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**Europe on the Road to the Third Stage of EMU:
Recent Evidence**

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Abstract

The paper deals with Europe's effort to proceed to the third stage of EMU and establish a common currency. It is argued that the success of the common currency experiment will greatly depend on the fulfillment of the Optimum Currency Area (OCA) criteria, on the adoption of the proper adjustment policies as well as on the political desirability of the project. The paper is organized as follows: Section 1 deals briefly with the index of criteria that define an OCA. Section 2 examines the extent to which Europe experiences common demand disturbances, while sections 3 and 4 focus on evidence about the mobility of factors of production across Europe, namely labor and capital. Section 5 examines the possibility of an increase in trade volume across the EU under fixed exchange rates or a common currency regime. Section 6 sheds light on the possibility of the EURO (the ex-ECU) to become a vehicle currency in the international financial system, and Section 7 is concerned with the benefits and costs of the establishment of a European Central Bank (ECB), paying special attention to seigniorage revenues. Section 8 deals with the necessity of establishing an EU federal mechanism facilitating adjustment. Section 9 sketches out a proper role for a hegemonic power in a common currency regime. Finally, section 10 examines EMU prospects during the transitional period. The paper closes with some concluding remarks, where the role of politics and coordination of economic policies are particularly emphasized as of cardinal importance on the road to the third stage of EMU.

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INTRODUCTION

Europe today stands at a monetary cross-roads. This paper examines the viability of the EU project to establish a common currency through testing it in the light of the Optimum Currency Area theory. There are some basic questions to which this paper seeks to deal with: Does Europe need a common currency? If yes, what has to be done to end the present transitional period with success? What would be the cost and how should the burden of adjustment be shared among EU member-states?

The theory of Optimum Currency Area (OCA) as defined in the seminal works of J. Meade (1957), R. Mundell (1961), R. McKinnon (1963) and P. Kenen (1969), give us an index of criteria as well as a theoretical framework in order to be able to answer the above questions and recognise whether a group of countries fulfill the prerequisites for constituting an OCA.

However, economics does not govern the world by itself. Politics, ideology, culture and the ways that people think and react, interfere and influence the way events unfold and make reality to deviate from well-constructed theories and paradigms. In this context, Europe's effort to proceed to the third stage of Economic and Monetary Unification (EMU), can not be understood by reference to economics alone. In investigating the reasons why Europe tries today to establish a common currency, politics and national interests are of cardinal importance in explaining the effort. Since this is true, one should not be surprised that arguments pro and against EMU are very common in the relevant literature.

Despite potential gains often mentioned in the literature or argued by EU officials, this paper argues that Europe as it is today does not constitute an "Optimum Currency Area". It is also argued that the success of the experiment to establish a common currency will greatly depend on the fulfillment of the OCA's criteria, on the adoption of the proper adjustment policies as well as on the political desirability of the project.

The paper is organised as follows: Section 1 deals briefly with the index of criteria which define an OCA. Section 2 examines the extent to which Europe experiences common demand disturbances, while sections 3 and 4 focus on evidence about the mobility of factors of production across Europe, namely labour and capital. Section 5 examines the possibility of an increase of trade volume across EU under fixed exchange rates or a common currency regime. Section 6 sheds light on the possibility of the EURO (the ex-ECU) to become a vehicle currency in the international financial system, and section 7 is concerned with the benefits and costs of the establishment of a European Central Bank (ECB), paying special attention to seigniorage revenues. Section 8 deals with the necessity of establishing a EU federal mechanism facilitating adjustment. Section 9 sketches-out a proper role for a hegemonic power in a common currency regime. Finally, section 10 examines EMU prospects during the transitional period.

The paper closes with the concluding remarks, where the role of politics and coordination of economic policies are particularly emphasized as of cardinal importance on the road to the third stage of EMU.

1. THE CASE FOR AN OPTIMUM CURRENCY AREA

Thirty-five years ago, R. Mundell (1961) in his seminal work about Optimum Currency Areas, argued that "it hardly appears within the realm of political feasibility that national currencies could ever be abandoned in favor of a common currency". We are today very close to the date of adoption of a common currency. However, few people seem to believe that a common European *nomisma* will establish itself on the threshold of the 21st century. It is not only the marginal *oui* of French referendum or the withdrawal of the Italian and British currencies from the ERM. It is mainly the growing discontent among Europeans with the policies followed in the present transitional period which have become

synonymous with austerity and high unemployment. As a consequence, it is essential to examine if tomorrow's benefits will compensate for today's high costs.

An Optimum Currency Area is a domain with a common currency, with fully flexible wages and prices, or alternatively with high mobility of factors of production, namely labour and capital. A currency area is optimal if participation does not raise a member's need to use its fiscal policy for domestic stabilization, or if it does not raise its vulnerability to real shocks or diminish its ability to deal with them (Kenen 1992).

It is to the benefit of individual countries to shape a common currency area in case they have high volume of trade exchanges among them, or if they are much dependent on trade. It is also an advantage to be geographically closed to each other, while a country should not be too large to constitute alone an Optimum Currency Area. The openness of an economy, which has to do with the portion of tradeables to non-tradeables goods, determines also the cost of abandoning autonomy in monetary policy, a by definition prerequisite for an individual country to join a common currency area. Extended openness, in other words, a high portion of tradeable goods make the instruments of monetary and exchange rate policies rather useless; while in case of external disequilibrium, every effort to devalue the national currency sooner or later ends up in intense internal imbalances characterized mainly by double or even triple-digit inflation rates.

An independent Central Bank with note-issuing powers is also needed to reassure that diversified and contradictory national monetary policies would not be followed, a fact which could lead to speculative attacks on "soft" currencies, especially in a regime of high capital mobility and free trade.

Last but not least, individual countries with the prospect for monetary unification, should experience similar/symmetric and not idiosyncratic demand disturbances. In other words, the mix of products they produce should be similar. In any other case and given the fact that by definition monetary autonomy is excluded, high mobility of labor and capital would be needed to compensate for the very possible case of, at least partially, sticky wages and prices.

Generally speaking, when a shift in demand from domestic to foreign goods requires adjustment in domestic costs, sacrificing monetary autonomy by joining a common currency area would be much more costly if wages are adjusted to demand disturbances less skillfully. In this case, the higher the mobility of factors of production, the less the cost of adjustment.

In the case that an individual country or region experiences an idiosyncratic demand shock, and the above mentioned prerequisites are not properly fulfilled, an institutional mechanism for redistributing income across countries and/or regions is needed in order to compensate lagging areas for loss of income and high unemployment rates. Fiscal federalism is considered to be the best way of acting against adverse phenomena, as indeed the case of other federal states such as the USA, Canada, Australia and Germany has shown. Europe seems to favor, up to now, direct transfers of incomes to the poorest regions, either in the form of structural funds and other programmes or in the context of the Common Agricultural Policy (CAP).

After briefly presenting the index of criteria for an OCA, let us now embark on Europe and, based on updated evidence, examine the extent to which the establishment of a common currency is a feasible and viable option.

2. DEMAND DISTURBANCES

The very first requirement to form an Optimum Currency Area lies in the incidence and magnitude of the idiosyncratic demand disturbances which individual countries experience as well as on the speed of adjustment (Eichengreen 1990, 1992 1993, Bayoumi and Eichengreen 1992a, 1992b). For an open economy, demand disturbances depend also on foreign market fluctuations and changes in imported oil prices. Assuming that foreign factors do not provoke a demand shock or in the case they provoke some, they influence

countries symmetrically; asymmetry in demand disturbances across regions and countries come mainly from differences in the mix of goods they produce. Other things equal, the product specialisation of individual countries, a factor first mentioned by Kenen (1969), no matter whether it is created by Heckscher-Ohlin factor endowments or strategic trade policies, determines both the incidence and magnitude of demand disturbances and so it constitutes a first credible factor to judge whether a common currency area is optimal or not. Although the official view of Europe (European Economy 1990, Emerson et al. 1992) insists on the ability of the EMU to converge structures of production around Europe, economic theory leaves no doubt that the deeper the market integration, the higher the product specialisation; and the greater the differences in the structure of production, the greater the incidence and the magnitude of the demand shocks that individual countries experience and the lower their speed of adjustment (if any).

In a case with multiple countries and currencies, governments are able to use the old, tried Keynesian policies to face idiosyncratic shocks, namely succeed in adjustment by applying accomodating monetary policies and using the exchange rate instrument to correct external disequilibrium. The greater the prevalence of asymmetric shocks, the higher the option value of independent monetary policy. However, as it is already argued, by definition EMU involves a sacrifice of monetary authority while monetary power in the final stage is transferred to the European Central Bank. While economic integration proceeds and diversity of production structures deepens across Europe, a negative aggregate demand shock will have a different impact on member-states. Hence, there is a need for the use of an autonomus monetary policy to restore internal and external imbalances, unless either wages and prices are flexible or the mobility of factors of production is as high as capable to restore equilibrium.

Table 1 presents evidence on the differences in structures of production among European member-states and, at the same time, it coincides with the evidence presented by Bayoumi and Eichengreen (1992a, 1994b) on the incidence and magnitude of idiosyncratic shocks across EU.

TABLE 1
PROPORTION OF TOTAL EMPLOYMENT BY SECTOR OF PRODUCTION

Eur	B	DK	D	Gr	E	(1992) %*						
						F	Irl	I	L	NL	P	UK
AGRICULTURE												
7	3	6	4	25	13	7	15	9	4	5	19	2
INDUSTRY												
33	32	27	40	26	33	30	29	32	29	27	35	33
SERVICES												
60	65	67	56	49	54	63	56	59	67	68	46	65
EMPLOYMENT AS A % OF TOTAL EMPLOYMENT IN MANUFACTURING (1993)**												
100	2.8	1.5	31.8	1.1	8.8	15.9	0.8	12.8	0.1	-	3.1	17.7

Source: *Eurostat (1992), **Eurostat (1995a)

Using the structural vector autoregression analysis to isolate disturbances, a method first developed by Blanchard and Quah (1989) and taking as a measure of comparison the case of the USA, Bayoumi and Eichengreen's (1992a) analysis reveals sharp differences in demand (and supply) shocks affecting the countries of the so-called "core Europe"

(Benelux, Denmark, France, Germany and the Netherlands) and the "peripheral States" (Greece, Portugal, Spain, Italy, Ireland; to those, they surprisingly add the UK). Bayoumi and Eichengreen (1992b) test for newcomers, place Austria and Sweden in the "core", while Finland and Norway are considered to experience demand disturbances more similar to the "periphery".

They also find no evidence of convergence in the sense that the distinction between shocks affecting the "core" and the "periphery" has become less pronounced over time. Adjustment is also found to be much slower in the periphery than in the core. Similar results are derived from more recent research by Button and Pentecost (1995) who reveal that membership in the Exchange Rate Mechanism (ERM) reduces speed of convergence.

In terms of regional GDP per head, convergence remains very limited, despite some money transfers to lagging regions. Large idiosyncratic shocks, in the absence of monetary policy autonomy or some exchange rate flexibility, seem to be associated with a large sacrifice mainly in terms of de-industrialisation, lost output and high unemployment rates in EU peripheral member-states in particular (table 7). Krugman (1993b) confirms the above by arguing that "...more integrated markets lead to divergence in both the economic structure and the growth rates of regions".

3. LABOUR MOBILITY

The negative effect on output and unemployment in lagging countries or regions, stemming originally from different structures of production, is also present in the case of the USA, an example which the official authorities of the EU (European Economy 1990), often recall to support the feasibility and viability of the EMU. As a matter of fact, diversified demand structures and disturbances are very common phenomena across USA regions too (Eichengreen 1992, 1993). One may think that NAFTA will make matters worse, to the extent that structural differences among the USA, Canada and Mexico are even larger. Despite (NAFTA) integration, nobody suggests that the three countries should form a currency union. The case of the USA and NAFTA is actually a case where the testing of the OCA doctrine would prove interesting. Factor mobility is high internally in the USA and low in NAFTA as a whole, and thus a system with national currencies and flexible exchange rates works effectively enough. Demand disturbances within the US are at least partially confronted with labor mobility which functions as an antidote to idiosyncratic shocks. Surplus labour goes to "successful" regions to meet the excess demand and low inflation rates; while, in lagging regions, high rates of unemployment are going down through labour migration and external imbalance is restored through domestic demand contraction.

Based on this ground, Meade (1957) and Mundell (1961) argued that conditions for a common currency in Europe do not exist mainly because of lack of labour mobility (at that time), a fact that makes more effective a system of flexible exchange rates in promoting both balance of payments equilibrium and internal stability. Kenen (1969) agrees that in the absence of labour mobility, currency fluctuation is needed to accomplish changes in the terms of trade necessary for restoring external disequilibrium.

While USA experiences relatively high labour mobility across states, evidence for Europe is rather poor. Eichengreen (1992, 1993, 1994) estimates that the elasticity of interregional migrational flows with respect to internal wage and employment differentials is smaller in Europe than in the USA. According to Hoeller and Louppe (1994) who, in an OECD study, present evidence from Eurostat cross-border residence of EU and non-EU nationals is very low as evidenced by the shares of EU and non-EU nationals in the EU population. They point-out that in 1991, cross-border residence of EU was only 1.4% of EU total population, while that of non-EU workers (mainly Turks) was 2.4%. According to Eurostat (1995c), since 1992 net migration has been falling. After reaching a high point of 3.7% in 1992, the net migration fell by almost half in 1994 (2%). According to my

calculations from Eurostat (1995b), migration within European member-states as a percentage of Europe's total population is less than 1% on average (table 2). Whatever the exact percentage of labor migration, it is of cardinal importance to keep in mind that it is very low and with no improvement over time. It is also worth mentioning that almost 3/4 of the migration flows are mainly resident in the

TABLE 2
MIGRATION WITHIN EU AS A % OF TOTAL EU (15) POPULATION

	Immigration	Emigration
B	0.7	0.3
DK	0.9	0.6
D	0.9	0.9
GR	0.3	-
E	0.1	-
F	0.2	-
IRL	1.2	1.2
I	0.2	0.1
L	2.8	1.7
NL	0.7	0.3
A	-	-
P	0.1	0.2
FIN	0.3	0.1
S	0.6	0.3
UK	0.4	0.4

Source: Calculations from Eurostat (1995b)

three most developed states of Europe, namely Germany, France and U.K., where labour is much more homogeneous and workers share the same skills - a factor first emphasized by Kenen (1969). But even there, German and French workers are only a third as likely to move across states as Americans are to move between states (Eichengreen 1993, 1994).

Accordingly, a study of OECD (1987) compares interregional mobility within the EU and the USA. Mobility within the US has been two to three times as high as mobility within European nations. It is also estimated that 50% of USA citizens have been moved across States and changed job, for at least once in their life. DeGrauwe and Vanhaverbeke (1991) in considering whether and how far labour mobility in Europe can compensate for the reduced reliance on real exchange rate flexibility, found that labour mobility plays a minor role in the adjustment process at the regional level of the same country. On the contrary, at the national level, they found almost no labour mobility. Finally, they distinguish the "northern model" of regional development with relatively large regional mobility of labour and low divergencies in output and unemployment, and in the "southern model" where labour is relatively immobile, divergencies in output and employment are relatively pronounced and large regional concentrations of unemployment exist. Their view is confirmed by statistical evidence provided by Eurostat (1995d) where divergence in unemployment rates between North and South Europe seems to be the rule. Suffice to say that in the top of the list are poor regions in Spain and Italy with more than one quarter of the labour force unemployed, while the lowest rates are observed (below 5%) in the northern regions in Luxembourg, Germany and N. Italy.

Thus, to the extent that regions and countries in Europe experience idiosyncratic demand disturbances and as by definition the option of exchange rate realignments in the final stage of EMU is excluded, a highly mobile labour force should move from regions of declining demand and high unemployment to "winners" regions. From the detailed evidence presented, and taking into account that linguistic and cultural differences in

Europe will continue to prevail for the foreseeable future, prospects for a dramatic increase of labour mobility in EU are rather poor.

4. CAPITAL MOBILITY

Pockets of high unemployment could also be prevented by an increase in capital flows across regions. Following Mundell's (1961) view that with pegged exchange rates and perfect mobility of capital, balance of payments equilibrium could be achieved, Ingram (1969) emphasized direct capital movements to lagging regions with high unemployment as a way of responding to idiosyncratic demand disturbances. In a fixed exchange rate area, high capital mobility may take care of external imbalance and high unemployment by shifting from surplus regions to deficit ones. It has also been argued that the elimination of risk through the fixing of exchange rates will increase trade and foreign investments across EU member-states (Emerson et al. 1992, McKinnon 1994).

However, there are certain theoretical objections to these doctrines. Eichengreen (1992) has shown that physical capital mobility eliminates the need for labour mobility only under restrictive assumptions. Capital flight to lagging regions requires constant returns to scale in production. If technology exhibits increasing returns, a shock which requires the expansion of one sector at the expense of another, may require the intersectoral reallocation of both factors of production for full efficiency to be achieved. On the same lines, Krugman (1993b) points-out that capital mobility will diversify long run growth in EU and EMU will make regional crises more intense and severe.

Besides the fact that the even low labour migration in Europe flows mainly to northern core regions, evidence provided by Eurostat (1993) shows that the European north, namely UK, Germany, France, Netherlands, Benelux and Denmark, receive around three quarters of the total of intra-EU direct investments, while the three poorest economies, Greece, Spain and Portugal receive less than 20% (table 3).

Statistical evidence coincides perfectly with Eichengreen's (1992) view presented above. There are two other explanations for this tendency. First,

TABLE 3
COUNTRIES RECEIVING AND COUNTRIES SENDING DIRECT
INVESTMENTS: PARTICIPATION OF EU MEMBER-STATES AS A % OF TOTAL
INTRA-EU INVESTMENT

	RECEIVING		SENDING	
	1985	1992	1984	1992
EUR	100	100	100	100
B/L	14	23	9.7	18.2
DK	0	2	3.3	2.3
D	10	4	41.3	19.3
GR	2	1	0.2	0.0
E	21	14	2.4	0.5
F	22	26	23.2	25.7
IRL	5	6	0.6	0.8
I	24	5	19.5	6.1
NL	6	6	54.3	13.1
P	4	4	0.0	1.0
UK	-7	9	-54.6	13.0

Source: Eurostat (1995a), p. 443

there are adverse externalities in the EU peripheral member-states (low quality in infrastructure, state administration, production services and labour skills), which prevail and reduce the investment rate of return and so, capital inflows are limited. Second, the risk premium r in the equation:

$$i=i^*+x+r,$$

where i is the rate of return on large investments, i^* is the interest rate abroad, and x is the expected depreciation (Dornbusch 1988a), is significantly higher in the EU periphery than in the core. The above equation determines the volume of capital movement inflows and hence either reserve losses or exchange rate problems. While depreciation in the EU periphery is artificially kept lower than what the inflation differentiation with Germany requires, the risk premium r is expected to be higher and, as a result, crowds-out investment and foreign capital inflows.

Evidence for the aggregate amount of total intra-EU direct investments as a share of total investments or to EU GDP, are not so encouraging. Based on my calculations from European Economy (1994, p. 132), OECD (1995a, p 24) and Eurostat (1993, p.32), intra-EU direct investments represent around 0.5% of the European GDP, while as a percentage of total investments taken place in EU represent little more than 2%. Noteworthy is that most of these capital flights, actually around 70%, concern mainly portfolio investments or the service sector (finance and banking, hotels, catering and other services), which should not be considered as directly productive (table 4).

TABLE 4
SECTORAL BREAKDOWN OF INTRA-EU DIRECT INVESTMENT
(Sectors receiving investment)

Sector	1984	1985	1990	1991
Energy	-4	-6	1	2
Industry	34	32	14	31
Construction	4	1	0	1
Services	65	76	85	67
Not allocated	1	-4	0	0
Total	100	100	100	100

Source: Eurostat (1993), p.42

Although update evidence concerning capital flights is disappointing, optimist voices (European Community 1990, Gros and Thygesen 1992, Emerson et al. 1992, Hoeller and Louppe 1994), insist that with the full accomplishment of the EMU, numbers will significantly improve, and capital flight will compensate for rigidities on other fronts. However, Kenen (1989), investigating the link between exchange rate variability and the level of foreign investments, does not find evidence of a significant statistical effect. Cushman (1988) reports evidence according to which foreign enterprises set up plants to produce the same product in different currency areas to hedge exchange rate risks. In addition, he argues that currency appreciation seems to diminish the amount of foreign direct investment inflows. Finally, one should not overlook that UK, USA and Japan account on average for some 60% of total outward investment. Multiple currencies and flexible exchange rates did not seem to function as obstacles for these countries to invest abroad.

According to the evidence presented, there is no evidence that an EU member-state would attract more foreign direct investments or encourage capital inflows under a fixed exchange rate regime or in a common currency area.

5. TRADE

The theory of Optimum Currency Area recognises that since a group of countries enjoy a large volume of trade among them, it would be in their benefit to abolish national currencies and adopt a common one, getting rid of transaction costs. Optimist voices point-out that the establishment of a common currency will also favor - besides other benefits -, network externalities involved in the use of a common currency (Dowd and Greenaway 1993), a further increase in the volume of trade among EU member-states and in trade dependence (European Community 1990, Emerson et al. 1992). The elimination of currency fluctuations within Europe will also mark, as is believed, the end of a period of uncertainty which is considered to diminish trade itself and trade-promoting benefits (McKinnon 1994). It is also believed that the EMS helps increase trade and reduce exchange rate misalignments without increasing price stability (Sapir and Sekkat 1995).

On the other hand, standard theory suggests that free trade combined with fixed exchange rates would prevent European governments from devising their domestic financial policy for the purpose of preserving domestic stability. J. Meade (1957) was indeed proposing many years ago, measures such as a common European budgetary policy and a Central Bank to overcome the adverse effects. I leave for the moment the issues of a ECB and fiscal federalism aside and I will come to these later on.

Feldstein (1992) arguing against EMU, held the view that businesses really do not care about the exchange rate risk. To him, even when they seem to care, they can hedge future outlays and receipts in the market for foreign exchange futures. While he marks the absence of any empirical study providing the opposite view where exchange rate volatility is argued to have a negative effect on trade, he uses the example of the sharp increase of the US and Japan exports in the '80s to support his position. He argues that trade volume within a common currency area such as in Europe may well be diminished when an individual member-state can not leave free its currency to fall in line (for example) with a fall of the dollar, in order to maintain exports. With an exchange rate irrevocably fixed, and the level of prices of domestically produced goods "sticky" to an unsupportable level, the loss of competitiveness will end up in a fall of exports and, as a consequence, of trade volume. This way, overall trade within EU may decrease for the sake of imports.

In our view, inability of EU mechanisms to face the incidence and magnitude of demand disturbances under a common currency regime, could also destroy production systems in lagging regions which otherwise would have survived, and in trade with other EU member-states. In this case, potential trade would be diminished too.

Relevant literature (Ingram 1969, Eichengreen 1990) leaves no doubt that market integration increases product specialisation and fosters trade among member-states, but it categorically states that there is not any theoretical support to the idea that in order to get optimal profits from trade, you have to abolish national currencies. Currency transaction costs are estimated to be too low (0.4% of the EU GDP) to influence trade in a negative way, while Frankel et al. (1992) consider various determinants of the volume of trade in a cross section of countries, concluding that the negative effect of exchange rate uncertainty on trade is quite small, around 0.7% of total EU trade volume.

Turning now to the evidence, we observe in table 5 that, in fact, the intra-EU trade as a share of total imports and exports of the EU has risen since 1960 around 50%, although the percentage change during the '80s has diminished, when EMS narrow exchange rate bands prevailed.

TABLE 5
INTRA-EU TRADE AS
% OF TOTAL TRADE

Year	Imports	Exports	Average Annual Percentage Change		
			Year	Imports	Exports
1960	37.9	40.8	70/60	13.4	15.4
1970	50.3	53.4	80/70	15.9	16.1
1980	49.2	55.7	92/82	7.9	7.5
1992	59.3	61.3			

Source: Eurostat (1994)

But, what is much more crucial is to examine if trade constitutes a large fraction of GDP of the EU. If it does, any changes in the exchange rate parities would become less powerful in affecting competitiveness because imported goods, whose prices change directly with the exchange rate, make up a large part of the overall price index.

Average intra-EU imports and exports of goods as a percent to GDP were correspondingly 13.2 and 13.4 in 1984, while ten years later the shares were down to 12.1 and 12.6 correspondingly again (European Economy 1994, p.148, p.152). OECD's (1995b, p.A71) *Economic Outlook* presents about the same evidence. Intra-EU imports are estimated as 13.69% of GDP (1993) and exports 14.4% (1993). The corresponding figures in 1982 were higher, 14.69% (imports) and 14.78% (exports) of GDP. Finally, Eurostat (1995a, p.260-261) clearly states that there is a reduction of trade dependence within the EU in the last decade.

Thus, despite the fact that intra-EU trade as a share of total trade of individual countries exceeds 60%, EU trade dependence (intra-EU trade as a % of GDP), seems to be rather low and so the exchange rate policy instrument remains important for the majority of member-states.

Worrisome in particular, is the deteriorating trade performance of the European "peripheral" member states (as shown in table 6) in contrast with the improvement of the performance of "core" Europe in the last decade. As we will see below, the deterioration of the trade performance of peripheral countries should be mainly attributed to accumulated appreciation of their "soft" currencies.

TABLE 6
INDEX OF TRADE PERFORMANCE
(Exports as a % of Imports)

Year	1984	1993			
			1984	1993	
Greece	50	38	DK	97	121
Portugal	86	83	F	90	102
Spain	73*	64	D	112	111
			I	80	114
			NL	101	109

*1985

Source: Eurostat (1995a), p.263

What should be taken seriously into account is that, along with Eichengreen's view (1993), there is no clear economic reason why factor and commodity markets cannot be integrated while exchange rates continue to float. The above evidence presented substantiates with this view.

6. EURO AS A VEHICLE CURRENCY IN THE INTERNATIONAL SYSTEM?

Benefits for the EU are said to arise with the adoption of a common currency. Emerson et al. (1992) point-out that the European currency will become a major international currency and advantages for the EU will appear while its banks and enterprises will conduct more of their international business in their own currency. Monetary authorities, moreover, will economize in external reserves and achieve international seigniorage gains. Frankel (1995) estimates that the US derives about \$ 12 billion a year in seigniorage from foreign holdings of US currency, which are conservatively estimated at 60% of total dollar currency in circulates.

Political benefits will also result while the EU will be in a much better position in means of power and prestige to benefit its interests and negotiate for a balanced multipolar system.

One cannot deny the benefits of a country or a group of countries having a currency dominating in the international financial system and enjoying a lion share of the international reserves. The role of the dollar as an international currency has much supported the post-World War II hegemonic role and the economic performance of the US. In fact, at that time, the US was enjoying the benefits of being indebted to foreign countries free of charge.

Despite efforts of the EU to speed-up the process of the EMU, EURO has not managed up to now to take over the dollar's dominant international role as a store of value, a unit of account and a means of payments (Kenen 1983, Feldstein 1992). As table 8 shows, even within the EU, EURO has a limited and indeed diminishing role as a store of value, while official EURO reserves in European countries are going down over time.

EURO RESERVES AS A % OF TOTAL RESERVES				1993	1993
	'83	'88	'93		
B	66.2	44.7	39.1	-1.7	11.9
DK	6.5	3.1	4.3	1.5	12.2
D	41.6	40.2	35.5	-1.1	8.9
GR	-	19.4	12.1	-0.5	9.7
E	-	11.3	18.5	-1.1	22.7
IRL	11.2	39.4	8.9	4.1	15.8
I	42.8	9.1	13.9	-1.2	10.7
L	-	24.4	17.2	1.7	2.1
NL	56.1	40.4	31.1	0.4	6.5
P	-	-	22.3	-1.2	5.5
UK	-	-	-	2.2	10.2
USA	-	-	-	3.1	6.8

Source: Eurostat (1995a) p.408

OECD (1995b)

An explanation of this tendency is that while greater exchange rate fixity prevails in Europe, the dollar functions as an international currency for the EU as a whole. That is also confirmed by Mundell (1969, 1994), who argues that a common currency area as a whole needs to keep international reserves (in dollars) for purposes of pursuing any given exchange rate target. Thus, the need for keeping reserves in European currencies to defend disturbances in the EMS seems not to have led either to any serious upsurge of reserves in European currencies or, even, to an increasing share of EURO in international positions.

TABLE 8
SHARES OF SELECTED CURRENCIES IN INTERNATIONAL POSITIONS
(%, end year)

Official holdings of foreign exchange in 1993

US dollar	61.4*
Deutschemark	16.1
Japanese yen	9.0
Pound sterling	3.4
French franc	2.2
Swiss franc	5.8
EURO and others	2.1

* Frankel (1995) points-out that dollar has increased its share in the '90s
Source: OECD (1995b)

However, to be fair, one has to wait until EURO stops to function as a basket currency and takes the place of the existing EU currencies. In any case, predictions are difficult to make but the up to now evidence does not seem to be so encouraging.

As seen in table 8, the US dollar has still the higher share in the invoicing of world trade, despite the fact that US trade and output have shrunk from 50% in the '40's to one quarter of world trade and output (Frankel 1995) and Asian countries have increased their trade with Japan.

In sum, for the time being, there have been no major changes in the role of the dollar as a chief vehicle and international currency in the foreign exchange markets. Moreover, today the dollar's relatively smaller share in international positions than in the '50s and '60s has not been followed by a corresponding EURO upsurge. Frankel (1995) explains the persistence of the pivotal role of the dollar in the international financial system, by recalling the economic size of the US, its highly developed financial markets, the historical background of the dollar and the steady international confidence in its value. Feldstein (1992) adds that dollar has already existed as a currency for more than 200 years and has acquired a reputation as a relatively reliable store of value and stable unit of account, in contrast with an infant EURO which does not enjoy the dollar's reputation and an untried European Central Bank.

One should add the almost continuing good economic performance of the US, indeed under low inflation rates, a fact that helped dollar to keep its position as the top international asset. In contrast, Europe, in the last two decades is stuck to low growth rates and, with its strong devotion to deflationary policies inspired and diffused mainly by Germany, has led itself to instability, uncertainty and high unemployment (see table 7).

7. EUROPEAN CENTRAL BANK AND SEIGNIORAGE REVENUES

As previously stated, since wages and prices are to a large extent sticky and national monetary policy is granted to the European Central Bank (EMU third stage), then in regions/countries experiencing idiosyncratic demand disturbances, output and employment will be contracted. The inevitable economic and social cost is expected to be mitigated by proper labor and capital flights. The creation of the European Central Bank in the final stage of EMU will be, according to some authors (Emerson et al. 1992, Gros and Thygesen 1992), a steady supporter of weaker regions or countries by guaranteeing price stability, low inflation, low interest rates and, thus, potential higher growth rates. The transfer of the credibility of hard currencies to soft ones will support lagging regions and the total benefits will outweigh the loss of seigniorage revenues, which in fact are highly important for the peripheral EU economies with relatively high inflation.

Seigniorage revenues are estimated to be around 2%-3% of GDP for "peripheral" Europe, namely for Greece, Portugal and Spain. Dornbusch (1988b, 1989c) points-out that the quest for disinflation (inflation rate convergence) has been pursued without recognition

of the longterm budget consequences of the soft currency countries. Other things equal, the public finance role of inflation is left totally aside and, as a result, fixing exchange rates and fiscal ceilings seem to be incompatible with optimal taxation (Grilli 1989). Therefore, to the extent that the loss of seigniorage revenues worsens the financial position of weaker economies, budget deficits and debt are expected to deteriorate even more, worsening fiscal divergence with the other EU "core countries" (see table 9), and increasing the possibility for a future violent exchange rate realignment through speculative attacks.

There is evidently room here for another criterion to be added to the existing index for an OCA: countries for whom the efficient tax structure implies the use of an inflation tax should not merge with others for whom zero inflation is the policy objective (because the marginal cost of an extra dollar of resources raised this way is significantly less than that of raising say social security tax rates) (Dornbusch 1988b). Dornbusch (1989c) also argues on the same lines, that the optimal tax-inflation mix depends on the growth rate of the economy. The lower trend growth rate the higher the optimal rate of inflation.

Can increased domestic taxation compensate for the loss of inflation tax? An increase in taxation by the member-state is in the case of free capital mobility not feasible. It could provoke a serious capital flight abroad, where tax rates may be lower, or discourage potential capital inflows causing serious problems on the external balance of the weaker countries. Even in the case that an increase in taxation would be feasible, one can not deny that increasing state revenues during slow growth periods, if impossible, is simply a bad policy prescription.

An ECB will in fact contribute to price stability. While this is a generally accepted and indeed desirable target, the issue at stake is to succeed at the least cost. As argued before, financial disarray in "peripheral Europe" in particular, could appear partly due to the loss of the seigniorage revenue. The ECB, which in the third stage of the EMU will, by definition, overtake monetary policy from member-states, is expected to find ways to enhance coordination among national monetary authorities (Eichengreen 1991) and distribute across EU member-states seigniorage revenues, which, indeed, are estimated to be around 30 billions EURO (Gros and Thygesen 1992).

ECB autonomy and discipline will not, as believed, condition national budgetary policies alone. The present EMS of fixed exchange rates has not prevented gross European debt to jump from 57% in 1991 to 70% in 1994 (European Economy 1994 and table 9 of this paper), and this is rather a proof that strict ceilings determined by the "top" do not work. An ECB will actually fail to achieve price stability if the government lacks fiscal discipline or, better, if individual governments decide to spend some money to alleviate disinflation. For example, in the case that a member-state income falls dramatically, then the marginality of public spending rises and it may be optimal even for a government fully committed to "discipline" to run a budget deficit in excess of 3%.

Summers (1988) has shown that the presence of a rule does not completely insulate an economy from various shocks. He argues that the prevalence of policy rules over discretionary policy in today's Europe, increases the output costs of the monetary policies applied and sticks the economies to a low-level equilibrium (suboptimal equilibrium), where the level of unemployment is high, recovery very slow (if any), and stabilization undesirable. Alesina and Summers (1993), while recognise that Central Bank independence promotes price stability, they found that it has no measurable impact on real economic performance. Examining the relationship between the degree of Central Bank independence and the level of variability of economic growth and interest rates in various countries, they found no correlation. On the contrary, they believe that politically sensitive Central Banks are likely to be more concerned than "independent" Central Banks with increasing output and reducing unemployment.

An ECB, besides price stability, should also be occupied with the redistribution of seigniorage, and with growth rates. A. Blinder (1994) and O. Blanchard (1993) add that the proper role of a Central Bank should be to keep the level of employment around its *niveau naturel*.

8. FISCAL FEDERALISM FOR FACILITATING ADJUSTMENT

Idiosyncratic shocks, low mobility of factors of production, some stickiness of wages and prices, and quite low economic performance, especially, in the so-called "peripheral" EU southern countries, make indispensable the existence of mechanisms or institutions to take care of balanced growth within the EU. To the rather discouraging evidence brought forth in this paper about the prospects for EMU, has to be added increased social unrest and discontent among European citizens about the whole project not only in "peripheral" countries and regions with excessive deficits, high unemployment and slow growth but also in countries such as Germany and France. It should also be recalled that UK and Italy have already withdrawn their currencies from the EMS.

It is certain that not all regions and countries in Europe will profit from the EMU. The case of the USA is a good example to Europe. A generous increase of the EU budget could not only resurrect enthusiasm for Europe. While domestic fiscal policies seem to be trapped in high public debts and deficits, with limited policy options due to Maastricht nominal ceilings, the responsiveness of national governments' countercyclical fiscal policy is dramatically reduced.

It is widely known that the EU budget represents only 1.27% of the EU GDP, a much lower share than what the European Commission itself has proposed in the past (5%-7% of GDP). It is also worth mentioning that 0.75% of the 1.27%, goes to the Common Agricultural Policy (CAP). As a result, the equalisation effect is estimated to be only around 0.01% (Eichengreen 1992).

In federal States such as the USA, Canada, Germany and Australia, the federal budget as a percent of GDP is four times higher even than these EU past proposals. Sala-i-Martin and Sachs (1991) suggest that the US federal fiscal system acts as an effective insurer against economic shocks in the economically diverse regions of the US. The US, they argue, is composed of vastly different economic regions representing varying levels of resources and production, but the federal government absorbs between one third and one half of each dollar of economic shocks to a region or state. Along with Sala-i-Martin and Sachs (1991), Bayoumi and Masson (1995) estimate the redistributive and stabilization effects in Canada and the USA, end up with approximately the same results. Both articles highlight that in the EU the corresponding effects are almost negligible, providing only one half a cent reduction per dollar in taxes in the event of an economic shock. Sala-i-Martin and Sachs (1991) accept that demand disturbances will have a severe adverse economic impact on the regions that experience them, because labour will continue to be relatively immobile and wages and prices, to a large extent, sticky. They reject the project of leaving these regions alone to face disturbances, not only because regions could not impose higher taxes, in a free capital mobility regime, but also because the high regional budget deficits provoked by lower taxes or higher spending will have an adverse result in the near future.

Thus, if Maastricht fiscal restraints are enforced, they could significantly diminish the stabilization capacity of national budgets (Bayoumi and Eichengreen 1994a, 1994c). A federal insurance scheme will redistribute income from the region that experiences a favorable shock to the region suffering an adverse shock, regardless of whether a region happens to be rich or poor (Sala-i-Martin and Sachs 1991). This will reduce also the need for nominal exchange rate realignments and speculative attacks. It will also have significant political and social benefits by convincing Europeans to build on what they have in common and restore their differences.

On the other hand, Alesina, Perotti and Spolaore (1995) recognise an economic and political risk in fiscal unions, while the cost of keeping together different institutions, individuals with diverse tastes, culture and priorities, is very high.

9. THE HEGEMONIC COUNTRY IN A COMMON CURRENCY AREA

This paper has examined problems arising from the adoption of a common currency in Europe. Evidently Europe does not constitute an OCA, but as the US example teaches us, the EMU project can be really worked out despite the fact that evidence presented is rather discouraging. It constitutes a common truth that the "peripheral" EU countries (Greece, Portugal, Spain), will face intense internal and external imbalances under a common currency. While member-states will give up monetary policy and lowering wages as a means of adjustment in "peripheral" Europe is not acceptable, the burden of adjustment should mainly fall to stronger/surplus economies, if EU unity is to survive. Cooperation among member-states in both economic policies and politics will need to confront complex problems in the near future.

In standard international macroeconomic theory, surplus countries enjoying low inflation rates, desire monetary expansion to some extent. As J. Meade (1957) correctly pointed-out, surplus countries of the European free-trade area, should put emphasis on the avoidance of deflation. On the contrary, Europe finds itself today trapped in a situation where the EU surplus countries deny to reflate their economies. This has an adverse side-effect for "peripheral" member-states, while the latter States can do nothing else than deflate too. Exchange rate variability can not be on the EMS policy agenda, while any effort from the already heavily indebted countries for some reflation would end up in both internal and external imbalances. Thus, the responsibility for undertaking the lion's share of the burden of adjustment falls to those countries with the best economic performance within EU, and the rising power in Europe, Germany in particular.

Germany, in the last few years has followed, especially since re-unification, a policy of fiscal expansion and tight money, a policy quite antithetical to what theory suggests, objecting that monetary expansion can stimulate growth. Krugman (1993a) predicted that fiscal consequences of the German re-unification would create strains on the EMS and force realignments. In Krugman's words, "the combination of fiscal expansion and tight money in Europe's key currency nation, would create a recession in the rest of the continent". Kenen (1995), notes that, in fact, it is Germany that in September 1992 proposed to Italy to devalue and opt-out of the EMS. By denying to reduce interest rates and tighten monetary policy, Germany damaged the system itself. This way, the cost of German re-unification was, at least partly, transferred to the EU as a whole, while the other member-states had to increase interest rates and to deflate even more in order to avoid capital outflows and devaluation.

With such disinflation policies spread all around Europe, one can not, of course, expect any future for the EU. Competitive disinflation ends up to a recession for all (Blanchard and Muet 1993), and this clearly should be avoided. Some expansion is clearly needed but it should be coordinated to benefit the EU as a whole (Blanchard, Dornbusch et al. 1984). Along the same lines, Kenen (1989) has argued that in a system of pegged exchange rates (such as the EMS), structural interdependence and coordination should increase because individual governments have less freedom to choose proper domestic policies.

Table 3 and 6 combined can give us an interesting insight into today's "cooperarion" process in Europe. Trade surpluses of the EU "core" are becoming even larger, while weaker countries see a corresponding deterioration (table 3). In a fixed exchange rate area, one would also expect some relevant capital flights to lagging countries to help them face capital drain and balance of payments disequilibrium. Instead of this, table 6 reveals that surplus countries (Germany and the Netherlands mainly) which used to invest three quarters of the total investments in other EU member-states in 1984, have dramatically reduced their share to one third in 1992. For Germany, in particular, one would expect to play the role that the US have played in the post-war period, as a surplus country and hegemonic power. Instead of this, Germany seems up to now not to be interested in undertaking this role in Europe.

10. TRANSITIONAL PERIOD AND EMU PROSPECTS

The present inconsistent quartet of -almost- fixed exchange rates (under the EMS), free trade, free capital mobility and to some extent independent monetary policies from the member-states is working at a very high cost, especially for the weaker economies which are urged to converge with the more advanced ones, in a very short period of time. While free trade and capital mobility are given and independent, to an extent, monetary policies will continue to exist at least until the end of this century, some flexibility in exchange rates is needed to prevent future turbulences and self-fulfilling speculative attacks (Eichengreen, Rose and Wyplosz 1994), which in turn, could threaten EMS credibility and diminish popularity for EMU even more. Kenen (1988, 1989, 1994), along the same lines, urges EMS members not to make the same mistakes they have in the past and not abandon exchange rate adjustability until they are ready to move to fully-fledged monetary union. In any other case, fixing irrevocably nominal exchange rates, as actually happens today, will lead to an extended overvaluation of some currencies, a scenario which could lead some countries to opt-out of the EMS at a higher cost later under the pressure of speculative attacks.

Frivolous overvaluation as a means to bring down inflation works at an extremely high cost in matters of growth and unemployment rates as can be seen in table 7. The extended currency appreciation has also serious negative side-effects on some member-states' external position by "taxing" their exports and "subsidizing" their imports. Growing deficits in peripheral member-states' trade balance in particular (see table 9) may undermine in turn their exchange rate stability.

Fixing nominal exchange rates, specifically in the present context of strict disinflation policies, has also adverse effects in matters of fiscal discipline and convergence. High real interest rates are needed to support currency participation in the EMS and so governments borrow in high interest rates to finance their budget deficits, a fact which deteriorates their financial position. In addition, the priority of the exchange rate fixity over seigniorage policies may result in a *rendez-vous* with speculation attacks because when a country with high seigniorage revenues tries to keep its currency within the EMS narrow band of ± 2.25 , it deteriorates its fiscal disarray by diminishing revenues from money creation (seigniorage). In this way, fiscal convergence with the other EU member-states becomes unfeasible.

Those arguments are compatible with what is observed in table 9, where gross debt as a % of GDP is increasing in most of the EU member-states and only Germany and France seem to fulfill today the Maastricht ceiling of 60% debt of GDP; Italy, Belgium and Greece exceed by far the 100% (125%, 134.5% and 114% respectively-1995). Similarly, only Germany's, Denmark's and Ireland's budget deficit as a % of GDP is below the Maastricht limit of 3%.

However, EMS narrow bands are not only opposite to convergence in financial targets. They are also at variance with convergence in interest rates, while different real interest rates among EU member-states are needed in order for a country to back up its currency and participate in the EMS.

TABLE 9
PROGRESS TOWARDS MAASTRICHT FINANCIAL TARGETS
 General government financial balances and general government gross debt as
 a % of nominal GDP; Trade balances in EU member-states (\$ Bil.)

Countries	Financial balances	Gross debt		Trade balances		
	1995	1993	1995	1980	1990	1995
A	-4.5	62.8	65.9	-	-	-
B	-4.3	137.2	134.5	(B/L) -5	0.8	3.9
DK	-2.1	80.3	75.8	-2	4.9	8.1
FN	-5.0	57.1	66.5	-	-	-
F	-5.0	45.8	51.2	-13	-12.9	11.4
G	-2.3	48.2	58.0	8	69.4	69.6
GR	-11.4	115.1	114.0	-5.6	-10.2	-15.5
IRL	-2.5	96.9	86.3	-2.2	4.0	10.5
I	-7.8	119.4	124.9	-15.9	-33.4	18.7
L	-	6.8	-	-	-	-
NL	-3.3	81.4	78.6	-1.4	10.2	18
P	-5.4	66.5	69.9	-4	-6.8	-7.3
S	-6.2	59.9	65.3	-11.7	-29.5	-17
SW	-9.2	74.7	84.2	-	-	-
UK	-4.2	48.4	54.3	3.2	-33.4	-18.7

Source: OECD (1995b)

Finally, on the growth rate issue, Eichengreen (1992) is correctly wondering how indebted countries are going to swing from a 5% and 10% deficit to substantial surplus for the debt ratio to be reduced to 60% by the second half of the '90s, without interrupting economic growth.

In accordance with the above views, Dornbusch (1989a, 1990, 1993, 1995) and Dornbusch and Werner (1994) point-out that exchange rate fixity and accumulation of inflation rate differentials (appreciation) for some countries and currencies, hurt their growth, increase their unemployment rates and lead to their deficit and debt mushrooming. In this context, Dornbusch (1989b, 1989c, 1990) proposes that "soft" currency countries should depreciate their currencies at a rate equal to their inflation differentiation with Germany. They would have some inflation and the fiscal advantage of seigniorage, but they would avoid high real interest rates and instability from real exchange rate variability (with a nominal anchor, real instability may be worse). Besides, "inflation tax" seems to be the only way, for the time being, to tax the extended underground economy in peripheral member-states.

Dornbusch's (1990) view for a two-track EMU is rather a reflection of Eichengreen's empirical evidence according to which structures of demand separate two group of countries within EU, "core" and "peripherals". The "core" countries experience similar demand disturbances, and may shape a hard currency club *tout d'abord*, without previous harmonization according to Maastricht nominal convergence criteria. The "soft" currency member-states, as argued, should allow their currencies to fluctuate because the trade-off between disinflation and unemployment for these countries is too high to be acceptable.

Dornbusch's view is theoretically correct, but there is an objection concerning politics. His proposition is difficult to be accepted politically, because it would mean both a failure of the whole EMU project and a *de facto* division of Europe between North and South, with possible severe repercussions for political unification. In addition, beside peripheral member-states, countries of the EU "core" seem to face also problems of speculative attacks, slow growth and high unemployment which -the case of France is a

good example-, threaten economic and social stability and cohesion. Accumulation of appreciation rates, even in developed EU countries, hurts their economic performance too, and thus, it would be better even for them, not to peg prematurely in the German anchor, but leave their currencies to fluctuate "under a close grip". Europe has to reject the dogma that anything beside fixed exchange rates is incredible and will provoke speculation. Pro-EMU policy-makers should accept the fact that speculative attacks occurred under the "narrow bands" of the EMS regime.

FINAL REMARKS: PROMOTING EU UNIFICATION, PREVENTING EU DIVISION

The desirability of EMU is back on the table. According to what has been argued, in present conditions, EMU for many member-states seems to be a leap in the dark. To shed some light, if Europe wants to keep on track it has to be more flexible and less dogmatic. In any other case, the cost of the transitional period may lead the whole project to eventual failure.

Europe has to escape from the "orthodoxy" of disinflation. Lack of growth as argued, hurts real convergence while exchange rate policy (EMS narrow bands) has been overused. External imbalances created by these policies impose that further recessionary measures have to be rejected. Some coordinating Keynesian expansion in the present environment of idle resources would mark a growth in output. Monetary expansion will not go into prices, as many pro-EMU EU officials believe.

Nominal convergence criteria, as we have argued, seem to be contradictory, preventing more than promoting real convergence and, indeed, producing speculative attacks. If not abandoned, as De Grauwe (1993) has proposed, they have to be interpreted liberally for those countries willing to enter to the third stage of EMU. For the "soft" currency countries in particular, they would rather be abandoned.

As far as it concerns the burden of adjustment, as we have argued, it should fall partly to some flexibilisation (wider bands) of the EMS. The lesson from the last crisis of the EMS is glaringly obvious. A crawling depreciation to cover inflation differentials with Germany would give a growth breath to "soft" currency lagging economies, at least in the short-run, while at the same time, it would make speculation for their currencies much more costly. Some inflation could be accepted since it would not be an obstacle to growth.

Furthemore, since demand structures and prerequisites for shaping an OCA are not fulfilled, active measures through coordination of member-states, should be taken on the road to the third stage of EMU. Redistribution to reduce long term income differentials across regions and stabilization measures to follow cyclical movements across regions, should be the point of reference. It should also be noted that even in the eventuality that labour migration across regions would increase across EU countries and regions in the near future, it would be unacceptable to leave lagging regions or even large parts of countries deserted and abandoned.

In this context, fiscal federalism, as argued, should be the first policy-priority for weaker economies and can serve both stabilization and redistribution. What is needed is the political will to dramatically increase the EU budget.

Along with an increase in EU budget, a European Payment System (EPS) could act as an inter-European security institution which will credit and borrow member-states with urgent financial needs.

A "Tobin tax" could also make speculation more expensive during the present transitional period. A tax or deposit requirement on bank lending to non-residents would make it more costly for speculators to borrow the domestic currency that they must sell when speculating in anticipation of a devaluation. A "Tobin tax" should be, for example, a 1% on each purchase or sale of foreign exchange, 2% for a round trip (Eichengreen and Wyplosz 1993). With this policy measure, one, in effect, puts restrictions on the free,

short-term or even daily speculative mobility of capital, supporting this way the "soft" EU currencies.

Eichengreen (1994) has also proposed money transfers on the basis of unemployment differentials. "Assuming that transfers are capped once the change in unemployment differentials reaches two percentage points, this proposal would require adding to the EU budget no more than 0.25% of EU GDP". It is estimated that this project, if applied, could compensate about 20% of a region's relative income, after a temporary decline.

One could find many other ways to help the EMU project to survive, but the most important one lies on the relative success of political unification. Appropriate adjustment policies will not suffice alone.

No country can make a decision to join a common currency area on purely economic grounds. If it is true that the decision to go forward with EMU is driven more by a desire for political unity than by sheer economic logic, generous political decisions should be taken to enforce real convergence of member-states by sharing the burden of adjustment efficiently between surplus and deficit countries. This is the only way to achieve economic and political stability in a currency union (Mundell 1969).

It is worrisome that some recent voices from Germany call for backing away from Monetary Unification now because they do not want to give up the mark. Recent proposals to increase significantly the size of the EU budget ran also into resistance. If this climate prevails in the coming years, we could expect that the EMU project will end up in failure.

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