary tendencies and effects, lack of productive capacity to employ the available labour, balance of trade and inflationary constraints, unemployment as a disciplining device, as amongst the more significant causes (some of which are more important at a particular time and country than others). Forces of cumulative causation operate in market economies to generate disparities between regions and countries, so that even if full employment can be achieved in the more prosperous regions the less prosperous regions are still left with substantial unemployment. We take the view that the real and the monetary sectors in any economy are closely linked. Proposals for a new Maastricht have to address two issues: first, what convergence criteria should be satisfied before a single currency is established, and second, what institutional arrangements should accompany the single currency. We turn to these issues in turn.

There is some clear sense in the requirements that interest rates and inflation rates should be aligned in those countries joining a single currency, and we would propose to retain those convergence criteria. There is also clear sense in the criteria on stability of exchange rate over a preceding two year period, and indeed we would interpret that criteria rather more strictly than appear to be the current intentions. But the level of the exchange rate is not independent of the level of economic activity, and hence a criterion for the convergence of the levels of economic activity is also required. It cannot be overemphasised that a currency entering the euro at an overvalued level will cause substantial adverse effects. Think of the deflation that would have to be endured to reduce prices in a country by say 10 per cent in order to offset an overvaluation of that order; or the difficulties which an economy would endure if the exchange rate were appropriate when that economy had say 20 per cent unemployment and others had 10 per cent. The convergence criteria on the level of economic activity comes in two parts. First, there should be the requirement that the average rate of unemployment (over the course of a business cycle) is broadly the same (say within 2 percentage points).[6] Locking together economies with very

different levels of unemployment, especially in the context of very small fiscal transfers is a recipe for long term disparities of unemployment. We would also argue for the convergence of unemployment to take place around a low level. Second, that the business cycles in the countries concerned are broadly in line with each other. Clearly if one country is at the top of the cycle and another at the bottom, the appropriate fiscal and monetary policies are quite different: at a minimum a single currency necessarily imposes a common monetary policy on participating countries (and we would argue for a degree of common fiscal policy).

It may be useful to draw on the 'optimum currency area' literature for guidance on the convergence criteria. This literature suggests that it would be desirable for a single currency to be used in an economic area within which there is openness of goods markets and the mobility of factors of production (labour, capital) and which shared similar inflationary tendencies. Mobility of labour within the EU remains low (especially by comparison with the US) and that is unlikely to change radically. Openness of goods markets may very well prevail but integrated stabilisation and political unification, or indeed similar inflationary tendencies are distant realities. Furthermore, members of the EMU will not constitute an optimal currency area unless the countries outside the Union *de jure*, act as *de facto* members of the Union. Unless, that is, countries outside the Union with trading and financial links with the EMU members, pursue economic policies compatible with those of the Union (Arrowsmith, 1995, p. 84).

Within a single country there are substantial, often virtually automatic, transfers of income from the more prosperous to the less prosperous regions. The automatic elements come from the tax and social security system and other elements come through regional policy and allocation of funds to local government. Countries with federal structures have a significant (say around half) of government expenditure at the national level with the national government having an ability to run deficits and operate fiscal policy, as well as to redistribute income between states. This is completely absent from the EU. Transfers from the operation of automatic stabilisers do not occur at the EU level and the discretionary transfers are relatively small. Hence the check on the decline of weak regions which emanates from these transfers is largely absent. Given the lower degree of labour mobility across national borders rather than within them, the complete loss of the exchange rate adjustment possibility requires an adequate policy of regional transfers through a Community fiscal policy to accompany the proposed common monetary policy. Such a common fiscal policy to be operated alongside and in co-ordination with the proposed common monetary policy is paramount.

There are obviously many differences between the member countries of the EU, some of which are particularly significant for the adoption of a single currency. The variations in labour market institutions, notably over wage determination, mean that

there are differing inflationary tendencies and different responses to shocks. The banking systems are at different stages of development with different characteristics where the capacity of banks to create credit depends on their stage of evolution. Banking systems in the peripheral countries (Greece, Portugal, Spain, Ireland) differ substantially from the ones in the core countries (and there are also important differences within the core countries, for example between UK and Germany). Peripheral countries are characterised by weaker banking sectors, more uncertainty and higher liquidity preferences than in the core countries.

It is difficult to formulate criteria on inflationary tendencies, though there may be a temptation to say that if the criterion on convergence of inflation and of unemployment rates were simultaneously satisfied, that would be a degree of support for the convergence of inflationary tendencies. Indeed, we may need convergence to Maastricht criteria, but this should be a stable convergence for a number of years with unemployment being low as well. Low unemployment along with low inflation over a number of years, should be the appropriate criteria for a country wishing to join the EU common currency. Goodhart (1996) has made a similar suggestion and argued that with the benefit of hindsight, it would 'have been desirable to supplement the inflation criterion with an unemployment criterion, for example, that no country could join without simultaneously having had inflation below 3 per cent and unemployment below, say 7.5 per cent over the previous two years' (p. 246). As indicated above, we would argue for a much lower level of unemployment as part of the convergence criteria.

This leads us to the institutional and policy arrangements. On the monetary side, the key question is the role of the central bank. We would argue for the objectives of the bank to include the pursuit of full employment and economic growth as well as price stability (recognising that there may be trade-offs between the objectives, though not necessarily in the manner suggested by the Philips' curve). The central bank would also have the objective of the regulation of the financial system, with the further aim to provide an orderly functioning of the credit system. In this context there is also a requirement for more effective accountability, which requires mechanisms of democratic influence (if not control) over the central bank from the European Parliament (and we would extend that to national Parliaments). This accountability would not affect the independence of the IESCB. It would reinforce the legitimacy of the institution and avoid at the same time dramatic conflicts between monetary policy and other EU objectives.

Conclusions

We have argued in this paper that the transition to a single European currency entails essentially two serious problems. The first is that a number of countries will not be able to meet the Maastricht criteria by the set day. The second is that the attempt to meet these criteria has been accompanied by higher unemployment rates throughout the EU. We have also argued that the problem of unemployment will persist for countries even within the EMU and the single currency in view of the requirement not to deviate from the set criteria. In view of these problems we have suggested a more realistic New Maastricht. While this would retain the criteria proposed in the Maastricht Treaty, it would redefine them to include low unemployment rates. This would ensure that convergence will embrace economic activity in addition to the other.

NOTES

[1] On January 1, 1999 the EURO is planned to be launched only for inter-bank/business transactions. The ECB will formally take charge of monetary policy from the European Monetary Institute (EMI) - the precursor of the ECB. On January 1, 2002 notes and coins denominated in EURO begin to circulate across the EU and national currencies are withdrawn.

[2] It could also have the effect of reducing a country's ability, or indeed willingness, to wage war. The Falklands War might not have been initiated under these circumstances. Perhaps after all there is something to be said for the limit on budget deficits!

[3] That does seem to involve something of a contradiction. Interest rates are to be used by the Central Bank to influence the money supply so that interest rates are seen as a monetary phenomenon. But here interest rates are seen as influenced by loanable funds considerations.

[4] Label B as the primary budget deficit (that is excluding interest payments), D as the government debt, r as the post tax rate of interest and g as the rate of growth (r and g can be in nominal or real terms as long as there is consistency though the Maastricht conditions appear to be in nominal terms). The growth of outstanding debt will be in line with the growth of GDP (and hence the debt to GDP ratio constant) when $(rD + B)/D = g$, and hence when $(rD + B)/GDP = gD/GDP$. The left hand side of this equation is the budget deficit (including interest payments) to GDP ratio and the right hand side the growth rate multiplied by the debt to GDP ratio. Thus figures for deficit of 3 per cent of GDP, debt of 60 per cent of GDP are consistent with a growth rate of 5 per cent. Note however that if the growth rate is less than the rate of interest, the primary budget deficit $(B = (g - r)D)$ will be negative, i.e. primary budget would be in

surplus. Further, the primary budget surplus would be growing over time as the interest payments mounted.

[5] One of the ironies in the UK is that some view that sterling joining the euro would lead to lower interest rates in the UK (with the interest rate for euros being more towards the rate on the Deutschemark than on sterling), which would stimulate demand (especially in light of the role of variable rate borrowing in the UK). The Treasury takes the view that such demand stimulus would have to be offset by fiscal deflation with tax increases. But this could not be implemented due to the government's fear of being labelled a tax raising one. A further irony is that sterling is currently riding high on the foreign exchange markets as it is seen as a safe haven over the next few years when the euro may be brought into being without sterling being a member.

[6] It should also be recognised that measured unemployment may not be a good indicator of the extent of slack in the labour market.

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Table 1: Convergence situation of potential EMU members

	Inflation Rate (Consumer)			Budget Deficit as per cent of GDP			Debt as per cent of GDP			Long-term Interest rate	ERM Band
Reference value	1996 2.5	1997 2.6	1998 3.1	1996 3.0	1997 3.0	1998 3.0	1996 60.0	1997 60.0	1998 60.0	Aug. 1997 8.0	(to be decided)
Germany	1.5	1.9	2.3	3.8	3.3	2.9	60.7	62.2	62.7	5.7	±15 per cent
France	2.0	1.1	1.3	4.1	3.2	3.2	55.4	57.7	59.2	5.6	±15 per cent
Italy	3.9	1.8	2.1	6.7	3.2	3.0	123.8	122.9	121.2	6.6	±15 per cent
UK	2.9	2.6	2.7	4.7	2.0	0.6	57.8	54.5	52.4	7.1	free floating
Spain	3.5	2.0	2.2	4.4	3.0	2.6	69.8	69.0	68.2	6.2	±15 per cent
Netherlands	2.1	2.3	2.3	2.3	2.1	1.8	78.0	73.6	71.2	5.5	±15 per cent
Belgium	2.1	1.6	1.9	3.2	2.8	2.6	127.4	125.1	122.8	5.7	±15 per cent
Sweden	0.8	1.0	2.0	2.5	2.1	0.0	77.7	77.1	73.9	6.5	free floating
Austria	1.9	1.5	1.6	3.9	2.5	2.5	70.0	68.0	67.6	5.7	±15 per cent
Denmark	2.2	2.5	2.6	1.4	-0.5	-0.5	69.9	66.4	63.2	6.2	±15 per cent
Finland	0.6	1.3	2.3	3.1	1.9	0.4	58.8	59.4	57.9	5.8	±15 per cent
Portugal	3.1	2.2	2.3	4.0	2.9	2.9	66.0	62.9	61.7	6.3	±15 per cent
Greece	8.2	5.7	4.7	7.4	4.7	4.1	111.8	108.0	104.2	9.6	free floating
Ireland	1.6	1.7	2.1	0.9	0.8	0.8	72.8	67.5	65.0	6.3	±15 per cent
Luxembourg	1.8	2.0	2.0	0.1	0.1	0.1	5.9	5.7	5.5	5.9	±15 per cent
countries meeting criteria											
YES	10	14	14	5	11	13	4	4	4	14	12
NO	5	1	1	10	4	2	11	11	11	1	3
All countries	15	15	15	15	15	15	15	15	15	15	15

Source: IMF World Economic Outlook, September 1997.

Table 2: Standardised unemployment rates: seasonally adjusted[i]

	1992	1993	1994	1995	1996	1997*
EU COUNTRIES						
Austria	3.6	4.2	3.8	3.9	4.4	6.6
Belgium	7.3	8.9	10.0	9.9	9.8	9.7
Denmark	9.2	10.1	8.2	7.2	6.9	6.4
Finland	13.0	17.7	17.4	16.2	15.3	15.3
France	10.4	11.7	12.3	11.7	12.4	12.6
Germany	6.6	7.9	8.4	8.2	8.9	9.5
Greece[ii]	7.9	8.6	8.9	9.7	9.8	10.0
Ireland	15.4	15.6	14.3	12.3	11.8	10.8
Italy	9.0	10.3	11.4	11.9	12.0	12.2
Luxembourg	2.1	2.7	3.2	2.9	3.3	3.7
Netherlands	5.6	6.6	7.1	6.9	6.3	5.6
Portugal	4.2	5.7	7.0	7.3	7.3	6.2
Spain	18.5	22.8	24.1	22.9	22.1	20.9
Sweden	5.6	9.5	9.8	9.2	10.0	10.7
UK	10.1	10.4	9.6	8.8	8.2	7.4
Average for EU Countries	8.6	10.2	10.4	9.9	9.9	9.4
NON-EU COUNTRIES						
Australia	10.7	11.0	9.8	8.6	8.6	8.7
Canada	11.3	11.2	10.4	9.5	9.7	9.5
Japan	2.2	2.5	2.9	3.1	3.4	3.4
Norway	5.9	6.1	5.5	5.0	4.9	4.2
USA	7.5	6.9	6.1	5.6	5.4	5.2
Average for Non-EU Countries	7.5	7.5	6.9	6.4	6.4	6.2

Sources:
[i] OECD Economic Outlook
[ii] Labour Market Trends and Ministry of National Economy (Greece)
* These are average figures of the first two quarters in 1997.