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Will EMU Work?

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Until recently, European monetary union seemed sufficiently remote that discussion focused on the prospects for it starting, not that it might collapse once it began. Now that Stage III is imminent, discussion has turned to the latter question. This has fueled a process of scenario building in which analysts speculate (pun intended) about how Europe's monetary union might fall apart. Their common theme is that the continent will find it difficult to live with a single monetary policy. To put the point in the jargon of the field, the European Union fails to satisfy the prerequisites for an optimum currency area. A common monetary policy would have very different economic effects in different parts of Europe, and the continent's low levels of labor mobility and wage flexibility will make it difficult to accommodate those differential regional impacts.

In fact, there are six good reasons for thinking that Europe's monetary union will succeed. First, the continent has been living quite happily with a common monetary policy for some time now. Intra-ERM interest rate differentials may not have disappeared, but they have shrunk to remarkably low levels. The recent revaluation of the Irish punt notwithstanding, changes in ERM exchange rates have been essentially absent since 1993. European policymakers evince little revealed preference for greater monetary autonomy, in other words. They have not found monetary cohabitation particularly uncomfortable.

Second, a majority coalition of member states who feel discriminated against by the ECB's common monetary policy is unlikely to form in the absence of an intellectual consensus on the nature of monetary policy asymmetries within Europe. Existing studies reach quite different conclusions about which European economies are most strongly affected by monetary impulses and which ones feel relatively little impact, at least initially. While there is some agreement that Germany's response is particularly slow, reflecting the bank-based nature of its financial system and the fact that, since it is less of a small open economy than most other EU member states, economic activity there is relatively insensitive to monetary-policy-induced exchange rate changes, even this is disputed. If there is no consensus about the asymmetric effects of a symmetric monetary policy, how then could there develop a cohesive political opposition to the European Central Bank's common monetary policy?

Third, the evidence suggests rather convincingly that business cycle disturbances will grow more symmetric with time. An influential NBER paper by Jeffrey Frankel and Andrew Rose demonstrates that the more extensively countries trade with one another, the more closely synchronized their business cycle fluctuations become, and the less need they retain for an independent monetary policy response. Since the Single Market and single currency will further deepen intra-European trade and economic interdependence more generally, it follows that cyclical fluctuations will be more symmetric than they have been in the past.

Fourth, labor market flexibility will likely improve. Labor mobility has a path-dependent character: migrants today follow migrants yesterday. Labor mobility depends on the development of expatriate networks, in other words. For many years, the development of those networks was slowed by restrictive government policies, but this has now been changed by the Single Market and the Schengen Agreement. Indeed, EMU will accelerate this process. Moreover, there is an accumulation of evidence since the early 1990s that growing monetary policy credibility has produced a slow but steady rise in wage flexibility in the hard-currency countries -- aside, ironically, from Germany and France. As unions realize that monetary policy makers can no longer resort to inflation and devaluation to offset any adverse effects of excessive wage demand, they will come to acknowledge the need for greater wage flexibility to clear the labor market. This suggests that the advent of a price-stability-oriented European Central Bank will be associated with a further increase in wage flexibility.

Fifth, close scrutiny of the Maastricht Treaty and the Pact on Stability and Growth suggests that Europe's automatic fiscal stabilizers will not be disabled. While fiscal flexibility will be maximized if member states continue to reduce their budget deficits from current levels close to the Stability Pact's 3 per cent reference values, member states will retain some fiscal flexibility even if further consolidation turns out to be slow. The Stability Pact entails a number of exemptions and exceptions for dealing with "special" and "exceptional" circumstances. This means that unusually severe recessions can continue to be moderated though the use of fiscal policy.

Sixth, and most importantly, the costs of exit from Europe's monetary union are high. Abandoning the monetary union will violate an international treaty signed by 15 European states. It will cast into doubt the entire European construction back to the Treaty of Rome. A country abandoning the monetary union would thus incur a high political cost, which is itself a considerable barrier to exit. This idea that countries will hesitate to abandon EMU because doing so will place the entire European project at risk underlies the belief that the monetary union, once started, is doomed to succeed.

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