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The Common Unresolved Problem with the EMS and EMU

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The formation of the European Monetary System (EMS) in March 1979 marks the beginning of a very important experiment in regional monetary integration, the ultimate goal of which is to achieve full monetary union in Europe, including a single currency and a union-wide central bank. The period from January 1987 until September 1992 witnessed a great deal of macroeconomic convergence in the large members of the EMS and greatly increased confidence that the process toward full monetary union in Europe was not only possible, but fully on track. In September 1992 and then again in August 1993, however, the EMS faced major crises, which at the time seemed to derail or at least to delay greatly the cause of monetary union in Europe.

Soon after the crises, however, the goal of monetary unification was pursued with renewed vigor, particularly by the two key nations, France and Germany. Although the earlier date of 1997 for full European Monetary Union (EMU) was missed, the nations of Europe are now scheduled to achieve it in 1999. That this will occur is now all but certain, but which, if any, of the Mediterranean members of the EMS will participate from the start remains to be seen (see Salvatore, 1996).

Although establishing the EMU will overcome some of the pitfalls of the EMS, the former will face the same basic problem as the latter. Specifically, the EMS crises reinforced the belief that a nation cannot simultaneously have fixed exchange rates, unrestricted international financial capital flows, and even a semi-autonomous monetary policy. In the face of a large asymmetric demand shock affecting only some EMS countries, something had to give, and this is exactly what happened in September 1992. At that time, Britain and Italy faced deep recession, but according to EMS rules they could neither allow their currencies to depreciate in order to stimulate exports nor stimulate domestic demand by lowering interest rates (conducting an easy monetary policy). With Germany keeping the interest rate high in order to contain domestic inflationary pressure resulting from unification, lowering interest rates in Britain and Italy would simply have resulted in a capital outflow without any stimulative effects on their economies.

For Britain and Italy, remaining in the Exchange Rate Mechanism (ERM) of the EMS would have meant standing idly by and watching their unemployment rates increase from already very high levels until the recession came to an end naturally and gradually over time. No government can afford to do this. As it was, the pound and the lira depreciated after Britain and Italy left the ERM in September 1992, interest rates were lowered, and Britain was the first of the large European countries to come out of the recession and to reduce significantly its unemployment rate. In Italy the effect was less evident because of the political problems, but a counterfactual simulation would in all likelihood also show major benefits. The EMS crisis was compounded when the French franc came under attack in August 1993. The crisis was inevitable because speculators had clearly understood that, with an inflation rate of only 2 percent per year, three-month interest rates of 8.8 percent, and unemployment running at a postwar high of 11.6 percent, the pressure on France to abandon the ERM had become irresistible.

Supporters of full European monetary union point out that the elimination of such currency crises is indeed one of the major benefits of full monetary union and a single currency (see Michele Fratianni et al., 1997). But even with a single currency, the problem of adjustment to a large asymmetric shock remains as with an optimum currency area. The reason is that having a single currency is more

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likely to be beneficial the greater is the mobility of resources among the various member nations/regions and the greater are their structural similarities. Then, specific national/regional problems, such as excessive unemployment resulting, for example, from an asymmetric reduction in demand in the nation/region, would be overcome by labor migration and fiscal redistribution. Thus, when the Northeast of the United States is in a recession, labor migrates to other parts of the nation, and the Northeast also receives a great deal of fiscal redistribution from other parts of the nation not affected by the recession. As a result, the harmful impact of the recession in the Northeast would be greatly dampened despite the fact that the Northeast cannot have an independent monetary policy.

These benefits would not flow at anywhere near the same extent to an EMU member nation facing a recession because of the much lower labor mobility and fiscal redistribution than in the United States. As a result, an EMU member nation that finds itself in a recession, asymmetrically from other EMU members, has no escape valve other than passively waiting for the recession to end or leaving the Union. To be sure, despite much greater labor mobility and fiscal redistribution, the United States may not be an optimum currency area either. The reason is that United States comprises at least four major regions, each specializing in a different sector or sectors: the Northeast in financial services, the Midwest in mining and manufacturing, the West in high technology, and the Southeast in tourism and agriculture. Since it is unlikely for these four major regions to move in step cyclically with one another, there would be a benefit from having region-specific monetary policies and perhaps even regional currencies.

However, while the United States is very likely not an optimum currency area, it gets much closer to being one than the EMU. In fact, the Organization for Economic Cooperation and Development (1986) and the European Commission (1990) found labor mobility among the EMU members to be only one-half to one-third that in the United States. Barry Eichengreen (1993) also points out that the EMU budget is only a little more than 1 percent of its GDP, and most of it is devoted to the Common Agricultural Policy, and thus not available for fiscal redistribution. Furthermore, the likely future expansion of the EMU to include some Eastern European countries would make the EMU even less of an optimal currency area.

A study by Lorenzo Bini-Smaghi and Silvia Vori (1993) compared the United States to the EMU and concluded that the 50 states of the United States were much less alike than the 12 countries of EMU. This does not make sense, however, because one cannot compare the 12 (at the time the authors wrote) countries of the EMU (or even the 15 of today) with the 50 states of the United States. If the three natural regions (north, center, and south) of Italy were considered separately, instead of the nation as a whole, and if the same were done for the other EMU nations (so as to have 40 or 50 regions of the EMU), we would surely find the regions of the EMU to be less alike than the states of the United States. But even that completely misses the point. The question is: how much flexibility and how much labor mobility and fiscal redistribution is there in the United States as compared to the EMU? As pointed out above, these are known to be much greater in the United States than in the EMU.

To conclude, moving to a full monetary union in Europe without first creating the conditions for its success is like putting the cart before the horse. A major asymmetric shock would result in unbearable pressure within the Union because of limited labor mobility, grossly inadequate fiscal redistribution, and a European central bank that will probably want to keep monetary conditions tight in order to make the Euro as strong as the dollar. This is surely the prescription for major future problems. One major benefit (besides those normally mentioned) that individual member countries may be seeking is the ability to invoke an EMU-imposed agreement for jointly curtailing welfare-state expenditures and increasing labor-market flexibility.

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